



TEXAS  
FARM CREDIT  
DISTRICT

2017 ANNUAL REPORT



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### FARM CREDIT BANK OF TEXAS

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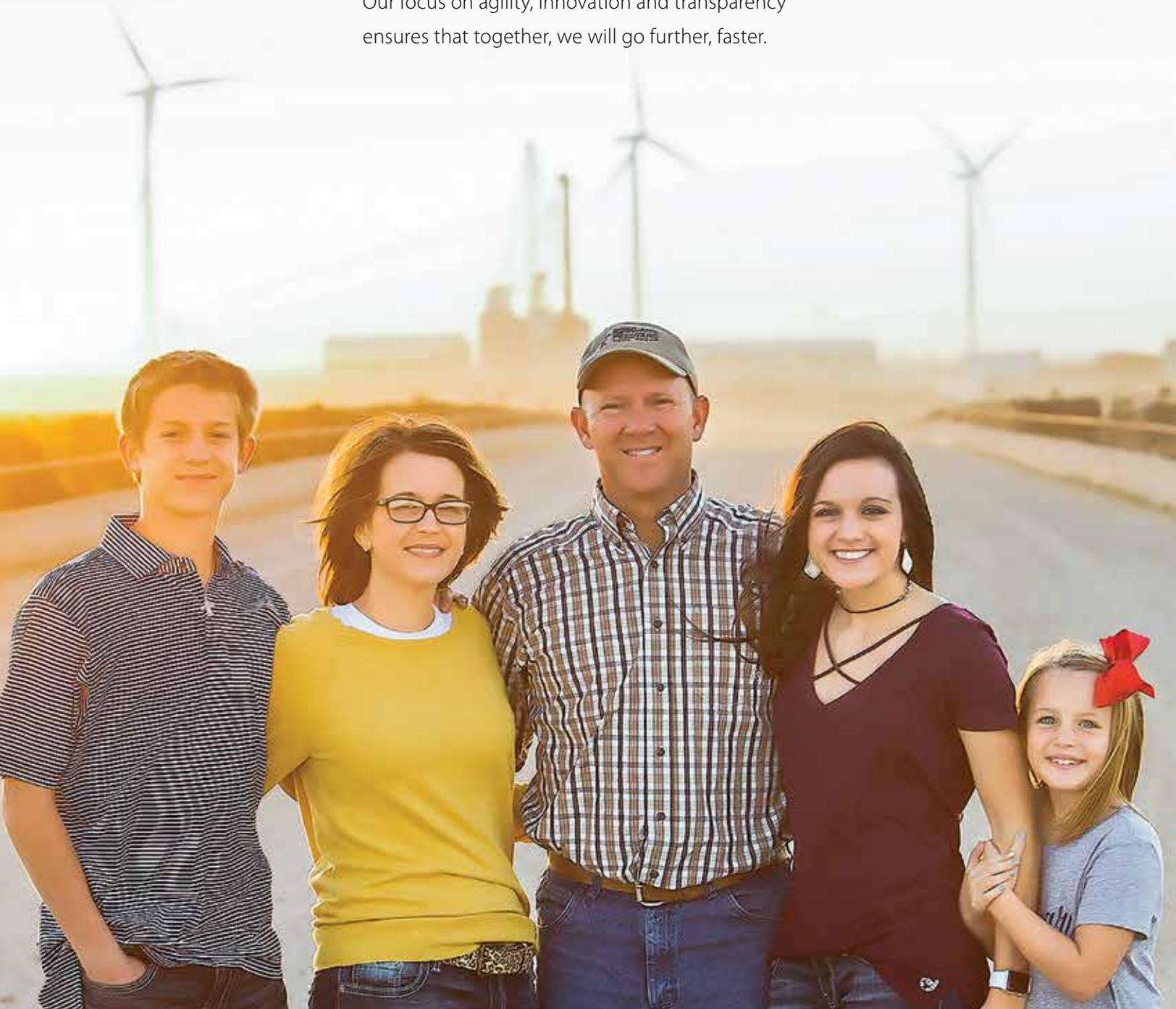


## **MATCHING STRENGTH WITH SPEED**

Partnerships are built on trust.

Dependable credit and customer service are the very foundation of Farm Credit's partnership with rural America. As modern agriculture rapidly grows to meet the global demand for food and fiber, the Texas Farm Credit District is keeping pace by providing the expertise, technology and reliable funding that customers need to meet their goals.

Our focus on agility, innovation and transparency ensures that together, we will go further, faster.



**OUR MISSION** is to enhance  
the quality of life in rural  
communities by using cooperative  
principles to provide competitive  
credit and superior service to  
our member-owners.





# FARM CREDIT BANK OF TEXAS

## BOARD OF DIRECTORS



From left to right are Brad C. Bean; Elizabeth G. "Betty" Flores; James F. "Jimmy" Dodson, chairman; Lester Little, vice chairman; Linda Floerke; M. Philip Guthrie; and Ralph W. "Buddy" Cortese.

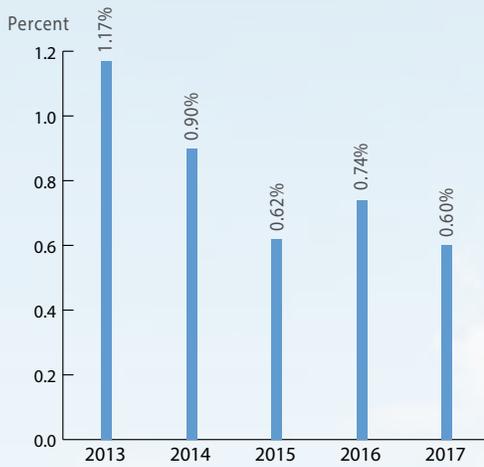


The bank provides funding and support services to the lending cooperatives in the Texas Farm Credit District, helping these local associations be successful so that they can help agricultural producers and rural communities succeed.

The bank's board of directors establishes policies for the bank, provides strategic direction, oversees bank management and ensures that the bank operates in a safe and sound manner.

The board members have extensive business and leadership experience in a variety of backgrounds. Five of the directors are farmers or ranchers, elected by the local financing cooperatives that own the bank. The two board-appointed directors have backgrounds in banking, finance and business operations.

**NONACCRUAL LOANS AND OTHER  
PROPERTY OWNED TO TOTAL LOANS  
AND OTHER PROPERTY OWNED AT YEAR END**



**TOTAL MEMBERS' EQUITY TO  
TOTAL ASSETS AT YEAR END**



**TOTAL LOANS OUTSTANDING  
AT YEAR END**



The Texas Farm Credit District — comprising the Farm Credit Bank of Texas and 14 affiliated lending cooperatives, also known as associations, in Alabama, Louisiana, Mississippi, New Mexico and Texas — reported strong financial results for 2017. Loan volume and total assets increased 5.9 percent and 6.3 percent, respectively, to new highs.

Together the bank and associations reported net income of \$439.4 million, an increase of 1.4 percent year over year. Net interest income increased 6.1 percent to a record \$771.0 million. The district's strong credit quality was unchanged from the prior year, with 98.5 percent of loans considered acceptable or special mention.

**2017 KEY FINANCIAL HIGHLIGHTS**  
(Dollars in Thousands)

|  |               |
|--|---------------|
| Total Loans.....                       | \$ 23,745,668 |
| Total Assets.....                      | \$ 29,717,122 |
| Net Income.....                        | \$ 439,395    |
| Return on Average Assets.....          | 1.52%         |
| Return on Average Members' Equity..... | 10.06%        |





## MESSAGE TO STOCKHOLDERS

For the Texas Farm Credit District, serving our customers and preparing for a strong future was rewarded by healthy loan growth, earnings and credit quality in 2017.

Together, the Farm Credit Bank of Texas and 14 associations reported \$439.4 million in net income, surpassing the previous record set in 2014. Combined district loan volume increased 5.9 percent, and credit quality held strong across the district.

Loan demand reflects the stability in our five-state territory, which is home to a strong economy and diverse agriculture industry. Each of our states experienced job growth in 2017, in keeping with the nation's long-running economic expansion. Customers also continued to benefit from very affordable borrowing costs despite a rise in short-term rates.

Land values remained stable overall, another indicator of the region's positive economic and agricultural conditions. Crop and livestock production was historically strong for many commodities in 2017, including cotton, beef and poultry.

Yet as any farmer will tell you, the sun doesn't shine every day. Ag producers have become increasingly innovative and efficient so that they can capture positive margins amid changeable weather and market forces.

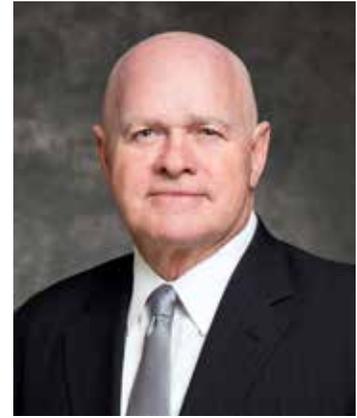
In order to be flexible and responsive to our borrowers' needs as they navigate a complex, fast-moving industry, we are modernizing the district's technology. State-of-the-art new tools are enhancing risk management, regulatory compliance and customer service, such as software that helps employees collect accurate information for rural home mortgage disclosures and a mobile application that gives lenders access to the same customer data out in the field as at their desks.

One advantage of technology is that people don't need to work in the same office to be on the same team. Recently associations have realigned some job duties, hiring more accounting and loan operations staff to handle certain transactions while branch employees focus on customers. Centralizing and specializing will have many benefits operationally, including enhancing associations' control environments, building employee expertise, and boosting efficiency so lenders can reach more customers.

The year also demonstrated that Farm Credit's support of agriculture and rural communities goes beyond financing. When portions of the district experienced wildfires and storms, employees personally checked on customers' welfare, cooked meals for hurricane victims, delivered feed and hay, helped with evacuations and repairs, and donated to relief funds. The same spirit motivates us to maintain a solid capital position and diversified, well-collateralized portfolio so customers can count on us for dependable credit.

We are well-positioned to take on new opportunities and challenges in 2018, and look forward to helping agriculture and rural communities flourish in the years ahead.

Larry R. Doyle  
Chief Executive Officer  
Farm Credit Bank of Texas



Larry Doyle

## **ADVANCING TOWARD THEIR GOALS**

For more than a century, Farm Credit has provided rural Americans with the credit necessary to achieve their goals and fulfill their dreams. Farm Credit financing has enabled young farmers to start their first farm, helped entrepreneurs to start agribusiness companies, and allowed families to build a home in the country and enjoy the rural lifestyle.

Over the years, our customers' financing needs have changed and expanded as agriculture has become more high-tech and capital-intensive. What hasn't changed is Farm Credit's support for agriculture and rural communities, and our desire to help our borrowers advance. When they need better equipment, updated facilities and new technology, Farm Credit will be there.

On the following pages, we introduce a few of the farmers, ranchers and agribusinesses who are part of the co-op family in the Texas Farm Credit District. We are proud that Farm Credit financing has helped propel them toward their goals.





## LAHEY VINEYARDS

### Brownfield, Texas

West Texas farmers Matt Adams and Jerry Weaver did not plan to own one of the largest vineyards in Texas. Rather, they just wanted to grow a crop that offered more market value than cotton, corn or peanuts.

Farming in the High Plains region, which produces 80 percent of the state's grapes, and in Terry County, the official Grape Capital of Texas, they turned to grapes as an alternative crop.

As the longtime friends tell it, they started researching the grape industry and running the numbers, and one thing led to another.

"We decided that once you get all set up, it's just as easy to plant 400 acres as it is 50 acres," says Adams. And so they did.

The pair joined forces and launched their commercial grape-growing operation, Lahey Vineyards, near Brownfield in 2012. But they did not enter the business blindly. Before committing their land to grapes, they visited vineyards from Texas to Oregon, talked to viticulture experts and large winery operators, created a marketing plan and identified risk management measures.

They also sought financing from Capital Farm Credit.

"I'd always heard good things about them," says Adams, referring to Capital's vineyard financing expertise. "We needed someone big to handle this operation, and they weren't scared of an operation of this magnitude."

In 2017, Lahey Vineyards had 39 different varieties of grapes planted on 880 acres. The year's harvest, which averaged 3 to 5 tons per acre, was sold under contract to about 22 wineries, including some in Oregon.

With over 350 bonded commercial wineries in Texas, and more opening their doors each year, Lahey Vineyards is poised to help meet demand for locally grown grapes.

"Grapes are a new commodity to us. They're up and coming, and I like the challenge," says Weaver. "But I just wish we'd done it when we were younger."

Vineyard manager Doug Fairbanks, left, and co-owner Matt Adams



Left to right: Lucas, Ed and Julie Ogaz

## SECO SPICE

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### Berino, New Mexico

When Edward and Julie Ogaz founded Seco Spice in 1996 with then-partner Michael Barnes, the southern New Mexico chile company was strictly a red chile processor. But as Americans' appetite for fiery foods has grown over the past two decades, so has Seco Spice.

In 21 years, the wholesaler's chile output has increased more than twentyfold, and it now processes up to 8 million dry pounds of chile annually. Today it produces dried rosemary, custom spice blends, and a variety of conventional and organic chile products for major fast-food chains, foreign and domestic spice companies, hot sauce businesses, oleoresin extraction plants, canneries and brokers.

Such steady growth and success can be attributed in part to Ed and Julie's focus on innovation and technology. Early on, they purchased a dehydration plant. Later they bought an organic processing plant and started growing organic peppers themselves. To meet demand for exotic and super-hot chiles, they began working with seed breeders to develop new varieties, including a Scorpion variety that they're hoping will set a heat record. Their son Lucas, an agronomist, coordinates with growers and labor crews and meets with clients.

Along the way, Ed and Michael, who both hold civil engineering degrees, designed and built their own mechanical de-stemmer, and in 2015, the company installed a \$1 million steam sterilizer.

Such dramatic growth was more than their local bank could support — but not Farm Credit. When the Ogazes sought financing for their latest million-dollar upgrade — new milling and blending equipment — they returned to Ag New Mexico, FCS, where they had previously done business.

"A lot of banks here aren't really focused on agriculture," Ed says. "We were growing too much for them."

"With the help of Farm Credit, this new facility should increase our productivity by four times. That will throw us on another plateau," he says.

## LAKE MAJESTIK FARMS

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### Flat Rock, Alabama

The Cornelison name is well-known in northeastern Alabama and across the Tennessee border, where Nic Cornelison and his father, Royce, operate a large commercial construction company.

But in recent years, the family has also been making a name in the Brangus cattle business with their Lake Majestik Farms at Flat Rock, Ala.

Twelve years ago, Nic purchased some cattle from his cousin to add to his own commercial herd.

"I bought my cousin's Brangus herd without any real knowledge of the breed," he says. He soon became a Brangus convert.

"When I put those cows in with my commercial Angus herd, I quickly noticed that the Brangus looked better and outperformed the other cattle," he says.

Nic soon established a breeding program that has resulted in a genetically outstanding herd. Today, Lake Majestik bulls sell for top prices, and the farm markets bull semen and embryos around the

globe. In addition, the Cornelisons sell their USDA-inspected and branded Brangus beef at the farm and to Alabama and Tennessee butcher shops and restaurants.

All of this interest has spurred the cattle operation's growth. Now close to 1,000 head of purebred and commercial black cattle, including 343 registered Brangus animals, graze Lake Majestik's gently rolling pastures.

With financing support from Alabama Farm Credit, the Lake Majestik operation has expanded to 4,600 acres in northeastern Alabama, some of which the Cornelison family has placed into conservation easements.

"They have really done a lot for not only the Brangus industry, but for this entire area," says Alabama Farm Credit Vice President and Branch Manager Jason Thomas. "They've been excellent caretakers of a lot of land around here."

In the next five to 10 years, Nic hopes he'll be able to make farming his full-time career.

"Working with my cattle and being home on the farm is what I love most," says Nic, who with his wife and two children also raises hunting dogs. "Frankly, I consider myself a very lucky guy."



Nic Cornelison



Roger Koehn, right, with daughter Katie and son Seth, who both work in the business

## SOUTHERN SEED & FEED

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### Macon, Mississippi

Every town has its heartbeat. And in Macon, Miss., a tiny town near the Alabama state line, some would argue that the hub is the Southern Seed & Feed mill, a thriving seed producer and manufacturer of livestock, pet and wildlife feeds.

But it didn't start out that way. For owner Roger Koehn, the business has grown from a small traveling seed-cleaning service to become a mainstay of the local agricultural economy.

"If you'd told me where we'd be now 30 years ago, I'd never have believed you," he says.

Koehn started the company in 1983 after he discovered, while cleaning seed for local farmers, that there was no local source for quality feed. He began selling cleaned shelled corn, a product that set him apart from other millers. By the late 1980s, his Southern Seed & Feed Triple-Cleaned Corn had become known throughout eastern Mississippi. Over the years, he expanded his product line and began formulating custom blends, and the Southern Seed & Feed brand became a mainstay in farm-supply stores throughout Mississippi and Alabama.

Today, Southern Seed & Feed maintains a collaborative relationship with the region's farming and trucking industries, purchasing grain and seed almost exclusively from local farmers, employing 57 full-time staff members and contracting with a number of local truckers.

In 2013, Mississippi Land Bank financed an expansion of the mill's off-loading area. Four years later, the Farm Credit lender financed a mill upgrade that will allow the company to manufacture pelleted feed on site and potentially purchase more grains from local farmers.

"The company greatly benefits this area," says Koehn's lender, Bart Harris, vice president and branch manager of Mississippi Land Bank. "The amount of grain and seed that is purchased by Southern Seed & Feed from local farmers and producers makes the company a valuable asset to our local farm community."



Left to right:  
David King, Dr. Terry King  
and Jay Yates

## KINGSLAND RANCH

### West Monroe, Louisiana

Diners at Restaurant Sage in West Monroe, La., might be surprised to learn that the contemporary farm-to-table eatery is owned by local heart specialist Dr. Terry King and his wife, Nancy, and son Brady. They might be even more surprised to know that some of the beef served at Sage is produced by the doctor, himself.

King, who practices pediatric cardiology, raises Red Brangus, Angus and Hereford cattle with his son David King and stepson, Jay Yates, on their 850-acre Kingsland Ranch. The operation focuses on producing pasture-raised beef for the health-conscious consumer and marketing it through local retail outlets and restaurants and direct to the public.

"We use no antibiotics or hormones. We make our own feed, so we know what's in it. If a calf is sick, then we remove it from the line, treat it, and then sell it for slaughter to someone else," King says.

Reared on a South Texas ranch, where he worked cattle from horseback and "knew where our food came from and what was

in it," King held a lifelong dream to have his own ranch. Medical school, military service and his early career intervened, but after opening a medical practice in West Monroe 40 years ago, he started to pursue his goal.

"I bought my first 75 acres in 1978," King recalls. "With help from the Louisiana Land Bank, I've been chipping away at the land around us ever since, buying up 40 acres here and 400 acres there."

His longtime loan officer, Louisiana Land Bank Vice President Keith Post, has witnessed the transformation of Kingsland Ranch by the cardiologist and his sons, who've spent hundreds of hours clearing brush and timber.

"Dr. King has bought parcel after parcel and slowly brought the land into its full potential by making improvements," says Post.

"I love what I do, every bit of it, both at the clinic and on the ranch," King says. "And Kingsland Ranch has certainly been a wonderful adventure."

# Five-Year Summary of Selected Combined Financial Data

## FARM CREDIT BANK OF TEXAS AND DISTRICT ASSOCIATIONS

| <i>(dollars in thousands)</i>                      | 2017                 | 2016                 | 2015                 | 2014                 | 2013                 |
|--|----------------------|----------------------|----------------------|----------------------|----------------------|
| <b>Balance Sheet Data</b>                          |                      |                      |                      |                      |                      |
| Cash, federal funds sold and overnight investments | \$ 313,841           | \$ 230,130           | \$ 573,265           | \$ 459,287           | \$ 631,865           |
| Investment securities                              | 5,163,813            | 4,857,068            | 4,475,318            | 4,125,477            | 3,693,524            |
| Loans  | 23,745,668           | 22,426,117           | 21,181,818           | 19,349,652           | 17,725,520           |
| Less allowance for loan losses                     | 83,268               | 81,737               | 70,350               | 64,357               | 74,164               |
| <b>Net loans</b>                                   | <b>23,662,400</b>    | <b>22,344,380</b>    | <b>21,111,468</b>    | <b>19,285,295</b>    | <b>17,651,356</b>    |
| Other property owned                               | 15,569               | 19,354               | 18,744               | 32,710               | 47,142               |
| Other assets                                       | 561,499              | 501,859              | 438,219              | 421,185              | 335,937              |
| <b>Total assets</b>                                | <b>\$ 29,717,122</b> | <b>\$ 27,952,791</b> | <b>\$ 26,617,014</b> | <b>\$ 24,323,954</b> | <b>\$ 22,359,824</b> |
| Obligations with maturities of one year or less    | \$ 12,160,938        | \$ 13,335,972        | \$ 12,248,212        | \$ 10,533,289        | \$ 9,267,894         |
| Obligations with maturities greater than one year  | 13,278,288           | 10,517,898           | 10,440,176           | 10,048,100           | 9,517,695            |
| <b>Total liabilities</b>                           | <b>25,439,226</b>    | <b>23,853,870</b>    | <b>22,688,388</b>    | <b>20,581,389</b>    | <b>18,785,589</b>    |
| Preferred stock                                    | 620,000              | 600,000              | 600,000              | 600,000              | 600,000              |
| Capital stock and participation certificates       | 65,982               | 64,434               | 62,456               | 60,242               | 59,225               |
| Allocated retained earnings                        | 685,506              | 631,647              | 548,804              | 505,779              | 440,177              |
| Unallocated retained earnings                      | 2,844,643            | 2,736,197            | 2,649,685            | 2,594,156            | 2,563,050            |
| Additional paid-in-capital                         | 224,625              | 224,625              | 224,625              | 149,179              | 22,737               |
| Accumulated other comprehensive loss               | (162,860)            | (157,982)            | (156,944)            | (166,791)            | (110,954)            |
| <b>Total members' equity</b>                       | <b>4,277,896</b>     | <b>4,098,921</b>     | <b>3,928,626</b>     | <b>3,742,565</b>     | <b>3,574,235</b>     |
| <b>Total liabilities and members' equity</b>       | <b>\$ 29,717,122</b> | <b>\$ 27,952,791</b> | <b>\$ 26,617,014</b> | <b>\$ 24,323,954</b> | <b>\$ 22,359,824</b> |
| <b>Statement of Income Data</b>                    |                      |                      |                      |                      |                      |
| Net interest income                                | \$ 770,953           | \$ 726,806           | \$ 697,936           | \$ 655,223           | \$ 630,817           |
| (Provision) negative provision for loan losses     | (5,065)              | (11,492)             | (5,653)              | 6,470                | (6,308)              |
| Noninterest expense, net                           | (326,011)            | (281,783)            | (265,519)            | (222,653)            | (205,389)            |
| (Provision for) benefit from income taxes          | (482)                | (91)                 | 75                   | (529)                | 160                  |
| <b>Net income</b>                                  | <b>\$ 439,395</b>    | <b>\$ 433,440</b>    | <b>\$ 426,839</b>    | <b>\$ 438,511</b>    | <b>\$ 419,280</b>    |
| <b>Key Financial Ratios (unaudited)</b>            |                      |                      |                      |                      |                      |
| Net income to:                                     |                      |                      |                      |                      |                      |
| Average assets                                     | 1.52%                | 1.58%                | 1.70%                | 1.90%                | 1.95%                |
| Average members' equity                            | 10.06                | 10.42                | 10.82                | 11.59                | 11.64                |
| Net interest income to average earning assets      | 2.73                 | 2.72                 | 2.86                 | 2.93                 | 3.03                 |
| Net charge-offs (recoveries) to average loans      | 0.02                 | <(0.1)               | 0.02                 | (0.02)               | 0.23                 |
| Total members' equity to total assets              | 14.40                | 14.66                | 14.76                | 15.38                | 15.98                |
| Allowance for loan losses to total loans           | 0.35                 | 0.36                 | 0.33                 | 0.33                 | 0.42                 |
| Common equity tier 1 ratio (bank only)             | 10.52                | n/a                  | n/a                  | n/a                  | n/a                  |
| Tier 1 capital ratio (bank only)                   | 16.59                | n/a                  | n/a                  | n/a                  | n/a                  |
| Total capital ratio (bank only)                    | 16.68                | n/a                  | n/a                  | n/a                  | n/a                  |
| Permanent capital ratio (bank only)                | 16.60                | 17.40                | 17.74                | 18.33                | 21.64                |
| Tier 1 leverage ratio (bank only)                  | 7.33                 | n/a                  | n/a                  | n/a                  | n/a                  |
| UREE leverage ratio (bank only)                    | 3.08                 | n/a                  | n/a                  | n/a                  | n/a                  |
| Total surplus ratio (bank only)                    | n/a                  | 14.98                | 15.48                | 15.86                | 17.29                |
| Core surplus ratio (bank only)                     | n/a                  | 9.97                 | 9.88                 | 10.07                | 10.12                |
| Net collateral ratio (bank only)                   | n/a                  | 107.35               | 107.70               | 108.00               | 108.67               |
| <b>Net Income Distributions (unaudited)</b>        |                      |                      |                      |                      |                      |
| Net income distributions                           |                      |                      |                      |                      |                      |
| Preferred stock cash dividends                     | \$ 50,750            | \$ 50,250            | \$ 50,250            | \$ 50,250            | \$ 49,931            |
| Patronage distributions                            |                      |                      |                      |                      |                      |
| Cash   | \$ 178,853           | \$ 169,310           | \$ 154,720           | \$ 154,236           | \$ 139,344           |
| Allocated retained earnings                        | 101,210              | 91,331               | 87,978               | 75,402               | 101,948              |

# Combined Average Balances and Net Interest Earnings

FARM CREDIT BANK OF TEXAS AND DISTRICT ASSOCIATIONS

(unaudited)  
December 31,

| <i>(dollars in thousands)</i>                             | 2017                 |                   |              | 2016                 |                   |              | 2015                 |                   |              |
|---|----------------------|-------------------|--------------|----------------------|-------------------|--------------|----------------------|-------------------|--------------|
|   | Average Balance      | Interest          | Average Rate | Average Balance      | Interest          | Average Rate | Average Balance      | Interest          | Average Rate |
| <b>Assets</b>   |                      |                   |              |                      |                   |              |                      |                   |              |
| Investment securities and federal funds sold              | \$ 5,119,341         | \$ 85,791         | 1.68%        | \$ 4,810,239         | \$ 70,658         | 1.47%        | \$ 4,280,222         | \$ 62,149         | 1.45%        |
| Loans   | 23,081,431           | 1,048,370         | 4.54         | 21,902,314           | 940,663           | 4.29         | 20,122,634           | 859,347           | 4.27         |
| <b>Total interest-earning assets</b>                      | <b>28,200,772</b>    | <b>1,134,161</b>  | <b>4.02</b>  | <b>26,712,553</b>    | <b>1,011,321</b>  | <b>3.79</b>  | <b>24,402,856</b>    | <b>921,496</b>    | <b>3.78</b>  |
| Cash  | 138,830              |                   |              | 331,618              |                   |              | 349,945              |                   |              |
| Accrued interest receivable                               | 199,615              |                   |              | 183,784              |                   |              | 168,664              |                   |              |
| Allowance for loan losses                                 | (83,960)             |                   |              | (76,103)             |                   |              | (62,726)             |                   |              |
| Other noninterest-earning assets                          | 421,298              |                   |              | 351,667              |                   |              | 304,810              |                   |              |
| <b>Total average assets</b>                               | <b>\$ 28,876,555</b> |                   |              | <b>\$ 27,503,519</b> |                   |              | <b>\$ 25,163,549</b> |                   |              |
| <b>Liabilities and Shareholders' Equity</b>               |                      |                   |              |                      |                   |              |                      |                   |              |
| Bonds, medium-term notes and subordinate debt, net        | \$ 17,856,961        | \$ 296,197        | 1.66%        | \$ 16,321,944        | \$ 228,466        | 1.40%        | \$ 15,184,487        | \$ 191,775        | 1.26%        |
| Discount notes, net, and other                            | 6,139,288            | 67,011            | 1.09         | 6,552,217            | 56,049            | 0.86         | 5,574,084            | 31,785            | 0.57         |
| <b>Total interest-bearing liabilities</b>                 | <b>23,996,249</b>    | <b>363,208</b>    | <b>1.51</b>  | <b>22,874,161</b>    | <b>284,515</b>    | <b>1.24</b>  | <b>20,758,571</b>    | <b>223,560</b>    | <b>1.08</b>  |
| Noninterest-bearing liabilities                           | 513,712              |                   |              | 469,623              |                   |              | 461,887              |                   |              |
| <b>Total liabilities</b>                                  | <b>24,509,961</b>    |                   |              | <b>23,343,784</b>    |                   |              | <b>21,220,458</b>    |                   |              |
| Shareholders' equity and retained earnings                | 4,366,594            |                   |              | 4,159,735            |                   |              | 3,943,091            |                   |              |
| <b>Total average liabilities and shareholders' equity</b> | <b>\$ 28,876,555</b> |                   |              | <b>\$ 27,503,519</b> |                   |              | <b>\$ 25,163,549</b> |                   |              |
| Net interest rate spread                                  |                      | <u>\$ 770,953</u> | 2.51%        |                      | <u>\$ 726,806</u> | 2.55%        |                      | <u>\$ 697,936</u> | 2.70%        |
| Net interest margin                                       |                      |                   | 2.73%        |                      |                   | 2.72%        |                      |                   | 2.86%        |



# Management's Discussion and Analysis (Unaudited)

*(Dollars in thousands, except as otherwise noted)*

The following commentary provides a discussion and analysis of the combined financial position and results of operations of the Farm Credit Bank of Texas (bank), the Federal Land Credit Association (FLCA) and the Agricultural Credit Associations (ACAs) for the years ended December 31, 2017, 2016 and 2015. The FLCA and ACAs collectively are referred to as "associations," and the bank and its affiliated associations are collectively referred to as "the district." The commentary should be read in conjunction with the accompanying combined financial statements, notes to the combined financial statements (notes) and additional sections of this report. The accompanying combined financial statements were prepared under the oversight of the bank's audit committee.

The district, which serves Texas, Alabama, Mississippi, Louisiana and most of New Mexico, is part of the federally chartered Farm Credit System (System). The bank provides funding to the associations which, in turn, provide credit to their borrower-shareholders. As of December 31, 2017, the district comprised the bank, one FLCA and 13 ACAs. The bank also had funding relationships with certain Other Financing Institutions (OFIs).

## Forward-Looking Information

This annual information report contains forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Words such as "anticipates," "believes," "could," "estimates," "may," "should," "will" or other variations of these terms are intended to identify the forward-looking statements. These statements are based on assumptions and analyses made in light of experience and other historical trends, current conditions and expected future developments. However, actual results and developments may differ materially from our expectations and predictions due to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties include, but are not limited to:

- political, legal, regulatory, and economic conditions and developments in the United States and abroad;
- economic fluctuations in the agricultural, rural utility, international and farm-related business sectors;
- weather-related, disease and other adverse climatic or biological conditions that periodically occur that impact agricultural productivity and income;
- changes in United States government support of the agricultural industry and the System as a government-sponsored enterprise, as well as investor and rating agency reactions to events involving the U.S. government and government-sponsored enterprises; and
- actions taken by the Federal Reserve System in implementing monetary policy.

## Critical Accounting Policies

The combined financial statements are reported in conformity with accounting principles generally accepted in the United States of America. Our significant accounting policies are critical to the understanding of our results of operations and financial position because some accounting policies require us to make complex or subjective

judgments and estimates that may affect the value of certain assets or liabilities. We consider these policies critical because management has to make judgments about matters that are inherently uncertain. For a complete discussion of significant accounting policies, see Note 2, "Summary of Significant Accounting Policies," to the accompanying combined financial statements. The following is a summary of certain critical policies.

- **Allowance for loan losses** — The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through loan loss reversals and loan charge-offs. The allowance for loan losses is determined based on a periodic evaluation of the loan portfolio, which identifies loans that may be impaired. Each of these individual loans are evaluated based on the borrower's overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantor; and, if appropriate, the estimated net realizable value of any collateral. If the present value of expected future cash flows (or, alternatively, the fair value of the collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), an impairment is recognized by making an addition to the allowance for loan losses with a corresponding charge to the provision for loan losses or by similarly adjusting an existing valuation allowance. In addition to these specific allowances, general allowances for loan losses are recorded to reflect expected credit deterioration and inherent losses in that portion of loans that are not individually evaluated.
- **Valuation methodologies** — Management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are used when estimating fair values for certain assets for which an observable liquid market exists, such as most investment securities. Third-party valuation services are utilized by management to obtain fair values for the majority of the bank's investments. Management utilizes significant estimates and assumptions to value items for which an observable liquid market does not exist. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain derivative and other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the district's results of operations.
- **Pensions and retirement plans** — The bank and its related associations participate in the district's defined benefit retirement plan (DB plan). The plan is noncontributory, and benefits are based on salary and years of service. In addition, the bank and its related associations also participate in defined contribution retirement savings plans. The bank and all associations provide certain health care

benefits to eligible retired employees and directors. District employees' eligibility for these benefits upon retirement is dependent on conditions set by each district employer.

The structure of the district's single-employer DB plan is characterized as multiemployer for participating employers' accounting purposes, since neither the assets, liabilities nor cost of any plan is segregated or separately accounted for by participating employers (bank and associations). No portion of any surplus assets is available to any participating employer. Participating employers are jointly and severally liable for the plan obligations. Upon withdrawal or termination of their participation in the plan, a participating employer must pay all associated costs of its withdrawal from the plan, including its unfunded liability (the difference between replacement annuities and the withdrawing employer's share of allocated plan assets). As a result, participating employers of the plan only recognize as cost the required contributions for the period and a liability for any unpaid contributions required for the period of their financial statements. Plan obligations, assets and the components of annual benefit expenses are recorded and reported upon combination only.

The expense for all retirement plans is recorded as part of salaries and employee benefits. The defined benefit pension plan expense is determined by actuarial valuations based on certain assumptions, including expected long-term rate of return on plan assets and discount rate. The expected return on plan assets for the year is calculated based on the composition of assets at the beginning of the year and the expected long-term rate of return on that portfolio of assets. The discount rate is used to determine the present value of our future benefit obligations. We selected the discount rate by reference to the Aon Hewitt AA Only Above-Median Yield Curve, actuarial analyses and industry norms. The Aon Hewitt yield curves are determined based on actual corporate bond yields for bonds rated AA as of the measurement date.

## OVERVIEW

### General

The district's loan portfolio totaled \$23.75 billion at December 31, 2017, a 5.9 percent increase from the prior year. The increase in loan volume in 2017 was primarily related to an increase in district associations' loan portfolios and an increase in the bank's capital markets loan portfolio. The district's net income for 2017 was \$439.4 million, an increase of \$6.0 million, or 1.4 percent, from the \$433.4 million in net income for 2016. The increase in net income for 2017 was driven by a \$44.1 million increase in net interest income, a \$6.4 million decrease in provision for loan losses, offset by a \$40.2 million increase in noninterest expense, a \$4.0 million decrease in noninterest income and a \$391 thousand increase in provision for income taxes.

The improvement in the district's net interest income was primarily driven by growth in earning assets, partially offset by a decrease in the net interest rate spread. The increase in noninterest expense included a \$16.7 million increase in professional fees and contract services, a \$15.5 million expense related to irregularities within an association's loan portfolio, a \$7.0 million increase in salaries and employee benefits and a \$2.5 million increase in occupancy and equipment. The decrease in provision for credit losses included a \$4.2 million decrease at the district associations and a \$2.2 million decrease in provision for loan losses at the bank.

The net interest rate margin increased 1 basis point to 2.73 percent for the year ended December 31, 2017, as compared with 2.72 percent for the same period of the prior year. This increase in the net interest margin resulted from a 5-basis-point increase in income earned on earning assets funded by noninterest-bearing sources (principally capital) due to increased interest rates.

During the third quarter of 2017, an association within the district determined the association's consolidated financial statements as of and for the year ended December 31, 2016, as well as the three months ended March 31, 2017, should no longer be relied upon and needed to be restated to correct misstatements in the association's consolidated financial statements. The association's restatements in 2016 decreased its consolidated other comprehensive income, and members' equity previously reported by \$8.1 million. These additional losses were the result of the activities of a former loan officer who breached the association's policies and procedures and engaged in improper conduct that included improperly advancing funds without appropriate approvals, offering unauthorized loan terms to borrowers, originating loans to fictitious borrowers, and originating loans and advancing funds based on fabricated documentation.

As a result of these activities, the 2016 association financial statements have been restated to properly reflect the following:

- Loan advances to fictitious borrowers were expensed and related accrued interest was reversed in the applicable period.
- Undocumented loan advances assigned to incorrect borrowers' accounts were expensed and related accrued interest was reversed in the applicable period.
- The fair value of loan concessions granted through refinancing of a relationship or as a result of the acceptance of rates and terms previously negotiated by the former loan officer, which were more favorable than market terms or rates, were recorded. This fair value adjustment, or discount, will be accreted into income over the contractual life of the loans, which ranges from 20 months to 30 years.
- Increase in the allowance for loan losses (through an increase in the provision for loan losses) for the additional risk quantified by management in the loan portfolio.

The district's combined financial statements for the year ended December 31, 2017 include out-of-period adjustments of \$8.1 million resulting from the association's restatement related to this matter (See Note 2 to the accompanying combined financial information statements for additional information). Although the association restated their 2016 financial statements, the district has evaluated the quantitative and qualitative aspects of these misstatements in accordance with applicable accounting guidance and has determined that such misstatements are not material to the current and previously issued district combined financial statements.

### Funding

During 2017, the System continued to have reliable access to the debt capital markets to support its mission of providing credit to farmers, ranchers and other eligible borrowers. Investor demand for Systemwide debt securities has remained favorable across all products. The bank has continued to have reliable access to funding at competitive rates and terms necessary to support the district's lending and business operations. Future ratings action affecting the U.S. government and related entities (including the System) may affect

the district's borrowing cost and/or limit our access to the debt capital markets, reducing our flexibility to issue debt across the full spectrum of the yield curve.

## Conditions in the Texas District

The district's non-farm economy remains strong. Increased oil prices have spurred additional activity in the Permian Basin of Texas and supported economic conditions in the largely rural areas of West Texas and southeastern New Mexico. According to the Federal Reserve Bank of Dallas, job growth in Texas will reach 3.4 percent in 2018, the highest rate in four years.

During 2017, beef production in the U.S. exceeded 26 billion pounds for the first time since 2011, and pork and chicken output both reached record highs. After earning relatively high returns in 2017, cattle feedlots have generally been operating at around breakeven through the first few months of 2018. The profitability of cattle ranchers is expected to decline marginally this year but should remain positive. Supported by continued increases in the size of the U.S. cattle herd, beef processors have fared well in recent quarters. Although the rate of expansion of the U.S. cattle herd slowed in 2017, beef production is expected to rise by about five percent this year. Absent a significant increase in export demand, the potential for cattle and beef prices to move higher during 2018 is likely to be limited. Commercial poultry producers have recently been earning net margins that are near the medium-term average. Producers in the U.S. are on high alert for potential avian influenza cases, as migratory birds travel northward across the country through early summer. Hog prices, which were relatively strong in the latter half of 2017, declined during the first quarter of 2018. The reduction in hog prices, which may lead to marginal losses for producers this year, was primarily due to instability in export markets and increased competition among processors. Prices for dairy products have trended lower during 2018, as seasonal factors and rising global production pressured markets. Feed prices remain at low to moderate levels, which has been supportive of profitability in many livestock-related industries despite lower revenues.

Worsening drought conditions across the Southwest, including throughout New Mexico and in much of Texas, have stressed pasture and row crop conditions. According to the U.S. Climate Prediction Center, dry weather is likely to continue in the affected areas through at least June 2018. If the drought intensifies, it could impact farmers' ability to plant spring crops in a timely fashion, reduce yield potential and cause premature liquidation of livestock. However, given the propensity for drought in the district, farmers in the region are adept at managing crop and livestock production with limited precipitation. Additionally, the U.S. Department of Agriculture estimates that there are over 4 million acres of irrigated farmland in Texas, which helps to mitigate the impact of reduced moisture on the state's agricultural sector.

In the district, planting season for most field crops is underway, with crop progress generally in line with the average pace observed during the most recent five years. According to the U.S. Department of Agriculture's Prospective Plantings Report, U.S. farmers are expected to increase farmland dedicated to cotton and wheat production in 2018, while decreasing cropland allocated to corn and soybeans. For the second consecutive year, cotton plantings are likely to increase significantly, as U.S. farmers look to take advantage of the crop's favorable pricing relative to alternatives and its yield potential in drier conditions. Texas cotton farmers are projected to plant about 7.3 million acres of cotton in 2018, the second-highest level observed since 1981.

The district is a crucial driver of global cotton production, as it accounts for about two-thirds of all U.S. farmland dedicated to the crop. For the first time in U.S. history, farmers are expected to allocate more acreage to soybeans than corn in 2018. Increasing global demand for soybeans, which are used as a source of protein in many livestock feeds, is driving acreage higher. Stocks of most field crops remain historically high following several consecutive years of above average U.S. and global output. Barring a substantial yield-reducing event in one of the world's major growing regions, field crop prices are likely to be stable to declining in 2018. Farmers in the district continue to utilize risk management tools — such as government-sponsored crop insurance programs and forwards, futures and options contracts — to mitigate risk and enhance margins.

According to the U.S. Department of Agriculture, the U.S. has had surpluses in agricultural trade for more than 60 years. Because about 20 percent of all U.S. agricultural production is exported, the prices of certain agricultural commodities might be susceptible to declines if export demand falls. Due to the geography of agricultural production and several other factors, the industry might also be selectively targeted by other countries during trade disputes. Commodities that are reliant on export markets for a relatively large share of total demand, such as tree nuts, cotton, soybeans, pork and dairy, may be particularly vulnerable. It should be noted, however, that exports have been strong year-to-date for many agricultural commodities, and the U.S. Department of Agriculture forecasted in February that the value of U.S. agricultural exports would be essentially unchanged in the 2018 fiscal year. Additionally, many of the district's borrowers employ hedging programs provided by independent third parties to protect against price volatility and secure profitability.

The district portfolio continues to be supported by strong credit quality, high levels of capital, low advance rates and diversification.

## Financial Highlights

- ❖ Net income totaled \$439.4 million for the year ended December 31, 2017, compared to \$433.4 million for 2016 and \$426.8 million for 2015, reflecting an increase of 1.4 percent from 2016.
- ❖ Net interest income for the year ended December 31, 2017, was \$771.0 million, compared to \$726.8 million for 2016 and \$697.9 million for 2015, reflecting a 6.1 percent increase over the year ended December 31, 2016 and a 10.5 percent increase over the year ended December 31, 2015.
- ❖ Return on average assets and return on average members' equity for the year ended December 31, 2017, were 1.5 percent and 10.1 percent, respectively, compared to 1.6 percent and 10.4 percent for 2016 and 1.7 percent and 10.8 percent for 2015, respectively.
- ❖ Patronage distributions declared totaled \$280.1 million in 2017, compared to \$260.6 million and \$242.7 million in 2016 and 2015, respectively.
- ❖ The aggregate principal amount of loans outstanding at December 31, 2017, was \$23.75 billion, compared to \$22.43 billion at December 31, 2016, reflecting an increase of 5.9 percent.

## RESULTS OF OPERATIONS

### Net Income

The district's net income of \$439.4 million for the year ended December 31, 2017, reflected an increase of 1.4 percent from net income of \$433.4 million for the year ended December 31, 2016. The

return on average assets decreased to 1.5 percent for the year ended December 31, 2017, from 1.6 percent reported for the year ended December 31, 2016. The increase in net income was due primarily to a \$44.1 million increase in net interest income, a \$6.4 million decrease in provision for loan losses discussed in the "Provision for Loan Losses" section of this discussion, offset by a \$40.2 million increase in noninterest expense, a \$4.0 million decrease in noninterest income and a \$391 increase in provision for income taxes.

## Changes in Components of Net Income

Discussion of the changes in components of net income is included in the following table:

|  | 2017 vs. 2016     | 2016 vs. 2015     |
|--|-------------------|-------------------|
| Net income (prior period)                        | \$ 433,440        | \$ 426,839        |
| Changes due to:                                  |                   |                   |
| Increase in interest income                      | 122,840           | 89,825            |
| Increase in interest expense                     | (78,693)          | (60,955)          |
| Increase in net interest income                  | 44,147            | 28,870            |
| Decrease (increase) in provision for loan losses | 6,427             | (5,839)           |
| (Decrease) increase in noninterest income        | (3,981)           | 11,604            |
| Increase in noninterest expense                  | (40,247)          | (27,868)          |
| Increase in provision for income taxes           | (391)             | (166)             |
| Total change in net income                       | 5,955             | 6,601             |
| Net income                                       | <u>\$ 439,395</u> | <u>\$ 433,440</u> |

## Interest Income

Total interest income for the year ended December 31, 2017, was \$1.13 billion, an increase of \$122.8 million, or 12.2 percent, compared to 2016. Total interest income for the year ended December 31, 2016, was \$1.01 billion, an increase of \$89.8 million, or 9.8 percent, compared to 2015. The increases for 2017 and 2016 were due to increases in earning assets, which included increases in the district associations' loan portfolios, the bank's investment portfolio and the bank's capital markets portfolio.

The following table illustrates the impact that volume and yield changes had on interest income over these periods:

|   | Year Ended December 31, |                  |
|---|-------------------------|------------------|
|   | 2017 vs. 2016           | 2016 vs. 2015    |
| Increase in average earning assets                      | \$ 1,488,219            | \$ 2,309,697     |
| Average yield (prior year)                              | 3.79%                   | 3.78%            |
| Interest income variance attributed to change in volume | 56,404                  | 87,307           |
| Average earning assets (current year)                   | 28,200,772              | 26,712,553       |
| Increase in average yield                               | 0.23%                   | 0.01%            |
| Interest income variance attributed to change in yield  | 66,436                  | 2,518            |
| Net change in interest income                           | <u>\$ 122,840</u>       | <u>\$ 89,825</u> |

## Interest Expense

Total interest expense for the year ended December 31, 2017, was \$363.2 million, an increase of \$ 78.7 million, or 27.7 percent, from the prior year. Total interest expense for the year ended December 31, 2016, was \$284.5 million, an increase of \$61.0 million, or 27.3 percent, from 2015. The increases for 2017 and 2016 were due primarily to an increase in interest-bearing liabilities and an increase in the average rate on debt.

The following table illustrates the impact that volume and rate changes had on interest expense over these periods:

|  | Year Ended December 31, |                  |
|--|-------------------------|------------------|
|  | 2017 vs. 2016           | 2016 vs. 2015    |
| Increase in average interest-bearing liabilities         | \$ 1,122,088            | \$ 2,110,576     |
| Average rate (prior year)                                | 1.24%                   | 1.08%            |
| Interest expense variance attributed to change in volume | 13,914                  | 22,794           |
| Average interest-bearing liabilities (current year)      | 23,996,249              | 22,869,147       |
| Increase in average rate                                 | 0.27%                   | 0.16%            |
| Interest expense variance attributed to change in rate   | 64,779                  | 38,161           |
| Net change in interest expense                           | <u>\$ 78,693</u>        | <u>\$ 60,955</u> |

## Net Interest Income

Net interest income increased by \$44.1 million, or 6.1 percent, from December 31, 2016 to December 31, 2017 and increased by \$28.9 million, or 4.1 percent, from 2015 to 2016. Factors responsible for these changes are illustrated in Figure 1.

The increase in net interest income at December 31, 2017 was the result of a \$1.49 billion increase in combined district average earning assets, offset by a 4-basis-point decrease in net interest rate spread to 2.51 percent. The increase in earning assets included growth in direct notes to district associations, the bank's capital markets loan portfolio and the investment portfolio. The decrease in the net interest rate spread was due to a 27-basis-point increase in the cost of average interest-bearing liabilities. The net interest rate margin increased 1 basis point to 2.73 percent for the year ended December 31, 2017, as compared with 2.72 percent for the same period of the prior year. This increase in the net interest margin resulted from a 5-basis-point increase in income earned on earning assets funded by noninterest-bearing sources (principally capital) due to increased interest rates.

Net interest income for 2016 increased from 2015 due to an increase in average-earning assets, offset by a 15-basis-point decrease in the interest rate spread.

Figure 1

## ANALYSIS OF NET INTEREST INCOME

|                              | 2017            |              | 2016            |            | 2015            |            |
|------------------------------|-----------------|--------------|-----------------|------------|-----------------|------------|
|                              | Average Balance | Interest     | Average Balance | Interest   | Average Balance | Interest   |
| Loans                        | \$ 23,081,431   | \$ 1,048,370 | \$ 21,902,314   | \$ 940,663 | \$ 20,122,634   | \$ 859,347 |
| Investments                  | 5,119,341       | 85,791       | 4,810,239       | 70,658     | 4,280,222       | 62,149     |
| Total earning assets         | 28,200,772      | 1,134,161    | 26,712,553      | 1,011,321  | 24,402,856      | 921,496    |
| Interest-bearing liabilities | 23,996,249      | 363,208      | 22,874,161      | 284,515    | 20,758,571      | 223,560    |
| Impact of capital            | \$ 4,204,523    |              | \$ 3,838,392    |            | \$ 3,644,285    |            |
| NET INTEREST INCOME          |                 | \$ 770,953   |                 | \$ 726,806 |                 | \$ 697,936 |

|  | Average Yield | Average Yield | Average Yield |
|--|---------------|---------------|---------------|
| Yield on loans                             | 4.54%         | 4.29%         | 4.27%         |
| Yield on investments                       | 1.68%         | 1.47%         | 1.45%         |
| Yield on earning assets                    | 4.02%         | 3.79%         | 3.78%         |
| Cost of interest-bearing liabilities       | 1.51%         | 1.24%         | 1.08%         |
| Interest rate spread                       | 2.51%         | 2.55%         | 2.70%         |
| Impact of capital                          | 0.22%         | 0.17%         | 0.16%         |
| Net interest income/average earning assets | 2.73%         | 2.72%         | 2.86%         |

### Provision for Loan Losses

The provision for loan losses for 2017 was \$5.1 million, reflecting a decrease of \$6.4 million from the \$11.5 million provision recorded in 2016. The associations' provisions decreased by \$4.2 million, while the provision for loan losses at the bank decreased by \$2.2 million. The decrease at the district associations included \$2.5 million of recoveries and a decrease in the general reserve on crop and livestock loans. The decrease at the bank was primarily due to the recognition of a negative provision in 2017, which included recoveries of \$1.4 million and a decrease in the general reserve.

### Noninterest Income

Noninterest income of \$63.4 million reflected a decrease of \$4.0 million, or 5.9 percent, from 2016 to 2017. The decrease was primarily due to a \$3.5 million decrease in patronage income and a \$2.0 million decrease in loan-related fees, offset by a \$1.4 million increase in other income primarily related to earnings on Rural Business Investment Companies (RBICs).

Noninterest income of \$67.4 million reflected an increase of \$11.6 million, or 20.8 percent, from 2015 to 2016. The increase was primarily due to a \$7.0 million increase in patronage income, a \$2.7 million increase in other income, a \$1.4 million increase in loan-related fees and a \$420 decrease in losses on loans held under the fair value option. The increase in other income was primarily due to a \$5,773 increase in gains on sale of loans from 2015 to 2016 and a decrease from the loss of a \$3,133 write-off in 2015 of loan accounting software no longer deemed a usable asset, net of a \$5,779 decrease in income on preferred stock dividends received in 2015 from an ethanol facility in other property owned (OPO).

### Noninterest Expenses

Noninterest expenses for 2017 totaled \$389.4 million, increasing \$40.2 million, or 11.5 percent, from 2016. The increase in noninterest expense include a \$16.7 million increase in professional fee and contract services, a \$15.5 million expense related to the breach of policies and procedures related expenses at an association, \$7.0 million increase in salaries and employee benefits and a \$2.5 million increase in occupancy and equipment. The \$16.7 million increase in professional fees and contract services included \$10.0 million in increased legal and accounting expenses associated with the breach of

policies and procedures at an association. The bank had increased consulting and legal costs included in professional fees. The \$6.9 million increase in salaries and employee benefits was due primarily to a \$6.6 million increase in compensation. The increase in occupancy and equipment expenses was mainly due to increases in building and computer expenses.

Noninterest expenses for 2016 totaled \$349.2 million, increasing \$27.9 million, or 8.7 percent, from 2015. The increase was primarily due to an increase of \$10.2 million in premiums to the FCSIC, an increase of \$8.6 million in salaries and employment benefits, an increase of \$5.2 million in net losses on OPO, an increase of \$2.1 million in occupancy and equipment expense and an increase of \$1.8 million on other operating expenses. Premiums to the FCSIC increased due to a rate increase on outstanding debt from 13 basis points in 2015 to 16 basis points for the first six months of 2016 and 18 basis points for the second half of 2016, and to an increase in debt required to fund earning asset growth. The \$8.6 million increase in salaries and employee benefits was due primarily to a \$7.5 million increase in compensation and related payroll taxes of \$5.0 million at the district's associations and \$2.5 million at the bank. The \$5.2 million increase in losses on OPO included a \$1.8 million increase in losses on disposal and valuation adjustments for acquired properties, and a \$3.1 million decrease in net gains on disposal of the preferred stock of an ethanol facility in 2015. The increase in occupancy and equipment expenses was mainly due to increases in computer expenses.

Operating expense (salaries and employee benefits, occupancy and equipment, FCSIC premiums and other operating expenses) statistics are set forth below for each of the three years ended December 31:

|   | 2017      | 2016      | 2015      |
|---|-----------|-----------|-----------|
| Excess of net interest income over operating expense                            | \$381,548 | \$379,827 | \$373,661 |
| Operating expense as a percentage of net interest income                        | 50.51%    | 47.74%    | 46.46%    |
| Operating expense as a percentage of net interest income and noninterest income | 46.67     | 43.69     | 43.02     |
| Operating expense as a percentage of average loans                              | 1.69      | 1.58      | 1.61      |
| Operating expense as a percentage of average earning assets                     | 1.38      | 1.30      | 1.33      |

The district's operating expense statistics for 2017 reflect the increase in operating expenses, offset by an increase in net interest income. The district's operating expense statistics for 2016 and 2015 reflect the increase in operating expenses, offset by increases in net interest income and noninterest income.

## CORPORATE RISK PROFILE

### Overview

The district is in the business of making and participating in agricultural and other loans which requires us to take certain risks in exchange for compensation for the risks undertaken. Management of risks inherent in our business is essential for our current and long-term financial performance. Our goal is to mitigate risk, where appropriate, and to properly and effectively identify, measure, price, monitor and report risks in our business activities.

The major types of risk to which we have exposure are:

- structural risk — risk inherent in our business and related to our structure (an interdependent network of lending institutions);
- credit risk — risk of loss arising from an obligor's failure to meet the terms of its contract or failure to perform as agreed;
- interest rate risk — risk that changes in interest rates may adversely affect our operating results and financial condition;
- liquidity risk — risk of loss arising from the inability to meet obligations when they come due without incurring unacceptable losses;
- operational risk — risk of loss resulting from inadequate or failed internal processes or systems, errors by employees or external events;
- reputational risk — risk of loss resulting from events, real or perceived, that shape the image of the bank, district associations, the System or any System entities, including the impact of investors' perceptions about agriculture, the reliability of district or System financial information or the overt actions of any district or System institution; and
- political risk — risk of loss of support for the Farm Credit System (System) and agriculture by the federal and state governments.

### Structural Risk Management

Structural risk results from the fact that the bank and its related associations are part of the System, which is comprised of banks and associations that are cooperatively owned, directly or indirectly, by their borrowers. While System institutions are financially and operationally interdependent, this structure at times requires action by consensus or contractual agreement. Further, there is structural risk in that only the banks are jointly and severally liable for the payments of Systemwide debt securities. Although capital at the association level reduces a bank's credit exposure with respect to its direct loans to its affiliated associations, this capital may not be available to support the payment of principal and interest on Systemwide debt securities.

In order to mitigate this risk, the System utilizes two integrated contractual agreements — the Amended and Restated Contractual Interbank Performance Agreement (CIPA), and the Third Amended and Restated Market Access Agreement (MAA). Under provisions of the CIPA, a score (CIPA score) is calculated that measures the financial condition and performance of each district using various ratios that

take into account the district's and bank's capital, asset quality, earnings, interest rate risk and liquidity. The CIPA score is then compared against the agreed-upon standard of financial condition and performance that each district must achieve and maintain. The measurement standard established under the CIPA is intended to provide an early-warning mechanism to assist in monitoring the financial condition of each district. The performance standard under the CIPA is based on the average CIPA score over a four-quarter period.

The MAA is designed to provide for the timely identification and resolution of individual bank financial issues and establishes performance criteria and procedures for the banks that provide operational oversight and control over a bank's access to System funding.

As required by the MAA, the banks and the Funding Corporation undertake a periodic formal review of the MAA to consider whether any amendments are appropriate. In connection with the most recent review, the banks and the Funding Corporation agreed to enter into the Third Amended and Restated MAA, which was effective on January 1, 2017.

Periodically, the CIPA model and the MAA performance criteria are reviewed to take into consideration current performance standards in the financial services industry or regulatory changes. As a result of the changes to regulatory capital ratio requirements that became effective January 1, 2017, the performance criteria set forth in the MAA are as follows:

- the defined CIPA scores,
- the tier 1 leverage ratio of a bank, and
- the total capital ratio of a bank.

The bank's tier 1 leverage ratio is tier 1 capital (primarily unallocated retained earnings, the bank's common stock, and preferred stock less certain regulatory required deductions) divided by non-risk adjusted assets, and the bank's total capital ratio is the sum of the bank's common equity tier 1 capital, additional tier 1 capital, and tier 2 capital elements, minus regulatory deductions and adjustments, divided by risk-adjusted assets.

If a bank fails to meet the above performance criteria, it will be placed into one of three categories. Each category gives the other System banks progressively more control over a bank that has declining financial performance under the MAA performance criteria. A "Category I" bank is subject to additional monitoring and reporting requirements; a "Category II" bank's ability to participate in issuances of Systemwide debt securities may be limited to refinancing maturing debt obligations; and a "Category III" bank may not be permitted to participate in issuances of Systemwide debt securities. A bank exits these categories by returning to compliance with the agreed-upon performance criteria.

The criteria for the tier 1 leverage ratio and the total capital ratio are:

|              | Tier 1<br>Leverage Ratio | Total<br>Capital Ratio |
|--------------|--------------------------|------------------------|
| Category I   | <5.0%                    | <10.5%                 |
| Category II  | <4.0%                    | <8.0%                  |
| Category III | <3.0%                    | <7.0%                  |

During the year ended December 31, 2017, all banks met the agreed-upon standards for the tier 1 leverage ratio and total capital ratios required by the MAA that became effective January 1, 2017.

As of December 31, 2017, all banks met the agreed-upon standard of financial condition and performance required by the CIPA. During the three years ended December 31, 2017, the banks met the defined CIPA score required by the MAA.

## Credit Risk Management

Credit risk arises from the potential inability of an obligor to meet its repayment obligation and exists in our outstanding loans, letters of credit, unfunded loan commitments, investment portfolio and derivative counterparty credit exposures. We manage credit risk associated with our retail lending activities through an assessment of the credit risk profile of an individual borrower. Each institution sets its own underwriting standards and lending policies, approved by their board of directors, that provide direction to loan officers. Underwriting standards include, among other things, an evaluation of:

- character — borrower integrity and credit history;
- capacity — repayment capacity of the borrower based on cash flows from operations or other sources of income;
- collateral — protects the lender in the event of default and represents a potential secondary source of loan repayment;
- capital — ability of the operation to survive unanticipated risks; and
- conditions — requirements that govern intended use of loan funds.

The retail credit risk management process begins with an analysis of the borrower’s credit history, repayment capacity and financial position. Repayment capacity focuses on the borrower’s ability to repay the loan based on cash flows from operations or other sources of income, including non-farm income. Real estate loans with terms greater than 10 years must be secured by first liens on the real estate (collateral). As required by Farm Credit Administration (FCA) regulations, each institution that makes loans on a secured basis must have collateral evaluation policies and procedures. Real estate loans with terms greater than 10 years may be made only in amounts up to 85 percent of the original appraised value of the property taken as security or up to 97 percent of the appraised value if guaranteed by a state, federal or other governmental agency. The actual loan to appraised value when loans are made is generally lower than the statutory maximum percentage. Appraisals are required for loans of more than \$250,000. This credit risk-rating process incorporates objective and subjective criteria to identify inherent strengths and weaknesses and risks in a particular relationship.

This credit risk-rating process uses a two-dimensional loan rating structure, incorporating a 14-point risk-rating scale to identify and track the probability of borrower default and a separate 4-point scale addressing loss given default. The 14-point risk-rating scale provides for nine “acceptable” categories, one “other assets especially mentioned” (OAEM) category, two “substandard” categories, one “doubtful” category and one “loss” category. The loss given default scale establishes ranges of anticipated economic loss if the loan defaults. The calculation of economic loss includes principal and interest as well as collections costs, legal fees and staff costs.

By buying and selling loans or interests in loans to or from other institutions within the System or outside the System, we limit our exposure to either a borrower or commodity concentration. This also allows us to manage growth and capital, and to improve geographic diversification.

Portfolio credit risk is also evaluated with the goal of managing the concentration of credit risk. Concentration risk is reviewed and measured by industry, commodity, geography and customer limits.

## Loan Portfolio

The district loan portfolio consists only of retail loans. Bank loans to its affiliated associations have been eliminated in the combined financial statements. Gross loan volume of \$23.75 billion at December 31, 2017, reflected an increase of \$1.32 billion, or 5.9 percent, from the \$22.43 billion loan portfolio balance at December 31, 2016. Loans, net of the allowance for loan losses, represented 79.6 percent, 79.9 percent and 79.3 percent of total assets as of December 31, 2017, 2016 and 2015, respectively.

Agricultural real estate mortgage loans totaled \$14.35 billion at December 31, 2017, an increase of \$888.8 million, or 6.6 percent, from 2016, and currently comprise approximately 60.4 percent of the district’s loan portfolio. Commercial loans for agricultural production, and processing and marketing totaled \$6.44 billion, an increase of \$559.7 million, or 9.5 percent, from 2016, and represented 27.1 percent of the loan portfolio at December 31, 2017. The composition of the district’s loan portfolio by category may be found in Note 4, “Loans and Allowance for Loan Losses,” to the accompanying combined financial statements. The increase of loan volume in 2017 was primarily related to a \$1.11 billion increase in district associations’ loan portfolios and a \$216.7 million increase in the bank’s capital markets loan portfolio. In 2016, association loan volume increased by \$1.24 billion, and in 2015 association loan volume increased by \$1.44 billion primarily due to improvements in general economic conditions.

The bank’s capital markets loan portfolio predominantly includes participations, syndications and purchased whole loans, along with other financing structures within our lending authorities. The bank also refers to the capital markets portfolio as participations purchased. In addition to purchasing loans from our district associations, which may exceed their hold limits, the bank seeks the purchase of participations and syndications originated outside of the district’s territory by other System institutions, commercial banks and other lenders. These loans may be held as earning assets of the bank or sub-participated to the associations or to other System entities.

The district’s concentration of credit risk in various agricultural commodities is shown in the following table at December 31 (*dollars in millions*):

| Commodity  | 2017      |      | 2016      |      | 2015      |      |
|------------|-----------|------|-----------|------|-----------|------|
|            | Amount    | %    | Amount    | %    | Amount    | %    |
| Livestock  | \$ 7,822  | 33%  | \$ 7,384  | 33%  | \$ 6,973  | 33%  |
| Crops      | 3,326     | 14   | 3,013     | 13   | 2,760     | 13   |
| Timber     | 1,794     | 8    | 1,758     | 8    | 1,688     | 8    |
| Cotton     | 884       | 4    | 850       | 4    | 820       | 4    |
| Poultry    | 948       | 4    | 874       | 4    | 758       | 4    |
| Dairy      | 873       | 4    | 771       | 3    | 645       | 3    |
| Rural home | 234       | 1    | 301       | 1    | 301       | 1    |
| Other      | 7,865     | 32   | 7,475     | 34   | 7,237     | 34   |
| Total      | \$ 23,746 | 100% | \$ 22,426 | 100% | \$ 21,182 | 100% |

The diversity of states underlying the district's loan portfolio is reflected in the following table:

|                  | December 31, |             |             |
|------------------|--------------|-------------|-------------|
|                  | 2017         | 2016        | 2015        |
| Texas            | 54%          | 55%         | 52%         |
| Mississippi      | 7            | 7           | 7           |
| Alabama          | 7            | 6           | 7           |
| Louisiana        | 4            | 5           | 3           |
| California       | 2            | 2           | 3           |
| All other states | 26           | 25          | 28          |
| Total            | <b>100%</b>  | <b>100%</b> | <b>100%</b> |

The bank and district associations review the credit quality of the loan portfolio as a part of their credit risk practices, using the classifications of the Uniform Classification System which is used by all System institutions. The classifications are defined as follows:

- **Acceptable** — Assets are expected to be fully collectible and represent the highest quality.
- **Other Assets Especially Mentioned (Special Mention)** — Assets are currently collectible but exhibit some potential weakness.
- **Substandard** — Assets exhibit some serious weakness in repayment capacity, equity and/or collateral pledged on the loan.
- **Doubtful** — Assets exhibit similar weaknesses to substandard assets, but have additional weaknesses in existing facts, conditions and values that make collection in full highly questionable.
- **Loss** — Assets are considered uncollectible.

The following table discloses the credit quality of the district's loan portfolio at December 31:

|                        | 2017          | 2016          | 2015          |
|------------------------|---------------|---------------|---------------|
| Acceptable             | 96.9%         | 96.7%         | 97.3%         |
| OAEM (special mention) | 1.6           | 1.8           | 1.6           |
| Substandard/doubtful   | 1.5           | 1.5           | 1.1           |
| Total                  | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |

During 2017, overall credit quality at the bank and at the district associations remained strong. Loans classified (under the FCA's Uniform Loan Classification System) as "acceptable" or "other assets especially mentioned" as a percentage of total loans and accrued interest receivable were 98.5 percent at December 31, 2017 compared to 98.5 percent at December 31, 2016, and 98.9 percent at December 31, 2015.

### High-Risk Assets

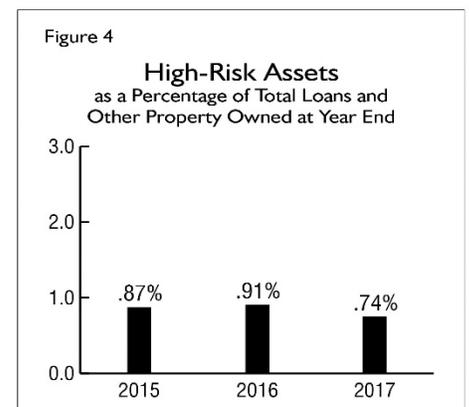
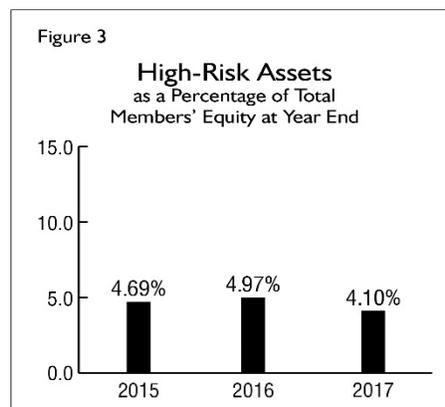
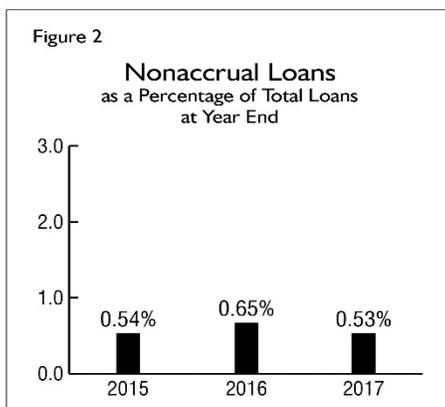
Nonperforming loan volume is composed of nonaccrual loans, accrual restructured loans and loans 90 days or more past due and still accruing interest, and is referred to as impaired loans. High-risk assets consist of impaired loans and other property owned. Total high-risk assets have decreased by \$28.5 million, or 14.0 percent, from \$203.8 million at December 31, 2016, to \$175.3 million at December 31, 2017. The decrease in high-risk assets during 2017 includes a \$19.5 million decrease in nonaccrual loans. The decrease in nonaccrual loans was primarily the result of repayments of \$99.4 million, transfers to accrual loans of \$10.0 million, the movement of loans to OPO totaling \$5.8 million, and charge-offs, net of recoveries, totaling \$4.2 million, offset by \$86.4 million in additions to nonaccrual from accrual status and \$11.3 million in advances on nonaccrual loans. The decrease in nonaccrual loans was primarily due to production and intermediate term loans at the district associations.

The following table discloses the components of the district's high-risk assets at December 31 (*dollars in millions*):

|  | 2017            | 2016     | 2015     |
|--|-----------------|----------|----------|
| Nonaccrual loans   | <b>\$ 126.2</b> | \$ 145.7 | \$ 113.4 |
| Accrual formally restructured loans                        | <b>30.5</b>     | 32.3     | 50.1     |
| Loans past due 90 days or more and still accruing interest | <b>3.0</b>      | 6.4      | 2.1      |
| Other property owned                                       | <b>15.6</b>     | 19.4     | 18.7     |
| Total  | <b>\$ 175.3</b> | \$ 203.8 | \$ 184.3 |

At December 31, 2017, \$78.9 million, or 62.5 percent, of loans classified as nonaccrual were current as to principal and interest, compared to \$89.7 million, or 61.6 percent, of nonaccrual loans at December 31, 2016, and \$55.0 million, or 48.5 percent, at December 31, 2015.

Figures 2, 3 and 4 provide analyses of the relationships of nonaccrual loans and high-risk assets to total loans and members' equity at December 31, 2017, 2016 and 2015.



## Allowance and Reserve for Credit Losses

At December 31, 2017, the allowance for loan losses was \$83.3 million, or 0.4 percent of total loans outstanding, compared to \$81.7 million, or 0.4 percent, and \$70.4 million, or 0.3 percent, at December 31, 2016 and 2015, respectively. Net charge-offs of \$4.2 million were recorded at December 31, 2017 compared to net recoveries of \$2.0 million and net charge-offs of \$3.6 million recorded at December 31, 2016 and 2015, respectively. The \$1.5 million increase in the allowance for loan losses during 2017 included a \$5.1 million provision for loan losses, \$3.9 million in recoveries, and a \$667 increase in the general allowance related to reserves for losses on unfunded commitments, which are recorded in other liabilities, net of \$8.1 million in charge-offs.

During the second quarter of 2017, the bank downgraded the direct loan to one of our affiliated associations to the special mention credit quality classification. This credit quality classification was affirmed by bank management prior to the issuance of this report. As of December 31, 2017, the direct note totaled \$890,952. The bank's loans to our affiliated associations are collateralized by substantially all of the association assets, earnings, capital and loan loss reserves of the association provide a buffer against losses in their retail portfolio. While the downgrade reflects control weaknesses at the affiliated association, the bank has not made any provision for loan loss or recorded any allowance for credit loss related to our direct note to that association because of the collateralization of the direct loan and other mitigating factors.

The allowance for loan losses for the district represents the aggregate of each entity's individual evaluation of its allowance for loan losses requirements. Although aggregated in the combined financial statements, the allowance for loan losses of each entity is particular to that institution and is not available to absorb losses realized by other institutions. The allowance for loan losses at each period end was considered by management to be adequate to absorb probable losses existing in and inherent to its loan portfolio. Management's evaluations consider factors including loan loss experience, portfolio quality, loan portfolio composition, current agricultural production conditions and economic conditions.

The following table provides an analysis of key statistics related to the allowance for loan losses at December 31:

|   | 2017 | 2016   | 2015 |
|---|------|--------|------|
| Allowance for loan losses as a percentage of: |      |        |      |
| Average loans                                 | 0.4% | 0.4%   | 0.4% |
| Loans at year end                             |      |        |      |
| Total loans                                   | 0.4  | 0.4    | 0.3  |
| Nonaccrual loans                              | 66.0 | 56.1   | 62.0 |
| Total impaired loans                          | 52.1 | 44.3   | 42.5 |
| Net charge-offs (recoveries) to average loans | 0.02 | <(0.1) | 0.02 |
| Provision expense to average loans            | <0.1 | <0.1   | <0.1 |

## Interest Rate Risk Management

Asset/liability management is the bank's process for directing and controlling the composition, level and flow of funds related to the bank's and district's interest-rate-sensitive assets and liabilities. The bank is able to manage the balance sheet composition by using various debt issuance strategies and hedging transactions to match its asset cash flows. Management's objective is to generate adequate and stable net interest income in a changing interest rate environment.

The bank uses a variety of techniques to manage its financial exposure to changes in market interest rates. These include monitoring the difference in the maturities or repricing cycles of interest-rate-sensitive assets and liabilities; simulating changes in net interest income under various interest rate scenarios; and monitoring the change in the market value of interest-rate-sensitive assets and liabilities under various interest rate scenarios.

The interest rate risk inherent in a district association's loan portfolio is substantially mitigated through its funding relationship with the bank. The bank manages interest rate risk through its direct loan pricing and asset/liability management process. Under the Farm Credit Act of 1971, as amended (Farm Credit Act), a district association is obligated to borrow only from the bank unless the bank approves borrowing from other funding sources. An association's indebtedness to the bank, under a general financing agreement between the bank and the association, represents demand borrowings by the association to fund the majority of its loan advances to association members.

Figure 5

### Interest Rate Gap Analysis

as of December 31, 2017

Interest-Sensitive Period

|   | One Month or Less | Over One Through Six Months | Over Six Through Twelve Months | Total Twelve Months or Less | Over One Year but Less Than Five Years | Over Five Years and Non-Rate Sensitive | Total         |
|---|-------------------|-----------------------------|--------------------------------|-----------------------------|--|--|---------------|
| <b>Interest-Earning Assets</b>                                      |                   |                             |                                |                             |  |  |               |
| Total loans   | \$ 7,782,914      | \$ 2,261,017                | \$ 1,652,299                   | \$ 11,696,230               | \$ 7,318,927                           | \$ 4,730,511                           | \$ 23,745,668 |
| Total investments   | 2,264,815         | 553,381                     | 280,410                        | 3,098,606                   | 1,407,018                              | 905,077                                | 5,410,701     |
| Total earning assets  | 10,047,729        | 2,814,398                   | 1,932,709                      | 14,794,836                  | 8,725,945                              | 5,635,588                              | 29,156,369    |
| <b>Interest-Bearing Liabilities</b>                                 |                   |                             |                                |                             |  |  |               |
| Total interest-bearing funds  | 8,308,612         | 3,008,687                   | 1,990,194                      | 13,307,493                  | 9,611,539                              | 1,912,329                              | 24,831,361    |
| Excess of interest-earning assets over interest-bearing liabilities | -                 | -                           | -                              | -                           | -                                      | 4,325,008                              | 4,325,008     |
| Total interest-bearing liabilities                                  | 8,308,612         | 3,008,687                   | 1,990,194                      | 13,307,493                  | 9,611,539                              | 6,237,337                              | \$ 29,156,369 |
| Interest rate sensitivity gap                                       | \$ 1,739,117      | \$ (194,289)                | \$ (57,485)                    | \$ 1,487,343                | \$ (885,594)                           | \$ (601,749)                           |               |
| Cumulative interest rate sensitivity gap                            | \$ 1,739,117      | \$ 1,544,828                | \$ 1,487,343                   | \$ 1,487,343                | \$ 601,749                             |  |               |

The district's net interest income is determined by the difference between income earned on loans and investments and the interest expense paid on funding sources, typically Systemwide bonds, medium-term notes and discount notes. The district's level of net interest income is affected by both changes in market interest rates and timing differences in the maturities or repricing cycles of interest-bearing assets and liabilities. Depending upon the direction and magnitude of changes in market interest rates, the district's net interest income may be affected either positively or negatively by the mismatch in the maturity or the repricing cycle of interest-rate-sensitive assets and liabilities.

The interest rate gap analysis in Figure 5 presents a comparison of interest-sensitive assets and liabilities in defined time segments as of December 31, 2017. The interest rate gap analysis is a static indicator, which does not reflect the dynamics of balance sheet, cash flows, rate and spread changes, and may not necessarily indicate the sensitivity of net interest income in a changing interest rate environment. Within the gap analysis, gaps are created when an institution uses its capital to fund assets. Capital reduces the amount of debt that otherwise would be required to fund a certain level of assets. The quantity of earning assets will exceed the quantity of interest-bearing liabilities in any repricing interval where capital provides part of the funding. The gap table above includes anticipated cash flows on interest-sensitive assets and liabilities given the current level of interest rates.

To reflect the expected cash flow and repricing characteristics of the district's balance sheet, an estimate of expected prepayments on loans and mortgage-related investments is used to adjust the maturities of the loans and investments in the earning assets section of the gap analysis. Changes in market interest rates will affect the volume of prepayments on loans. Correspondingly, adjustments have been made to reflect the characteristics of callable debt instruments and the effect derivative financial instruments have on the repricing structure of the district's balance sheet.

The bank may use derivative financial instruments to manage the district's interest rate risk and liquidity position. Interest rate swaps for asset/liability management purposes may be used to change the repricing characteristics of liabilities to match the repricing characteristics of the assets they support. The bank does not hold, and is restricted by policy from holding, derivative financial instruments for trading purposes and is not a party to leveraged derivative transactions.

At December 31, 2017, the bank held interest rate caps with a notional amount of \$195.0 million and a fair value of \$396, and pay fixed interest rate swap contracts with a notional amount of \$250.0 million and a fair value of \$8,288. See Note 16, "Derivative Instruments and Hedging Activity," to the accompanying combined financial statements for further discussion. Unrealized losses on interest rate caps, the difference between the amortized cost and fair value, are recorded as a reduction of accumulated other comprehensive income. To the extent that its derivatives have a negative fair value, the bank has a payable on the instrument and the counterparty is exposed to the credit risk of the bank. To the extent that its derivatives have a positive fair value, the bank has a receivable on the instrument and is therefore exposed to credit risk from the counterparty. To manage this credit risk, the bank has bilateral collateral agreements to reduce potential exposure, diversify counterparties in the swap transactions and monitor the credit ratings of all counterparties with whom it transacts.

Figure 6 summarizes the bank's activity in derivative financial instruments for 2017. At December 31, 2017, the bank had credit risk exposure to four counterparties on derivative contracts totaling \$8.7 million.

Figure 6

### Activity in Derivative Financial Instruments (Notional Amounts)

| <i>(in millions)</i>                | Pay Fixed<br>Swaps | Interest<br>Caps | Total         |
|-------------------------------------|--------------------|------------------|---------------|
| Balance at January 1, 2017          | \$ 200             | \$ 170           | \$ 370        |
| Additions                           | 50                 | 75               | 125           |
| Maturities/amortizations            | -                  | (50)             | (50)          |
| <b>Balance at December 31, 2017</b> | <b>\$ 250</b>      | <b>\$ 195</b>    | <b>\$ 445</b> |

Interest rate risk exposure as measured by simulation modeling calculates the district's expected net interest income and market value of equity based upon projections of interest-rate-sensitive assets, liabilities, derivative financial instruments and interest rate scenarios. The bank monitors the district's financial exposure to instantaneous and parallel changes in interest rates of 200 basis points up or down over a rolling 12-month period. Per FCA regulations, when the current three-month Treasury bill interest rate is less than 4 percent, the minus 200-basis-point scenario should be replaced with a downward shock equal to one-half of the three-month Treasury bill rate. As of December 31, 2017, projected district net interest income would increase by \$21.9 million, or 2.9 percent, if interest rates were to increase by 200 basis points, and would decrease by \$2.6 million, or 0.3 percent, if interest rates were to decrease by 69 basis points. In general, the bank's ability to exercise call options on debt benefits the district in the event of decreasing interest rates. In a rising interest rate scenario, the benefit of rate increases on investments, association loans and the bank's participation loans would outpace the increase in the cost of debt.

### Liquidity Risk Management

The district's liquidity risk management practices ensure the district's ability to meet its financial obligations. These obligations include the repayment of Systemwide debt securities as they mature, the ability to fund new and existing loan and other funding commitments, and the ability to fund operations in a cost-effective manner. A primary objective of liquidity risk management is to plan for unanticipated changes in the capital markets.

Farm Credit System Insurance Corporation (FCSIC) insures the timely payment of principal and interest on Systemwide debt securities. FCSIC maintains the Farm Credit Insurance Fund (Insurance Fund) for this purpose and for certain other purposes. In the event a System bank is unable to timely pay principal or interest on any insured debt obligation for which that bank is primarily liable, FCSIC must expend amounts in the Insurance Fund to the extent available to insure the timely payment of principal and interest on the debt obligation. The provisions of the Farm Credit Act providing for joint and several liability of the System banks on the debt obligation cannot be invoked until the Insurance Fund is exhausted. However, because of other mandatory and discretionary uses of the Insurance Fund, there is no assurance that there will be sufficient funds to pay the principal or interest on the insured debt obligation. The insurance provided through use of the Insurance Fund is not an obligation of and is not a guarantee by the U.S. government.

FCSIC has an agreement with the Federal Financing Bank, a federal instrumentality subject to the supervision and direction of the U.S.

Treasury, pursuant to which the Federal Financing Bank would advance funds to FCSIC. Under its existing statutory authority, FCSIC may use these funds to provide assistance to the System banks in demanding market circumstances which threaten the banks' ability to pay maturing debt obligations. The agreement provides for advances of up to \$10.00 billion and terminates on September 30, 2018, unless otherwise renewed. The decision whether to seek funds from the Federal Financing Bank is at the discretion of FCSIC, and each funding obligation of the Federal Financing Bank is subject to various terms and conditions and, as a result, there can be no assurance that funding will be available if needed by the System.

The bank's primary source of liquidity is the ability to issue Systemwide debt securities, which are the general unsecured joint and several obligations of the System banks as discussed below. As a secondary source of liquidity, the bank maintains an investment portfolio comprised primarily of high-quality liquid securities. The securities provide a stable source of income for the bank, and their high quality ensures the portfolio can quickly be converted to cash should the need arise.

FCA regulations require each bank to maintain a minimum of 90 days of liquidity coverage on a continuous basis, assuming no access to the capital markets. Liquidity coverage is defined as the number of days that maturing Systemwide debt securities could be funded with cash and eligible liquidity investments maintained by the bank. Regulations on liquidity reserve requirement divided the existing eligible liquidity reserve requirement into three levels: Level 1 consists of cash and cash-like instruments and must provide 15 days of coverage; Level 2 consists primarily of government-guaranteed securities and must provide 30 days of coverage (combined with Level 1); and Level 3 consists primarily of agency-guaranteed securities and must provide a total of 90 days of coverage (combined with Level 1 and Level 2). Additionally, regulations require the bank to maintain a supplemental liquidity reserve above the 90-day minimum to cover cash flow requirements unique to the bank. At December 31, 2017, the bank met all individual level criteria and had a total of 227 days of liquidity coverage, as compared with 199 days at December 31, 2016. The bank's balance in federal funds increased by \$224.0 million, or 978.1 percent, from December 31, 2016 to December 31, 2017. The increase in federal funds resulted in a lower cash balance with both included in Level 1 liquidity.

## Funding Sources

The bank continually raises funds to support our mission to provide credit and related services to the rural and agricultural sectors, repay maturing Systemwide debt securities and meet other obligations. As a government-sponsored enterprise, the bank has access to the nation's and world's capital markets. This access has provided us with a dependable source of competitively priced debt that is critical to support our mission of providing funding to the rural and agricultural sectors. Moody's Investors Service and Standard & Poor's rate the System's long-term debt as Aaa and AA+, respectively. These rating agencies base their ratings on many quantitative and qualitative factors, including the System's government-sponsored enterprise status. Standard and Poor's rating on long-term debt of AA+ is in concert with its sovereign credit rating on the United States of America at AA+. Material changes to the factors considered could result in a different debt rating. However, as a result of the System's financial performance, credit quality and standing in the capital markets, we anticipate continued access to funding necessary to support System

needs. The U.S. government does not guarantee, directly or indirectly, Systemwide debt securities.

In September 2008, the bank issued \$50.0 million in subordinated debt in a private placement to one investor. The debt was a 10-year instrument with a coupon rate of 8.406 percent. Prior to the bank's issuance of its Class B noncumulative subordinated perpetual preferred stock (Class B Series 1) in August 2010, the subordinated debt received preferential regulatory capital and collateral treatment, being includible in portions of permanent capital and total surplus and being excludable from total liabilities for purposes of net collateral ratio calculation. Regulatory conditions related to the issuance of the Class B Series 1 preferred stock reduced the benefit of the favorable capital ratio treatment received by subordinated debt, and required that it no longer receive favorable treatment in net collateral calculations.

On March 10, 2016, the FCA approved a final rule to modify the regulatory capital requirements for System banks and associations, effective January 1, 2017. The final rule to modify regulatory capital requirements changed the favorable capital treatment of the subordinated debt, and, therefore, qualified as a regulatory event triggering a right of redemption under the terms of the subordinated debt. On March 30, 2016, the bank's board approved a resolution authorizing the redemption of all outstanding debt at par. The redemption occurred on June 6, 2016.

The bank receives ratings from two rating agencies:

- On April 6, 2018, Fitch Ratings affirmed the bank's long-term and short-term issuer default ratings (IDRs) at "AA-" and "F1+," respectively, with a stable outlook. Fitch also affirmed the bank's noncumulative perpetual preferred stock rating at "BBB" and its support floor at "AA-." Fitch affirmed the Farm Credit System's long-term and short-term IDRs at "AAA" and "F1+," respectively, with a stable outlook, and its support floor at "AAA." As a government-sponsored entity, the System benefits from implicit government support. The ratings and rating outlook are directly linked to the U.S. sovereign rating. The affirmation of the System banks' IDRs reflect their prudent, conservative credit culture, their unique funding advantage and their structural second-loss position on the majority of their loan portfolio.
- On November 17, 2017, Moody's Investors Service affirmed the bank's issuer rating at "Aa3" and its noncumulative preferred stock rating at "Baa1 (hyb)," with a stable outlook. The Aa3 issuer rating reflects the bank's "a1" baseline credit assessment (BCA), very high cooperative support from the other Federal Farm Credit Banks and moderate support from the U.S. government, which has an "Aaa," stable outlook. The bank's preferred stock rating incorporated the bank's BCA, very high cooperative support from the other Federal Farm Credit Banks and notching reflecting the debt's relative positions in the bank's capital structure. The bank's "a1" BCA incorporates its solid capital levels, adequate risk-adjusted profitability and liquidity, as well as the benefits associated with its lending to related associations and their strong capital levels. The "a1" BCA is one of Moody's highest assessments of any financial institution, both domestically and globally.

The following table provides a summary of the period-end balances of the debt obligations of the district:

| (dollars in thousands)           | December 31,  |               |               |
|----------------------------------|---------------|---------------|---------------|
|                                  | 2017          | 2016          | 2015          |
| Bonds and term notes outstanding | \$ 18,615,696 | \$ 16,838,489 | \$ 15,769,466 |
| Average effective interest rate  | 1.69%         | 1.34%         | 1.26%         |
| Average life (years)             | 2.9           | 2.6           | 2.7           |
| Subordinated debt outstanding    | \$ -          | \$ -          | \$ 49,801     |
| Average effective interest rate  | -             | -             | 8.41%         |
| Average life (years)             | -             | -             | 2.8           |
| Discount notes outstanding       | \$ 2,335,527  | \$ 2,552,173  | \$ 2,437,259  |
| Average effective interest rate  | 1.27%         | 0.63%         | 0.30%         |
| Average life (days)              | 135           | 157           | 110           |
| Notes payable to other           |               |               |               |
| System banks                     | \$ 3,850,000  | \$ 3,850,000  | \$ 3,850,000  |
| Average effective interest rate  | 1.72%         | 1.08%         | 0.73%         |
| Average life (years)             | 1.0 or less   | 1.0 or less   | 1.0 or less   |

The following table provides a summary of the average balances of the debt obligations of the district for the years ended December 31:

|  | 2017          | 2016          | 2015          |
|--|---------------|---------------|---------------|
| Average interest-bearing liabilities outstanding       | \$ 23,996,249 | \$ 22,874,161 | \$ 20,758,571 |
| Average interest rates on interest-bearing liabilities | 1.51%         | 1.24%         | 1.08%         |

## Investments

As permitted under FCA regulations, a bank is authorized to hold eligible investments for the purposes of maintaining a diverse source of liquidity, profitably managing short-term surplus funds and managing interest rate risk. The bank is authorized to hold an amount not to exceed 35 percent of loans outstanding. The bank's holdings are within this limit as of December 31, 2017. FCA regulations also permit an association to hold eligible investments with the approval of its affiliated bank.

FCA regulations also define eligible investments by specifying credit-rating criteria, final maturity limit and percentage of investment portfolio limit for each investment type. Generally, the bank's investments 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 eligibility rating criteria, the investment becomes ineligible.

The bank's available-for-sale investments include a liquidity portfolio and a portfolio of other investments. The majority of the liquidity portfolio's mortgage-backed securities were federal agency-guaranteed collateralized mortgage-backed securities, including Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) securities. The other investments portfolio consists of Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed agricultural mortgage-backed securities (AMBS).

A summary of the amortized cost and fair value of investment securities available for sale, at December 31:

|   | 2017               |                     | 2016           |              |
|---|--------------------|---------------------|----------------|--------------|
|   | Amortized Cost     | Fair Value          | Amortized Cost | Fair Value   |
| Agency-guaranteed debt                                    | \$ 198,246         | \$ 195,248          | \$ 225,457     | \$ 222,374   |
| Corporate debt  | 252,482            | 252,609             | 202,365        | 202,403      |
| Federal agency collateralized mortgage-backed securities: |                    |                     |                |              |
| GNMA  | 2,012,484          | 1,984,662           | 1,697,627      | 1,682,999    |
| FNMA & FHLMC  | 2,395,248          | 2,372,053           | 2,308,775      | 2,290,579    |
| U.S. Treasury securities                                  | 249,860            | 249,207             | 249,502        | 249,006      |
| Asset-backed securities                                   | 47,914             | 47,889              | 130,703        | 130,679      |
| <b>Total liquidity investments</b>                        | <b>\$5,156,234</b> | <b>\$ 5,101,668</b> | \$ 4,814,429   | \$ 4,778,040 |

The district's other investments, totaling \$62.1 million, consisted of Farmer Mac AMBS. The bank held AMBS with a fair value of \$43.3 million in an available-for-sale other investments portfolio, and associations held AMBS with an amortized cost of \$18.8 million in a held-to-maturity portfolio. The Farmer Mac securities are backed by loans originated by the associations and previously held by the associations under the Farmer Mac long-term standby commitments to purchase agreements.

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

The bank's available-for-sale other investments portfolio, which is not included in its liquidity portfolio, consisted of Farmer Mac AMBS at December 31:

|   | 2017           |            | 2016           |            |
|---|----------------|------------|----------------|------------|
|   | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Agricultural mortgage-backed securities | \$ 45,564      | \$ 43,317  | \$ 55,475      | \$ 53,335  |

During 2017, 2016 and 2015, the bank had no credit losses related to OTTI securities. The bank held no securities that were designated as OTTI securities at December 31, 2017 and December 31, 2016. The composition and characteristics of the district's investment securities are described in Note 3, "Investment Securities," to the accompanying combined financial statements.

## Capital Adequacy

District members' equity totaled \$4.28 billion at December 31, 2017, including \$620.0 million in preferred stock, \$66.0 million in capital stock and participation certificates, \$3.53 billion in retained earnings and \$224.6 million in additional paid-in-capital, offset by accumulated other comprehensive losses of \$162.9 million.

*Bank Class B Series 1 Noncumulative Subordinated Perpetual Preferred Stock (Class B-1 preferred stock)* – On August 26, 2010, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, representing 300,000 shares at \$1,000 per share par value for net proceeds of \$296.6 million. The net proceeds of the issuance were used to increase the bank’s capital and for general corporate purposes. Dividends on the preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable semi-annually in arrears on the fifteenth day of June and December in each year, commencing December 15, 2010, at an annual fixed rate of 10 percent of par value of \$1,000 per share. The Class B-1 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank after the dividend payment date in June 2020. The Class B-1 preferred stock ranks, both as to dividends and upon liquidation, senior to all of our outstanding capital stock. Class B-1 preferred stock dividends are required by “dividend/patronage stopper” clauses to be declared and accrued before payment of bank investment and direct note patronage to associations and OFIs can be paid. In 2017, 2016 and 2015, Class B-1 preferred stock dividends totaling \$30.0 million for each respective year were declared and paid. At December 31, 2017, dividends payable on Class B-1 preferred stock totaled \$15.0 million.

*Bank Class B Series 2 Noncumulative Subordinated Perpetual Preferred Stock (Class B-2 preferred stock)* – On July 23, 2013, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, Series 2, representing three million shares at \$100 per share par value, for net proceeds of \$295.9 million. Dividends on the Class B-2 preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable quarterly in arrears on the fifteenth day of March, June, September and December in each year, commencing September 15, 2013, at an annual fixed rate of 6.75 percent of par value of \$100 per share up to, but excluding September 15, 2023, from and after which date will be paid at an annual rate of the 3-Month USD LIBOR plus 4.01 percent. The Class B-2 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank on any dividend payment date on or after September 15, 2023. The Class B-2 preferred stock ranks, both as to dividends and upon liquidation, pari passu with respect to the existing Class B-1 preferred stock, and senior to all of the bank’s outstanding capital stock. Class B-2 preferred stock dividends are required by “dividend/patronage stopper” clauses to be declared and accrued before payment of bank investment and direct note patronage to associations and OFIs can be paid. In 2017, 2016 and 2015, Class B-2 preferred stock dividends totaling \$20.3 million for each respective year were declared and paid. At December 31, 2017, dividends payable on Class B-2 preferred stock totaled \$5.1 million.

During the first quarter of 2017 a district association issued \$20.0 million shares of fixed-to-floating perpetual cumulative preferred stock with a par value of \$1.00 per share. The preferred stock will have a fixed rate dividend of 5.0 percent above 6-month LIBOR. On or after five years, the association may, at its option, redeem all or part of the preferred stock. In 2017, fixed-to-floating perpetual cumulative preferred stock dividends totaling \$500 were declared and paid by a district association.

Borrower equity purchases required by association capitalization bylaws (see Note 9, “Members’ Equity,” to the accompanying combined financial statements), combined with a history of growth in

retained earnings at district institutions, have resulted in district institutions being able to maintain strong capital positions. The \$4.28 billion capital position of the district at December 31, 2017, reflects an increase of 4.4 percent over the December 31, 2016, capital position of \$4.10 billion. This increase is attributable to net income of \$439.4 million in 2017, a net increase in capital stock and allocated earnings of \$55.4 million and issuance of \$20.0 million in preferred stock at a district association, offset by patronage declared of \$178.9 million, dividends accrued and paid on preferred stock totaling \$50.8 million, and a \$4.9 million increase in accumulated other comprehensive loss.

In 2016, one of the district’s associations transferred its balance of non-restricted nonqualified surplus from unallocated retained earnings to allocated retained earnings within the member’s equity sections of the combined financial statements. The decision for the transfer was to consider the nonqualified surplus eligible for future distribution, although no formal distribution schedule exists and any future distribution of this nonqualified surplus is solely restricted to the discretion of the association’s board of directors. The transfer resulted in an increase of \$36.0 million in allocated retained earnings and a decrease by the same amount in unallocated retained earnings in year 2016.

During the third quarter of 2017, the association Class A Common Stockholders approved an amendment to the bank’s capitalization bylaws. The amended bylaws became effective September 15, 2017, resulting in updates to certain sections of the bylaws to conform to the FCA’s updated capital adequacy regulations. The amendments did not result in significant changes to the regulatory capital requirements of the bank as of December 31, 2017.

Accumulated other comprehensive loss totaled \$162.9 million at December 31, 2017, an increase of \$4.9 million from December 31, 2016. The \$4.9 million increase in accumulated other comprehensive losses included \$18.3 million in unrealized losses on investments, offset by the amortization of \$13.1 million in net unrealized pension and other postretirement benefit costs, and unrealized gains of \$305 in cash flow interest rate swaps and interest rate caps.

The return on average members’ equity for the year ended December 31, 2017 was 10.1 percent, compared to 10.4 percent and 10.8 percent reported for the years ended December 31, 2016 and 2015, respectively.

FCA regulations require System institutions to compute common equity tier 1 ratio, tier 1 capital ratio, total capital ratio, permanent capital ratio, tier 1 leverage ratio and a unallocated retained earnings equivalents (UREE) ratio, and maintain at least the minimum standard for each ratio. In those instances where an entity may not be in compliance, the regulations require the entity to submit a corrective plan to the FCA designed to move the institution into compliance. As of December 31, 2017, the bank and all district associations were in compliance with the regulations. Note 9, “Members’ Equity,” to the accompanying combined financial statements outlines the ranges of capital ratios for the bank and district associations. The bank’s tier 1 capital ratio of 16.6 percent at December 31, 2017, is considered adequate, in accordance with the capital plan adopted by the bank’s board of directors.

Capital adequacy is evaluated using various ratios for which the FCA has established regulatory minimums. Effective January 1, 2017, the new regulatory capital ratios were implemented by the

bank and associations. Regulatory ratios remained well above regulatory minimums, including the conservation and leverage buffers at December 31, 2017.

The following table reflects the bank and associations' capital ratios at December 31:

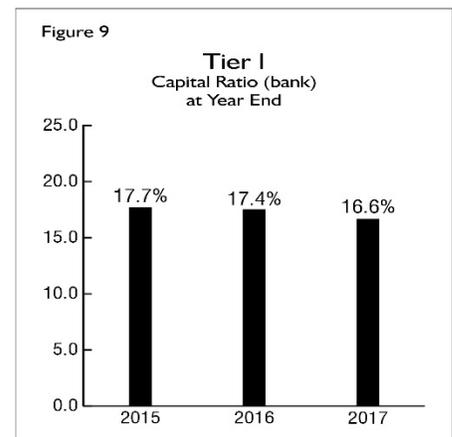
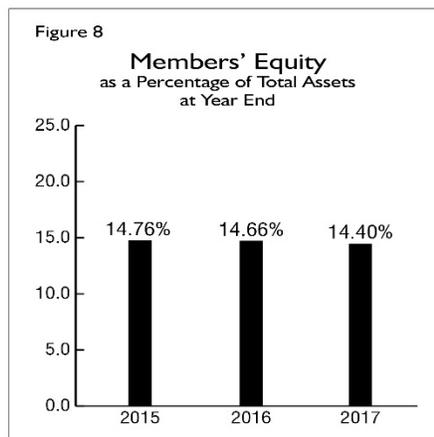
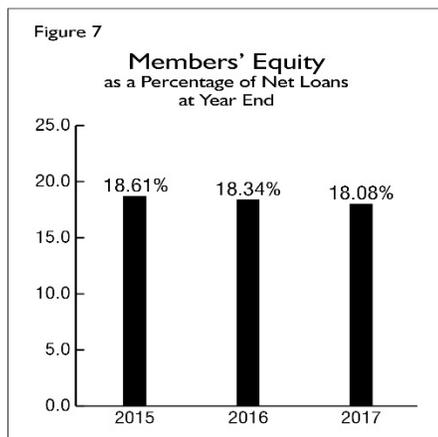
|                                   | Bank   | FLCA   | ACAs            | Total Regulatory Requirement |
|-----------------------------------|--------|--------|-----------------|------------------------------|
| Permanent capital ratio ranges    | 16.60% | 17.15% | 13.20% - 23.00% | 7.00%                        |
| Common equity tier 1 ratio ranges | 10.52  | 17.10  | 12.27 - 22.81   | 7.00                         |
| Tier 1 capital ratio ranges       | 16.59  | 17.10  | 12.27 - 22.81   | 8.50                         |
| Total capital ratio ranges        | 16.68  | 17.41  | 13.53 - 23.63   | 10.50                        |
| Tier 1 leverage ratio ranges      | 7.33   | 17.74  | 10.76 - 21.68   | 5.00                         |
| UREE leverage ratio ranges        | 3.08   | 18.86  | 9.23 - 22.76    | 1.50                         |

The following table reflects the bank's capital ratios effective prior to January 1, 2017 at December 31:

|                       | 2016   | 2015   | 2014   | 2013   | 2012   | Total Regulatory Requirement |
|-----------------------|--------|--------|--------|--------|--------|------------------------------|
| Total surplus ratio   | 14.98% | 15.48% | 15.86% | 17.29% | 15.92% | 7.00%                        |
| Core surplus ratio    | 9.97   | 9.88   | 10.07  | 10.12  | 9.92   | 3.50                         |
| Net collateral ratio* | 107.35 | 107.70 | 108.00 | 108.67 | 107.94 | 103.00                       |

\*The bank's minimum net collateral ratio for regulatory purposes while any subordinated debt was outstanding was 104.00. The bank redeemed all of its outstanding subordinated debt in June 2016. The debt was issued in September 2008.

An analysis of the trend in the district's capital ratios is presented in Figures 7, 8 and 9.



## Operational Risk Management

Operational risk is the risk of loss resulting from inadequate or failed processes or systems, human factors or external events, including the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system, and the risk of fraud by employees or persons outside the System. The board of directors of each institution is required, by regulation, to adopt an internal control policy that provides adequate direction to the institution in establishing effective control over and accountability for operations, programs and resources.

The policy must include, at a minimum, the following items:

- direction to management that assigns responsibility for the internal control function to an officer of the institution;
- adoption of internal audit and control procedures;
- direction for the operation of a program to review and assess its assets;
- adoption of loan, loan-related assets and appraisal review standards, including standards for scope of review selection and standards for work papers and supporting documentation;
- adoption of asset quality classification standards;

- adoption of standards for assessing credit administration, including the appraisal of collateral; and
- adoption of standards for the training required to initiate a program.

In general, we address operational risk through the organization's internal governance structure. Exposure to operational risk is typically identified with the assistance of senior management, and internal audit plans are risk-based and are re-evaluated on an annual basis, or more frequently, if necessary. The board of directors is responsible for defining the role of the audit committee in providing oversight and review of the institution's internal controls.

## Reputational Risk Management

Reputational risk is defined as the negative impact resulting from events, real or perceived, that shape the image of the bank, the System or any of its entities. The bank and its affiliated associations could be harmed if its reputation were impacted by negative publicity about the System as a whole, an individual System entity or the agriculture industry in general.

Reputational risk is the direct responsibility of each System entity. For reputational issues that have broader consequences for the System as a whole, System governance will communicate guidance to the System supporting those business practices that are consistent with our mission.

## Political Risk Management

We, as part of the System, are an instrumentality of the federal government and are intended to further governmental policy concerning the extension of credit to or for the benefit of agricultural and rural America. The System and its borrowers may be significantly affected by federal legislation that affects the System directly, such as changes to the Farm Credit Act, or indirectly, such as agricultural appropriations bills. Political risk to the System is the risk of loss of support for the System or agriculture by the U.S. government.

We manage political risk by actively supporting The Farm Credit Council (Council), which is a full-service, federal trade association representing the System before Congress, the executive branch and others. The Council provides the mechanism for “grassroots” involvement in the development of System positions and policies with respect to federal legislation and government actions that impact the System. Additionally, we take an active role in representing the individual interests of System institutions and their borrowers before Congress. In addition to the Council, each district has its own council, which is a member of the Council. The district councils represent the interests of their members on a local and state level, as well as on a federal level.

## Recent Accounting Pronouncements

In August 2017, the Financial Accounting Standards Board (FASB) issued guidance entitled “Targeted Improvements to Accounting for Hedging Activities.” The guidance better aligns an entity’s risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments in this guidance require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This guidance also addresses the timing of effectiveness testing, qualitative and quantitative effectiveness testing and components that can be excluded from effectiveness testing. This guidance becomes effective for interim and annual periods beginning after December 15, 2018. The district is evaluating the impact of adoption on the district’s financial condition and its results of operations.

In March 2017, the FASB issued guidance entitled “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Cost.” The guidance requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. Other components are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. This guidance became effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance will not impact the district’s financial condition but will change the classification of certain items in its results of operations.

In August 2016, the FASB issued guidance entitled “Classification of Certain Cash Receipts and Cash Payments.” The guidance addresses specific cash flow issues with the objective of reducing the diversity in

the classification of these cash flows. Included in the cash flow issues are debt repayment or debt extinguishment costs and settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing. This guidance became effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance is not expected to impact the district’s financial condition or its results of operations but will change the classification of certain items in the statement of cash flows.

In June 2016, the FASB issued guidance entitled “Measurement of Credit Losses on Financial Instruments.” The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. For public business entities that are not U.S. Securities and Exchange Commission filers this guidance becomes effective for interim and annual periods beginning after December 15, 2020, with early application permitted. The district is evaluating the impact of adoption on the district’s financial condition and its results of operations.

In February 2016, the FASB issued guidance entitled “Leases.” The guidance requires the recognition by lessees of lease assets and lease liabilities on the balance sheet for the rights and obligations created by those leases. Leases with lease terms of more than 12 months are impacted by this guidance. This guidance becomes effective for interim and annual periods beginning after December 15, 2018, with early application permitted. The district is evaluating the impact of adoption on its financial condition and results of operations.

In January 2016, the FASB issued guidance entitled “Recognition and Measurement of Financial Assets and Liabilities.” The guidance affects, among other things, the presentation and disclosure requirements for financial instruments. For public entities, the guidance eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments carried at amortized cost. This guidance became effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance will not impact the district’s financial condition or its results of operations.

In May 2015, the FASB issued guidance entitled “Disclosure for Investments in Certain Entities That Calculate Net Asset per Share (or Its Equivalent)” related to measuring the fair value of certain investments using the net assets value per share of the investment. The amendments remove the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. This guidance was effective for the annual period beginning after December 15, 2016, retrospectively, and for annual periods thereafter. Earlier

application was permitted. In 2016, the district adopted this guidance, which did not have a significant impact on the district's financial statements. See Note 11, "Employee Benefit Plans," for additional information.

In May 2014, the FASB issued guidance entitled, "Revenue from Contracts with Customers." The guidance governs revenue recognition from contracts with customers and requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Financial instruments and other contractual rights within the scope of other guidance issued by the FASB are excluded from the scope of this new revenue recognition guidance. In this regard, a majority of our contracts would be excluded from the scope of this new guidance. In August 2015, the FASB issued an update that deferred this guidance by one year, which resulted in the new revenue standard becoming effective for interim and annual reporting periods beginning after December 15, 2017. The district has determined that the effect of adoption is not material to the combined financial condition or results of operations and will not change its current recognition practices.

## Regulatory Matters

At December 31, 2017, there were no district associations under written agreements with the Farm Credit Administration.

On July 28, 2016, the Farm Credit Administration published a final regulation to modify the regulatory capital requirements for System banks and associations. The stated objectives of the rule were as follows:

- To modernize capital requirements while ensuring that the institutions continue to hold sufficient regulatory capital to fulfill their mission as a government-sponsored enterprise,
- To ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach that the federal banking regulatory agencies have adopted, but also to ensure that the rules recognize the cooperative structure and the organization of the System,
- To make System regulatory capital requirements more transparent, and
- To meet the requirements of section 939A of the Dodd-Frank Act.

The final rule replaced existing core surplus and total surplus requirements with common equity tier 1, tier 1 capital and total capital risk-based capital ratio requirements. The final rule also replaced the existing net collateral ratio with a tier 1 leverage ratio and is applicable to all banks and associations. The permanent capital ratio will continue to remain in effect with the final rule.

The new capital requirements became effective January 1, 2017, with a three-year phase-in of the capital conservation buffer applied to the

risk-adjusted capital ratios. The bank and its affiliated associations are in compliance with the required minimum capital standards and met the conservation buffers as of December 31, 2017.

On June 12, 2014, the Farm Credit Administration (FCA) approved a proposed rule to revise the requirements governing the eligibility of investments for System banks and associations. The stated objectives of the proposed rule are as follows:

- To strengthen the safety and soundness of System banks and associations,
- To ensure that System banks hold sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption,
- To enhance the ability of the System banks to supply credit to agricultural and aquatic producers,
- To comply with the requirements of section 939A of the Dodd-Frank Act,
- To modernize the investment eligibility criteria for System banks, and
- To revise the investment regulation for System associations to improve their investment management practices so they are more resilient to risk.

On May 10, 2018, the Farm Credit Administration adopted a final rule that primarily implements the requirements of Section 939A of the Dodd-Frank Act and grants associations greater flexibility regarding the risk management purposes for which they hold investments while establishing new limits on the amount and types of investments they may hold. The final rule will become effective January 1, 2019.

## Other

New U.S. tax laws resulting from legislation commonly known as the Tax Cuts and Jobs Acts of 2017 (TCJA) were enacted in late 2017. Among other things, the TCJA changed the federal corporate tax rate from 35 percent to 21 percent. The bank is exempt from federal and certain other income taxes as provided by the Farm Credit Act; however, the change in the federal corporate tax rate had a financial statement impact for year-end 2017 for district associations that had required the revaluation of any deferred taxes (assets or liabilities), which resulted in either a tax expense or tax benefit to the income statement. While the full impact of the TCJA is difficult to predict and may not be fully known for several years, changes that could affect the bank and associations' business and customers include, but are not limited to, modifications to deductions surrounding interest expense and equipment purchases, tax incentives related to renewable energy initiatives, deductions impacting agricultural producers who sell their products to cooperatives and the overall changes in the competitive environment impacting financial institutions.



## Report of Management

The Farm Credit Bank of Texas and the Texas Farm Credit District Associations

The accompanying combined financial statements of the Farm Credit Bank of Texas (bank) and its affiliated associations, collectively referred to as the district, are prepared by management, which is responsible for their integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The combined financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America. Other financial information included in the annual report is consistent with that in the combined financial statements.

To meet its responsibility for reliable financial information, management depends on the accounting and internal control systems which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. The systems have been designed to recognize that the cost of internal controls must be related to the benefits derived. The combined financial statements are audited by PricewaterhouseCoopers LLP (PwC), independent auditors, who also obtain an understanding of internal controls to the extent necessary to comply with auditing standards generally accepted in the United States of America. The Farm Credit Bank of Texas and district associations are also examined by the Farm Credit Administration.

In the opinion of management, the combined financial statements are true and correct and fairly state the financial position of the bank and district associations at December 31, 2017, 2016 and 2015. The independent auditors have direct access to the audit committee, which is composed solely of directors who are not officers or employees of the bank or district associations.

The undersigned certify that we have reviewed the December 31, 2017, annual 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.

James F. Dodson  
Chairman of the Board

Larry R. Doyle  
Chief Executive Officer

Amie Pala  
Chief Financial Officer

May 30, 2018



## Report of Audit Committee

The Farm Credit Bank of Texas and the Texas Farm Credit District Associations

The audit committee (committee) is composed of the entire board of directors of the Farm Credit Bank of Texas (bank). None of the directors who serve on the committee is an employee of the bank and in the opinion of the board of directors, each is free of any relationship with the bank or management that would interfere with the director's independent judgment on the committee.

The committee has adopted a written charter that has been approved by the board of directors. The committee has reviewed and discussed the audited financial statements with management, which has primary responsibility for the financial statements. The financial statements were prepared under the oversight of the committee.

PricewaterhouseCoopers LLP (PwC), the bank and district associations combined independent auditors for 2017, is responsible for expressing an opinion on the conformity of the bank and district associations combined audited financial statements with accounting principles generally accepted in the United States of America. The committee has discussed with PwC the matters that are required to be discussed by Statement on Auditing Standards No. 114 (The Auditor's Communication With Those Charged With Governance). The committee discussed with PwC its independence from the bank and district associations combined. The committee also reviewed the non-audit services provided by PwC and concluded that these services were not incompatible with maintaining PwC's independence.

Based on the considerations referred to above, the committee recommended to the board of directors that the audited financial statements be included in the bank and district associations combined Annual Report for 2017. The foregoing report is provided by the following independent directors, who constitute the committee:

Brad C. Bean, Chairman  
M. Philip Guthrie, Vice Chairman  
Ralph W. Cortese  
James F. Dodson  
Linda C. Floerke  
Elizabeth G. Flores  
Lester Little

Audit Committee Members

May 30, 2018



## Report on Internal Control Over Financial Reporting

The Farm Credit Bank of Texas' (bank's) and each affiliated district association's (district association's) principal executives and principal financial officers are responsible for establishing and maintaining adequate internal control over financial reporting for their respective financial statements. For purposes of this report, "internal controls over financial reporting" is defined as a process designed by, or under the supervision of, the bank's and each district association's respective principal executives and principal financial officers, or persons performing similar functions, with review by their respective board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting information used in the preparation of the combined district financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). Internal controls over financial reporting include those policies and procedures that: (1) pertain to the maintenance of records, that in reasonable detail accurately and fairly reflect the respective transactions and dispositions of the assets of the bank and each district association; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial information in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the bank and each district association; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the bank's and each district association's assets that could have a material effect on the institution's or the combined district financial statements.

The bank's and each district association's management has completed an assessment of the effectiveness of their respective internal control over financial reporting as of December 31, 2017. In making their assessments, management used the updated Internal Control – Integrated Framework promulgated by the Committee of Sponsoring Organizations of the Treadway Commission on May 14, 2013, commonly referred to as the "COSO 2013 Framework." This evaluation of the district financial statements relies upon the evaluations made by the bank and by its associations through the individual certifications that each association provides to the bank.

Based on the assessment of internal controls over financial reporting as of December 31, 2017, the district has concluded that the combined financial results of the bank and its affiliated district associations resulted in material weaknesses over internal controls related to the design and operating effectiveness of certain controls at one district association.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that creates a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis.

A district association concluded that material weaknesses in internal controls over financial reporting existed in the following areas as of December 31, 2017:

- Disbursements – loan disbursements (check and construction draws) were made without proper documentation and approval. Checks could be issued without being complete, accurate and properly recorded due to lack of segregation of duties;
- Cash Control Transfers – policies and procedures related to transfers between loan accounts were not in place, thereby allowing inaccurate entries to the loan accounting system;
- Segregation of Duties – there were ineffective segregation of duties and monitoring processes related to several system accesses in the loan origination and accounting systems, which created the potential for unauthorized activity.

With the exception of this association, no other material weaknesses in internal controls over financial reporting were found in the bank and its other affiliated district associations as of December 31, 2017, which impacted the district's assessment.

Larry R. Doyle  
Chief Executive Officer

Amie Pala  
Chief Financial Officer

May 30, 2018



## **Report of Independent Auditors**

To the Board of Directors of Farm Credit Bank of Texas and Texas Farm Credit District Associations

We have audited the accompanying combined financial statements of Farm Credit Bank of Texas and Texas Farm Credit District Associations (the District), which comprise the combined balance sheets as of December 31, 2017, 2016, and 2015, and the related combined statements of comprehensive income, changes in members' equity and cash flows for the years then ended.

### ***Management's Responsibility for the Combined Financial Statements***

Management is responsible for the preparation and fair presentation of the combined financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of combined financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditors' Responsibility***

Our responsibility is to express an opinion on the combined financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the District's preparation and fair presentation of the combined financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the District's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the combined financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Farm Credit Bank of Texas and Texas Farm Credit District Associations as of December 31, 2017, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*PricewaterhouseCoopers LLP*

May 30, 2018

# Combined Balance Sheets

## FARM CREDIT BANK OF TEXAS AND DISTRICT ASSOCIATIONS

| <i>(dollars in thousands)</i>  | December 31,         |                      |                      |
|--|----------------------|----------------------|----------------------|
|  | 2017                 | 2016                 | 2015                 |
| <b>Assets</b>  |                      |                      |                      |
| Cash   | \$ 66,953            | \$ 207,229           | \$ 550,852           |
| Federal funds sold and overnight investments   | 246,888              | 22,901               | 22,413               |
| Investment securities  | 5,163,813            | 4,857,068            | 4,475,318            |
| Loans (includes \$9,908, \$16,311 and \$27,506 at fair value held under fair value option) | 23,745,668           | 22,426,117           | 21,181,818           |
| Less allowance for loan losses   | 83,268               | 81,737               | 70,350               |
| Net loans  | <u>23,662,400</u>    | <u>22,344,380</u>    | <u>21,111,468</u>    |
| Accrued interest receivable  | 202,748              | 182,012              | 166,462              |
| Other property owned   | 15,569               | 19,354               | 18,744               |
| Premises and equipment, net  | 134,617              | 122,645              | 105,040              |
| Other assets   | 224,134              | 197,202              | 166,717              |
| <b>Total assets</b>  | <u>\$ 29,717,122</u> | <u>\$ 27,952,791</u> | <u>\$ 26,617,014</u> |
| <b>Liabilities and members' equity</b>   |                      |                      |                      |
| Liabilities  |                      |                      |                      |
| Bonds and notes, net   | \$ 24,801,223        | \$ 23,240,663        | \$ 22,056,726        |
| Subordinated debt, net   | -                    | -                    | 49,801               |
| Accrued interest payable   | 70,197               | 54,245               | 47,351               |
| Patronage distributions payable  | 170,022              | 157,101              | 141,878              |
| Preferred stock dividends payable  | 20,063               | 20,063               | 20,063               |
| Other liabilities  | 377,721              | 381,798              | 372,569              |
| <b>Total liabilities</b>   | <u>25,439,226</u>    | <u>23,853,870</u>    | <u>22,688,388</u>    |
| <b>Commitments and contingencies (Note 13)</b>   |                      |                      |                      |
| <b>Members' equity</b>   |                      |                      |                      |
| Preferred stock  | 620,000              | 600,000              | 600,000              |
| Common stock and participation certificates  | 65,982               | 64,434               | 62,456               |
| Allocated retained earnings  | 685,506              | 631,647              | 548,804              |
| Unallocated retained earnings  | 2,844,643            | 2,736,197            | 2,649,685            |
| Additional paid-in-capital   | 224,625              | 224,625              | 224,625              |
| Accumulated other comprehensive loss   | (162,860)            | (157,982)            | (156,944)            |
| <b>Total members' equity</b>   | <u>4,277,896</u>     | <u>4,098,921</u>     | <u>3,928,626</u>     |
| <b>Total liabilities and members' equity</b>   | <u>\$ 29,717,122</u> | <u>\$ 27,952,791</u> | <u>\$ 26,617,014</u> |

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

# Combined Statements of Comprehensive Income

## FARM CREDIT BANK OF TEXAS AND DISTRICT ASSOCIATIONS

| <i>(dollars in thousands)</i>                              | Year Ended December 31, |                   |                   |
|--|-------------------------|-------------------|-------------------|
|  | 2017                    | 2016              | 2015              |
| Investment securities                                      | \$ 85,791               | \$ 70,658         | \$ 62,149         |
| Loans  | 1,048,370               | 940,663           | 859,347           |
| <b>Total interest income</b>                               | <b>1,134,161</b>        | <b>1,011,321</b>  | <b>921,496</b>    |
| Bonds, notes and subordinated debt                         | 296,197                 | 242,191           | 191,625           |
| Notes payable and other                                    | 67,011                  | 42,324            | 31,935            |
| <b>Total interest expense</b>                              | <b>363,208</b>          | <b>284,515</b>    | <b>223,560</b>    |
| <b>Net interest income</b>                                 | <b>770,953</b>          | <b>726,806</b>    | <b>697,936</b>    |
| Provision for loan losses                                  | 5,065                   | 11,492            | 5,653             |
| <b>Net interest income after provision for loan losses</b> | <b>765,888</b>          | <b>715,314</b>    | <b>692,283</b>    |
| Patronage income   | 25,400                  | 28,875            | 21,878            |
| Fees for loan-related services                             | 28,033                  | 30,022            | 28,584            |
| Loss on loans held under fair value option                 | (300)                   | (418)             | (838)             |
| Other income, net  | 10,261                  | 8,896             | 6,147             |
| <b>Total noninterest income</b>                            | <b>63,394</b>           | <b>67,375</b>     | <b>55,771</b>     |
| Salaries and employee benefits                             | 206,448                 | 199,453           | 190,895           |
| Occupancy and equipment                                    | 33,307                  | 30,846            | 28,775            |
| Insurance Fund premiums                                    | 31,846                  | 34,206            | 23,953            |
| (Gain) loss on other property owned, net                   | (308)                   | 2,179             | (2,985)           |
| Other operating expenses                                   | 118,112                 | 82,474            | 80,652            |
| <b>Total noninterest expense</b>                           | <b>389,405</b>          | <b>349,158</b>    | <b>321,290</b>    |
| <b>Income before income taxes</b>                          | <b>439,877</b>          | <b>433,531</b>    | <b>426,764</b>    |
| Provision for income (benefit from) taxes                  | 482                     | 91                | (75)              |
| <b>Net income</b>  | <b>\$ 439,395</b>       | <b>\$ 433,440</b> | <b>\$ 426,839</b> |
| <b>Other comprehensive (loss) gain</b>                     |                         |                   |                   |
| Change in pension and postretirement benefit plans         | 13,100                  | 3,887             | 18,235            |
| Change in unrealized loss on investments                   | (18,283)                | (13,253)          | (9,176)           |
| Change in cash flow derivative instruments                 | 305                     | 8,328             | 788               |
| <b>Total other comprehensive (loss) gain</b>               | <b>(4,878)</b>          | <b>(1,038)</b>    | <b>9,847</b>      |
| <b>Comprehensive Income</b>                                | <b>\$ 434,517</b>       | <b>\$ 432,402</b> | <b>\$ 436,686</b> |

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

# Combined Statements of Changes in Members' Equity

## FARM CREDIT BANK OF TEXAS AND DISTRICT ASSOCIATIONS

| <i>(dollars in thousands)</i>   | Preferred Stock | Common Stock and Participation Certificates | Retained Earnings |                  |                  | Additional Paid-in-Capital | Accumulated Other Comprehensive Loss | Total Members' Equity |
|---|-----------------|---|-------------------|------------------|------------------|----------------------------|--------------------------------------|-----------------------|
|   |                 |   | Allocated         | Unallocated      | Total            |                            |                                      |                       |
| Balance at December 31, 2014  | \$ 600,000      | \$ 60,242                                   | \$ 505,779        | \$ 2,594,156     | \$ 3,099,935     | \$ 149,179                 | \$ (166,791)                         | \$ 3,742,565          |
| Net income  | -               | -   | -                 | 426,839          | 426,839          | -                          | -                                    | 426,839               |
| Other comprehensive income  | -               | -   | -                 | -                | -                | -                          | 9,847                                | 9,847                 |
| Capital stock/participation certificates and allocated retained earnings issued         | -               | 9,793                                       | -                 | -                | -                | -                          | -                                    | 9,793                 |
| Capital stock/participation certificates and allocated retained earnings retired        | -               | (7,579)                                     | (44,953)          | -                | (44,953)         | -                          | -                                    | (52,532)              |
| Equity issued upon association merger   | -               | -   | -                 | -                | -                | 75,446                     | -                                    | 75,446                |
| Equity retired upon association merger  | -               | -   | -                 | (75,446)         | (75,446)         | -                          | -                                    | (75,446)              |
| Net reduction in surplus due to net fair value adjustments related to merger            | -               | -   | -                 | (2,916)          | (2,916)          | -                          | -                                    | (2,916)               |
| Preferred stock dividends   | -               | -   | -                 | (50,250)         | (50,250)         | -                          | -                                    | (50,250)              |
| Patronage distributions   |                 |   |                   |                  |                  |                            |                                      |                       |
| Cash  | -               | -   | -                 | (154,720)        | (154,720)        | -                          | -                                    | (154,720)             |
| Members' equity   | -               | -   | 87,978            | (87,978)         | -                | -                          | -                                    | -                     |
| Balance at December 31, 2015  | 600,000         | 62,456                                      | 548,804           | 2,649,685        | 3,198,489        | 224,625                    | (156,944)                            | 3,928,626             |
| Net income  | -               | -   | -                 | 433,440          | 433,440          | -                          | -                                    | 433,440               |
| Other comprehensive loss  | -               | -   | -                 | -                | -                | -                          | (1,038)                              | (1,038)               |
| Capital stock/participation certificates and allocated retained earnings issued         | -               | 9,873                                       | -                 | -                | -                | -                          | -                                    | 9,873                 |
| Capital stock/participation certificates and allocated retained earnings retired        | -               | (7,895)                                     | (44,525)          | -                | (44,525)         | -                          | -                                    | (52,420)              |
| Preferred stock dividends   | -               | -   | -                 | (50,250)         | (50,250)         | -                          | -                                    | (50,250)              |
| Patronage distributions   |                 |   |                   |                  |                  |                            |                                      |                       |
| Cash  | -               | -   | -                 | (169,310)        | (169,310)        | -                          | -                                    | (169,310)             |
| Members' equity   | -               | -   | 91,331            | (91,331)         | -                | -                          | -                                    | -                     |
| Transfer of nonqualified surplus  | -               | -   | 36,037            | (36,037)         | -                | -                          | -                                    | -                     |
| Balance at December 31, 2016  | 600,000         | 64,434                                      | 631,647           | 2,736,197        | 3,367,844        | 224,625                    | (157,982)                            | 4,098,921             |
| <b>Net income</b>   | -               | -   | -                 | <b>439,395</b>   | <b>439,395</b>   | -                          | -                                    | <b>439,395</b>        |
| <b>Other comprehensive loss</b>   | -               | -   | -                 | -                | -                | -                          | <b>(4,878)</b>                       | <b>(4,878)</b>        |
| <b>Capital stock/participation certificates and allocated retained earnings issued</b>  | -               | <b>9,768</b>                                | -                 | -                | -                | -                          | -                                    | <b>9,768</b>          |
| <b>Capital stock/participation certificates and allocated retained earnings retired</b> | -               | <b>(8,220)</b>                              | <b>(47,351)</b>   | -                | <b>(47,351)</b>  | -                          | -                                    | <b>(55,571)</b>       |
| <b>Preferred stock issued</b>   | <b>20,000</b>   | -   | -                 | -                | -                | -                          | -                                    | <b>20,000</b>         |
| <b>Issuance costs on preferred stock</b>  | -               | -   | -                 | <b>(136)</b>     | <b>(136)</b>     | -                          | -                                    | <b>(136)</b>          |
| <b>Preferred stock dividends</b>  | -               | -   | -                 | <b>(50,750)</b>  | <b>(50,750)</b>  | -                          | -                                    | <b>(50,750)</b>       |
| <b>Patronage distributions</b>  |                 |   |                   |                  |                  |                            |                                      |                       |
| <b>Cash</b>   | -               | -   | -                 | <b>(178,853)</b> | <b>(178,853)</b> | -                          | -                                    | <b>(178,853)</b>      |
| <b>Members' equity</b>  | -               | -   | <b>101,210</b>    | <b>(101,210)</b> | -                | -                          | -                                    | -                     |
| Balance at December 31, 2017  | \$ 620,000      | \$ 65,982                                   | \$ 685,506        | \$ 2,844,643     | \$ 3,530,149     | \$ 224,625                 | \$ (162,860)                         | \$ 4,277,896          |

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

# Combined Statements of Cash Flows

## FARM CREDIT BANK OF TEXAS AND DISTRICT ASSOCIATIONS

| <i>(dollars in thousands)</i>  | Year Ended December 31, |                    |                    |
|--|-------------------------|--------------------|--------------------|
|  | 2017                    | 2016               | 2015               |
| <b>Cash Flow From Operating Activities</b>   |                         |                    |                    |
| Net income   | \$ 439,395              | \$ 433,440         | \$ 426,839         |
| Reconciliation of net income to net cash provided by operating activities                        |                         |                    |                    |
| Provision for loan losses  | 5,065                   | 11,492             | 5,653              |
| Carrying value adjustments on other property owned   | 965                     | 846                | 1,486              |
| (Gain) loss from sales of other property owned   | (1,390)                 | 913                | (4,597)            |
| Depreciation and amortization on premises and equipment  | 16,341                  | 15,068             | 13,697             |
| Accretion of net premium on loans  | 6,310                   | 9,405              | 11,765             |
| Amortization and accretion on debt instruments   | 27,916                  | 27,153             | 14,326             |
| Accretion of yield related to loans and notes payable acquired in merger                         | (959)                   | (2,256)            | -                  |
| Accretion of net premium on investments  | 5,518                   | 3,711              | 1,064              |
| Net change in fair value of concessions granted  | 14,625                  | -                  | -                  |
| Decrease in fair value of loans held under fair value option                                     | 300                     | 418                | 838                |
| Decrease in fair value of loan held for sale   | -                       | -                  | 77                 |
| Gain on sale of loans  | (3,624)                 | (5,537)            | -                  |
| (Gain) loss on other earning assets  | (693)                   | 480                | -                  |
| Allocated equity patronage from System bank  | (14,588)                | (13,852)           | (13,550)           |
| Loss from sales of premises and equipment, net   | 2,788                   | 6,897              | 90                 |
| Increase in accrued interest receivable  | (20,735)                | (15,550)           | (16,378)           |
| (Increase) decrease in other assets, net   | (755)                   | (6,569)            | 14,911             |
| Increase in accrued interest payable   | 15,952                  | 6,896              | 7,138              |
| Increase in other liabilities, net   | 8,547                   | 26,471             | 30,016             |
| <b>Net cash provided by operating activities</b>   | <b>500,978</b>          | <b>499,426</b>     | <b>493,375</b>     |
| <b>Cash Flows From Investing Activities</b>  |                         |                    |                    |
| Net increase in federal funds sold   | (223,987)               | (488)              | (327)              |
| Investment securities  |                         |                    |                    |
| Purchases  | (1,498,827)             | (1,565,893)        | (1,412,538)        |
| Proceeds from maturities, calls and prepayments  | 1,168,281               | 1,167,174          | 1,052,458          |
| Increase in loans, net   | (1,377,911)             | (1,435,459)        | (1,816,659)        |
| Proceeds from sale of loans  | 28,658                  | 171,900            | 200,000            |
| Proceeds from sale of other property owned   | 9,598                   | 8,599              | 21,213             |
| Proceeds from sale of premises and equipment   | 2,590                   | 3,998              | 7,769              |
| Expenditures for premises and equipment  | (33,691)                | (43,071)           | (32,158)           |
| Investment in other earning assets   | (9,120)                 | (6,478)            | (6,919)            |
| <b>Net cash used in investing activities</b>   | <b>(1,934,409)</b>      | <b>(1,699,718)</b> | <b>(1,987,161)</b> |
| <b>Cash Flows From Financing Activities</b>  |                         |                    |                    |
| Bonds and notes issued   | 11,863,920              | 19,670,304         | 15,030,200         |
| Bonds and notes retired  | (10,331,274)            | (18,513,323)       | (13,165,277)       |
| Redemption of subordinate debt   | -                       | (50,000)           | -                  |
| Increase in guaranteed obligations to government entities  | 3,915                   | -                  | -                  |
| Decrease in advanced conditional payments  | (352)                   | (2,991)            | (1,209)            |
| Preferred stock issued   | 20,000                  | -                  | -                  |
| Issuance costs on preferred stock  | (136)                   | -                  | -                  |
| Repayments on capital lease obligation   | (432)                   | (440)              | (94)               |
| Capital stock and participation certificates issued  | 9,768                   | 9,873              | 9,793              |
| Capital stock and participation certificates retired and allocated retained earnings distributed | (8,220)                 | (7,895)            | (7,579)            |
| Fair value adjustment related to association merger  | -                       | -                  | (2,916)            |
| Cash dividends on preferred stock  | (50,750)                | (50,250)           | (50,250)           |
| Cash patronage distributions paid  | (213,284)               | (198,609)          | (205,231)          |
| <b>Net cash provided by financing activities</b>   | <b>1,293,155</b>        | <b>856,669</b>     | <b>1,607,437</b>   |
| Net (decrease) increase in cash  | (140,276)               | (343,623)          | 113,651            |
| Cash at beginning of year  | 207,229                 | 550,852            | 437,201            |
| <b>Cash at end of year</b>   | <b>\$ 66,953</b>        | <b>\$ 207,229</b>  | <b>\$ 550,852</b>  |
| <b>Supplemental Schedule of Noncash Investing and Financing Activities</b>                       |                         |                    |                    |
| Financed sales of other property owned   | \$ 345                  | \$ 695             | \$ 2,325           |
| Loans transferred to other property owned  | 5,836                   | 11,664             | 6,461              |
| Undocumented advances expense, net   | 300                     | -                  | -                  |
| Net increase in unrealized losses on investment securities                                       | (18,283)                | (13,253)           | (9,176)            |
| Preferred stock dividend payable   | 20,063                  | 20,063             | 20,063             |
| Cash dividends or patronage distributions payable  | 170,022                 | 157,101            | 141,878            |
| Patronage distribution stock   | 5,973                   | 5,968              | 4,695              |
| Capital lease obligation   | 652                     | 1,084              | 1,028              |
| <b>Supplemental Information</b>  |                         |                    |                    |
| Cash paid during the year for:   |                         |                    |                    |
| Interest   | \$ 347,256              | \$ 277,621         | \$ 216,422         |
| Income taxes (refund) payment  | (120)                   | 2                  | 2                  |

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



# Notes to Combined Financial Statements

*Farm Credit Bank of Texas and District Associations*

*(dollars in thousands, except per share amounts and as noted)*

## Note 1 — Organization and Operations

### A. Organization:

The Farm Credit Bank of Texas (bank) is one of the banks of the Farm Credit System (System), a nationwide system of cooperatively owned banks and associations established by acts of Congress. The System is currently subject to the provisions of the Farm Credit Act. The System specializes in providing financing and related services to qualified borrowers for agricultural and rural purposes.

As of December 31, 2017, the nation was served by three Farm Credit Banks (FCBs), each of which has specific lending authority within its chartered territory, and one Agricultural Credit Bank (ACB) — collectively, the “System banks” — which has nationwide lending authority for lending to cooperatives. The ACB also has lending authorities of an FCB within its chartered territories. The bank is chartered to service the states of Alabama, Louisiana, Mississippi, New Mexico and Texas.

Each FCB and the ACB serve one or more Agricultural Credit Associations (ACAs) and/or Federal Land Credit Associations (FLCAs). The bank and its related associations collectively are referred to as the Farm Credit Bank of Texas and affiliated associations (district). The district’s one FLCA, 13 ACA parent associations, each containing two wholly-owned subsidiaries (an FLCA and a Production Credit Association [PCA]), certain Other Financing Institutions (OFIs) and preferred stockholders jointly owned the bank at December 31, 2017. The FLCA and ACAs collectively are referred to as associations.

Each FCB and the ACB provides funding for its district associations and is responsible for supervising certain activities of the associations within their districts. The FCBs and/or associations make loans to or for the benefit of eligible borrower-stockholders for qualified agricultural purposes. District associations borrow the majority of funds from their related bank. The System banks obtain a substantial majority of their funds for lending operations through the sale of consolidated Systemwide bonds and notes to the public, but also obtain a portion of their funds from internally generated earnings and from the issuance of common and preferred stock.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the bank and associations. The FCA examines the activities of System institutions to ensure their compliance with the Farm Credit Act, FCA regulations, and safe and sound banking practices.

### B. Operations:

The Farm Credit Act sets forth the types of authorized lending activities and financial services which can be offered by the bank and the associations and defines the eligible borrowers which they may serve. The associations are authorized to provide, or participate with other lenders to provide, credit, credit commitments

and related services to eligible borrowers. Eligible borrowers are defined as (a) bona fide farmers and ranchers and producers or harvesters of aquatic products, (b) persons furnishing to farmers and ranchers services directly related to their on-farm operating needs, (c) owners of rural homes, (d) rural residents and (e) farm-related businesses. The bank also may lend to any national bank, state bank, trust company, agricultural credit corporation, incorporated livestock loan company, savings institution, credit union or any association of agricultural producers (aggregately referred to as OFIs) engaged in the making of loans to farmers and ranchers, and any corporation engaged in the making of loans to producers or harvesters of aquatic products.

The associations also serve as intermediaries in offering credit life and multi-peril crop insurance and financial management services to their borrowers.

FCA regulations require borrower information be held in strict confidence by Farm Credit institutions, their directors, officers and employees. Directors and employees of the Farm Credit institutions are prohibited, except under specified circumstances, from disclosing nonpublic personal information about members.

The FLCA borrows funds from the bank and in turn originates and services long-term real estate mortgage loans made to its members. The OFIs borrow from the bank and, in turn, originate and service short- and intermediate-term loans for their members. The ACAs borrow from the bank and in turn may originate and service both long-term real estate mortgage and short- and intermediate-term loans to their members. ACAs may form a parent-subsidiary structure and may operate their long-term mortgage activities through an FLCA subsidiary and their short- and intermediate-term lending activities through a PCA subsidiary. In the states of Alabama, Louisiana, Mississippi, New Mexico and Texas, the bank may purchase from the FLCA and ACAs long-term real estate mortgage loans and, from ACAs, short- and intermediate-term loans.

The bank, in conjunction with other banks in the System, jointly owns several service organizations which were created to provide a variety of services for the System. The bank has ownership interests in the following service organizations:

- Federal Farm Credit Banks Funding Corporation (Funding Corporation) — provides for the issuance, marketing and processing of Systemwide debt securities using a network of investment dealers and dealer banks. The Funding Corporation also provides financial management and reporting services.
- Farm Credit System Building Association — leases premises and equipment to the FCA, as required by the Farm Credit Act.
- Farm Credit System Association Captive Insurance Company — as a reciprocal insurer, provides insurance services to its member organizations.

In addition, The Farm Credit Council acts as a full-service, federated trade association which represents the System before Congress, the executive branch and others, and provides support services to System institutions on a fee basis.

The Farm Credit Act also established the Farm Credit System Insurance Corporation (FCSIC) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used to (1) insure the timely payment of principal and interest on Systemwide debt obligations (insured debt), (2) ensure the retirement of protected borrower capital at par or stated value and (3) for other specified purposes. The Insurance Fund is also available for the discretionary uses, by FCSIC, of providing assistance to certain troubled System institutions and to cover the operating expenses of FCSIC. Each System bank has been required to pay premiums, which may be passed on to the associations, into the Insurance Fund based on its annual average adjusted outstanding insured debt until the assets in the Insurance Fund reach the “secure base amount,” which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (adjusted to reflect the reduced risk on loans or investments guaranteed by federal or state governments) or such other percentage of the aggregate obligations as FCSIC in its sole discretion determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, FCSIC is required to reduce premiums and may return excess funds above the secure base amount to System institutions. In March 2018, the FCSIC’s board approved and distributed excess funds to the System. For the Texas district, the excess funds received totaled \$19.3 million.

## Note 2 — Summary of Significant Accounting Policies

The accounting and reporting policies of the combined bank and associations conform to accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of combined financial statements in conformity with GAAP requires the managements of the bank and associations to make estimates and assumptions that affect the amounts reported in the combined financial statements and accompanying notes. Significant estimates are discussed in these notes as applicable.

Certain amounts in prior years’ combined financial statements have been reclassified to conform to the current year’s presentation.

The accompanying combined financial statements include the accounts of the bank and associations, and reflect the investments in and allocated earnings of the service organizations in which the bank has partial ownership interests. All significant transactions and balances between the bank and associations have been eliminated in combination. The multiemployer structure of the district’s defined benefit retirement plan results in the recording of the plan upon combination only.

During the third quarter of 2017, an association within the district determined that the association’s consolidated financial statements as of and for the year ended December 31, 2016, as well as the three months ended March 31, 2017, should no longer be relied upon and needed to be restated to correct misstatements in the association’s consolidated financial statements. The association’s restatements in 2016 decreased its consolidated other comprehensive income and members’ equity previously reported by \$8.1 million. These additional losses were the result of the activities of a former loan officer

who breached the association’s policies and procedures and engaged in improper conduct that included improperly advancing funds without appropriate approvals, offering unauthorized loan terms to borrowers, originating loans to fictitious borrowers, and originating loans and advancing funds based on fabricated documentation.

The district’s combined financial statements for the year ended December 31, 2017 include out-of-period adjustments of \$8.1 million resulting from the association’s restatement related to this matter. The significant financial line items impacted included a loan decrease of \$5.0 million, an allowance for loan losses and provision for loan losses increase of \$3.0 million and a noninterest expense increase of \$5.0 million. Although the association restated their 2016 financial statements, the district has evaluated the quantitative and qualitative aspects of these misstatements in accordance with applicable accounting guidance and has determined that such misstatements are not material to the current and previously issued district combined financial statements.

### A. Cash:

Cash, as included in the financial statements, represents cash on hand and on deposit at banks and at the Federal Reserve.

### B. Investment Securities:

The bank and associations, as permitted under FCA regulations, hold eligible investments for the purposes of maintaining a liquidity reserve, managing short-term surplus funds and managing interest rate risk.

The bank’s investments are to be held for an indefinite time period and, accordingly, have been classified as available for sale at December 31, 2017, 2016 and 2015, respectively. These investments are reported at fair value, and unrealized holding gains and losses on investments are netted and reported as a separate component of members’ equity in the balance sheet (accumulated other comprehensive gain [loss]). Changes in the fair value of these investments are reflected as direct charges or credits to other comprehensive income, unless the investment is deemed to be other-than-temporarily impaired (OTTI). The bank reviews all investments that are in a loss position in order to determine whether the unrealized loss, which is considered an impairment, is temporary or other-than-temporary. Impairment is considered to be other-than-temporary if the present value of cash flows expected to be collected from the debt security is less than the amortized cost basis of the security (any such shortfall is referred to as a “credit loss”). If an entity intends to sell an impaired debt security or is more likely than not to be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the impairment is other-than-temporary and should be recognized currently in earnings in an amount equal to the entire difference between fair value and amortized cost. If a credit loss exists, but an entity does not intend to sell the impaired debt security and is not more likely than not to be required to sell before recovery, the impairment is other-than-temporary and should be separated into (i) the estimated amount relating to credit loss and (ii) the amount relating to all other factors. Only the estimated credit loss amount is recognized currently in earnings, with the remainder of the loss amount recognized in other comprehensive income. In subsequent periods, if the present value of cash flows expected to be collected is less than the amortized cost basis, the bank would record an additional

other-than-temporarily impaired and adjust the yield of the security prospectively. The amount of total other-than-temporarily impaired for an available-for-sale security that previously was impaired is determined as the difference between its carrying amount prior to the determination of other-than-temporarily impaired and its fair value. Gains and losses on the sales of investments available-for-sale are determined using the specific identification method. Premiums and discounts are amortized or accreted into interest income over the term of the respective issues. The bank does not hold investments for trading purposes.

The bank and associations may also hold additional investments in accordance with mission-related investment programs, approved by the FCA. These programs allow the bank and associations to make investments that further the System's mission to serve rural America. Mission-related investments are not included in liquidity calculations and are not covered by the eligible investment limitations specified by the FCA regulations. Mortgage-backed securities issued by the Federal Agricultural Mortgage Corporation (Farmer Mac) are considered other investments and are also excluded from the eligible investment limitation and liquidity calculations. Mission-related investments for which the associations have the intent and ability to hold to maturity are classified as held-to-maturity and carried at cost, adjusted for the amortization of premiums and accretion of discounts.

At December 31, 2017, the district held other investments, totaling \$62.1 million, which consisted of Farmer Mac guaranteed agricultural mortgage-backed securities (AMBS). The bank held AMBS with a fair value of \$43.3 million in an available-for-sale other investments portfolio, and associations held AMBS with an amortized cost of \$18.8 million in a held-to-maturity portfolio. The Farmer Mac securities are backed by loans originated by the associations and previously held by the associations under the Farmer Mac long-term standby commitments to purchase agreements.

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

The bank and an association are limited partners in certain Rural Business Investment Companies (RBICs) for various relationship and strategic reasons. These RBICs facilitate equity and debt investments in agriculture-related businesses that create growth and job opportunities in rural America. These investments are accounted for under the equity method as the bank and association are considered to have significant influence.

The district's holdings in investment securities are more fully described in Note 3, "Investment Securities."

## C. Loans and Allowance for Loan Losses:

Long-term real estate mortgage loans can have maturities ranging from five to 40 years. Substantially all short-term and intermediate-term loans are made for agricultural production or operating purposes and have maturities of 10 years or less.

Loans are carried at their principal amount outstanding adjusted for charge-offs and any unearned income or unamortized discount. Interest on loans is accrued and credited to interest income based on the daily principal amount outstanding. Funds which are held by the district on behalf of the borrowers, where legal right of setoff exists, and which can be used to reduce outstanding loan balances at the district's discretion, are netted against loans in the combined balance sheets.

Loan origination fee income and direct loan origination costs are capitalized and the net fee or cost is amortized over the life of the related loans as an adjustment to yield.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan and are generally considered substandard or doubtful, which is in accordance with the loan rating model, as described below. Impaired loans include nonaccrual loans, accrual restructured loans, and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full.

A restructured loan constitutes a troubled debt restructuring if for economic or legal reasons related to the debtor's financial difficulties the bank or association grants a concession to the debtor that it would not otherwise consider. A concession is generally granted in order to minimize the bank or association's economic loss and avoid foreclosure. Concessions vary by program, are borrower-specific and may include interest rate reductions, term extensions, payment deferrals or the acceptance of additional collateral in lieu of payments. In limited circumstances, principal may be forgiven. A loan restructured in a troubled debt restructuring is an impaired loan.

Impaired loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately secured and in the process of collection) or circumstances indicate that full collection of principal and interest is in doubt. In accordance with FCA regulations, all loans 180 days or more past due are considered nonaccrual. When a loan is placed in nonaccrual status, accrued interest that is considered uncollectible is either reversed (if current year interest) or charged against the allowance for loan losses (if prior year interest). Loans are charged off at the time they are determined to be uncollectible.

Payments received on nonaccrual loans are generally applied to the recorded investment in the loan asset. If collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it, payments are recognized as interest income. Nonaccrual loans may be returned to accrual status when contractual principal and interest are current, the borrower has

demonstrated payment performance, there are no unrecovered prior charge-offs and collection of future payments is no longer in doubt. If previously unrecognized interest income exists at the time the loan is transferred to accrual status, cash received at the time of or subsequent to the transfer is first recorded as interest income until such time as the recorded balance equals the contractual indebtedness of the borrower.

The bank and related associations use a two-dimensional loan rating model based on an internally generated combined System risk-rating guidance that incorporates a 14-point risk-rating scale to identify and track the probability of borrower default and a separate scale addressing loss given default over a period of time. Probability of default is the probability that a borrower will experience a default within 12 months from the date of the determination of the risk rating. A default is considered to have occurred if the lender believes the borrower will not be able to pay its obligation in full or the borrower is past due more than 90 days. The loss given default is management's estimate as to the anticipated economic loss on a specific loan assuming default has occurred or is expected to occur within the next 12 months.

Each of the probability of default categories carries a distinct percentage of default probability. The 14-point risk-rating scale provides for granularity of the probability of default, especially in the acceptable ratings. There are nine acceptable categories that range from a borrower of the highest quality to a borrower of minimally acceptable quality. The probability of default between "1" and "9" is very narrow and would reflect almost no default to a minimal default percentage. The probability of default grows more rapidly as a loan moves from a "9" to other assets especially mentioned and grows significantly as a loan moves to a substandard (viable) level. A substandard (nonviable) rating indicates that the probability of default is almost certain.

The credit risk-rating methodology is a key component of the bank's and associations' allowance for loan losses evaluation, and is generally incorporated into the institution's loan underwriting standards and internal lending limit. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition, collateral value, portfolio quality, current production conditions and economic conditions, and prior loan loss experience.

The allowance for loan losses encompasses various judgments, evaluations and appraisals with respect to the loans and their underlying security that, by their nature, contain elements of uncertainty and imprecision. Changes in the agricultural economy and their impact on borrower repayment capacity will cause these various judgments, evaluations and appraisals to change over time. Accordingly, actual circumstances could vary significantly from the institutions' expectations and predictions of those circumstances. The allowance is increased through provisions for loan losses and loan recoveries and is decreased through reversals of provisions for loan losses and loan charge-offs. The level of allowance for loan losses is generally based on recent charge-off experience adjusted for relevant environmental factors. The

allowance for loan losses includes components for loans individually evaluated for impairment, loans collectively evaluated for impairment and loans acquired with deteriorated credit quality. Generally, for loans individually evaluated, the allowance for loan losses represents the difference between the recorded investment in the loan and the present value of the cash flows expected to be collected discounted at the loan's effective interest rate, or at the fair value of the collateral, if the loan is collateral-dependent. For those loans collectively evaluated for impairment, the allowance for loan losses is determined using the risk-rating model.

The allowance for loan losses is a valuation account used to reasonably estimate loan and lease losses as of the financial statement date. Determining the appropriate allowance for loan losses balance involves significant judgment about when a loss has been incurred and the amount of that loss. The determination of the allowance for loan losses is based on management's current judgments about the credit quality of its loan portfolio. A specific allowance may be established for impaired loans under authoritative accounting guidance. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral-dependent.

#### D. Other Property Owned:

Other property owned (OPO), consisting of real and personal property acquired through foreclosure or deed in lieu of foreclosure, is recorded at fair value, based on appraisal, less estimated selling costs upon acquisition. Any initial reduction in the carrying amount of a loan to the fair value of the collateral received is charged to the allowance for loan losses. On at least an annual basis, revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in losses (gains) on OPO.

#### E. Premises and Equipment:

Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation expense is calculated using the straight-line method over the estimated useful lives of 40 years for buildings and improvements, three to 10 years for furniture, equipment and certain leasehold improvements, and three years for automobiles. Computer software and hardware are amortized over three to 10 years. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense, and improvements are capitalized and amortized over the remaining useful life of the asset.

#### F. Other Assets and Other Liabilities:

The bank and associations are authorized under the Farm Credit Act to accept "advance conditional payments" (ACPs) from borrowers. To the extent the borrower's access to such ACPs is restricted and the legal right of setoff exists, the ACPs are netted against the borrower's related loan balance. ACPs which are held by the district but cannot be used to reduce outstanding loan balances, except at the direction of the borrower, are classified as

other liabilities in the combined balance sheets. ACPs are not insured, and interest is generally paid by the associations on such balances. The total outstanding balances of advance conditional payments, both netted against loans and classified as other liabilities, at December 31, 2017, 2016 and 2015 were \$198.2 million, \$194.2 million and \$192.5 million, respectively.

Derivative financial instruments are included on the balance sheet at fair value, as either other assets or other liabilities.

Other assets may include any loans that are designated as a held-for-sale portfolio.

## G. Employee Benefit Plans:

Employees of the bank and associations participate in one of two districtwide retirement plans and are eligible to participate in the 401(k) plan of the district. Within the 401(k) plan, a certain percentage of employee contributions is matched by the bank and associations. The 401(k) plan costs are expensed as incurred. Additionally, certain qualified individuals in the bank and associations may participate in a separate, nonqualified supplemental 401(k) plan.

As more fully described in Note 11, "Employee Benefit Plans," these plans are accounted for and reported in accordance with authoritative accounting guidance. The bank and all associations provide certain health care benefits to eligible retired employees and directors. District employees' eligibility for these benefits upon retirement is dependent on conditions set by each district employer.

The structure of the district's defined benefit plan is characterized as multiemployer, since neither the assets, liabilities nor cost of any plan is segregated or separately accounted for by participating employers (bank and associations). No portion of any surplus assets is available to any participating employer. Participating employers are jointly and severally liable for the plan obligations. Upon withdrawal or termination of their participation in the plan, a participating employer must pay all associated costs of its withdrawal from the plan, including its unfunded liability (the difference between replacement annuities and the withdrawing employer's share of allocated plan assets) and associated costs of withdrawal. As a result, participating employers of the plans only recognize as cost the required contributions for the period and a liability for any unpaid contributions required for the period of their financial statements. The majority of plan obligations, assets and the components of annual benefit expenses are recorded and reported upon combination at the district level only.

Authoritative accounting guidance requires the accrual of the expected cost of providing postretirement benefits other than pensions (primarily health care benefits) to an employee and an employee's beneficiaries and covered dependents during the years that the employee renders service necessary to become eligible for these benefits.

## H. Income Taxes:

The bank, the FLCA and the FLCA subsidiaries of ACA parent companies are exempt from federal and certain other income taxes as provided in the Farm Credit Act. The ACAs and their PCA subsidiaries provide for federal and certain other income taxes.

Certain ACAs operate as cooperatives which qualify for tax treatment under Subchapter T of the Internal Revenue Code. These ACAs and their PCA subsidiaries can exclude from taxable income amounts distributed as qualified patronage distributions to borrowers in the form of cash, stock or allocated retained earnings. Provisions for income taxes for these ACAs are made only on the earnings not distributed as qualified patronage distributions. Certain ACAs distribute patronage on the basis of taxable income. In this method, deferred income taxes are provided on the taxable income of ACAs on the basis of a proportionate share of the tax effect of temporary differences not allocated in patronage form. Other ACAs distribute patronage on the basis of book income. In this method, deferred taxes are recorded on the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. For most ACAs, a valuation allowance is provided for the deferred tax assets to the extent that it is more likely than not (over 50 percent probability), based on management's estimate, that they will not be realized. The consideration of valuation allowances involves various estimates and assumptions as to future taxable earnings, including the effects of our expected patronage program, which reduce taxable earnings.

New U.S. tax laws resulting from legislation commonly known as the Tax Cuts and Jobs Acts of 2017 (TCJA) were enacted in late 2017. Among other things, the TCJA changed the federal corporate tax rate from 35 percent to 21 percent. The bank is exempt from federal and certain other income taxes as provided by the Farm Credit Act; however, the change in the federal corporate tax rate had a financial statement impact for year-end 2017 for district associations that required the revaluation of any deferred taxes (assets or liabilities) in the year of enactment (2017). This resulted in either a tax expense or tax benefit to the income statement.

As of December 31, 2017, deferred income taxes have not been provided by the ACAs and their PCA subsidiaries on \$36.0 million of pre-1993 patronage distributions from the bank because management's intent is to (1) permanently invest these and other undistributed earnings in the bank, thereby indefinitely postponing their conversion to cash, or (2) pass any distributions related to pre-1993 earnings to borrowers through qualified patronage allocations. No deferred taxes have been provided on the bank's post-1994 unallocated earnings. The bank currently has no plans to distribute unallocated bank earnings and does not contemplate circumstances which, if distributions were made, would result in income taxes being paid at the association level.

## I. Derivative Instruments and Hedging Activity:

In the normal course of business, the bank may enter into derivative financial instruments, including interest rate swaps and caps, which are principally used to manage interest rate risk on assets, liabilities and firm commitments. Derivatives are recorded on the balance sheet as assets and liabilities at fair value.

For fair-value hedge transactions which hedge changes in the fair value of assets, liabilities or firm commitments, changes in the fair value of the derivative will generally be offset by changes in the hedged item's fair value. For cash flow hedges, which hedge the exposure to variability in expected future cash flows, changes in the fair value of the derivative are reflected in accumulated

other comprehensive income. The bank formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives to specific liabilities on the balance sheet. The bank may use interest rate swaps whose critical terms match the corresponding hedged item, thereby qualifying for short-cut treatment under the provisions of authoritative accounting guidance, and are presumed to be highly effective in offsetting changes in the fair value. The bank would discontinue hedge accounting prospectively when the bank determines that a derivative has not been or is not expected to be effective as a hedge. In the event that hedge accounting were discontinued and the derivative remained outstanding, the bank would carry the derivative at its fair value on the balance sheet, recognizing changes in fair value in current period earnings. See Note 16, "Derivative Instruments and Hedging Activity," for additional disclosures about derivative instruments.

#### J. Fair Value Measurements:

The Financial Accounting Standards Board (FASB) guidance 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. Included in Level 1 are assets held in trust funds, which relate to deferred compensation. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace.

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. The market value of collateral assets and liabilities is their face value, plus accrued interest, as these instruments are cash balances; therefore, fair value approximates face value. Pension plan assets that are derived from observable inputs, including corporate bonds and mortgage-backed securities, are reported in Level 2.

Level 3 — Unobservable inputs are those that are supported by little or no market activity and that are significant to the determination of 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 in-

struments 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 the district's Farmer Mac AMBS, certain loans and OPO.

The fair value disclosures are presented in Note 15, "Fair Value Measurements."

#### K. Recently Issued or Adopted Accounting Pronouncements:

In August 2017, the FASB issued guidance entitled "Targeted Improvements to Accounting for Hedging Activities." The guidance better aligns an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments in this guidance require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This guidance also addresses the timing of effectiveness testing, qualitative and quantitative effectiveness testing and components that can be excluded from effectiveness testing. This guidance becomes effective for interim and annual periods beginning after December 15, 2018. The district is evaluating the impact of adoption on the district's financial condition and its results of operations.

In March 2017, the FASB issued guidance entitled "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Cost." The guidance requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. Other components are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. This guidance became effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance will not impact the district's financial condition but will change the classification of certain items in the results of operations.

In August 2016, the FASB issued guidance entitled "Classification of Certain Cash Receipts and Cash Payments." The guidance addresses specific cash flow issues with the objective of reducing the diversity in the classification of these cash flows. Included in the cash flow issues are debt repayment or debt extinguishment costs and settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing. This guidance became effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance is not expected to impact the district's financial condition or its results of operations but could change the classification of certain items in the statement of cash flows.

In June 2016, the FASB issued guidance entitled "Measurement of Credit Losses on Financial Instruments." The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable

information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. For public business entities that are not U.S. Securities and Exchange Commission filers this guidance becomes effective for interim and annual periods beginning after December 15, 2020, with early application permitted. The district is evaluating the impact of adoption on the district's financial condition and its results of operations.

In February 2016, the FASB issued guidance entitled "Leases." The guidance requires the recognition by lessees of lease assets and lease liabilities on the balance sheet for the rights and obligations created by those leases. Leases with lease terms of more than 12 months are impacted by this guidance. This guidance becomes effective for interim and annual periods beginning after December 15, 2018, with early application permitted. The district is evaluating the impact of adoption on its financial condition and results of operations.

In January 2016, the FASB issued guidance entitled "Recognition and Measurement of Financial Assets and Liabilities." The guidance affects, among other things, the presentation and disclosure requirements for financial instruments. For public entities, the guidance eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments carried at amortized cost. This guidance became effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance will not impact the district's financial condition or its results of operations.

In May 2015, the FASB issued guidance entitled "Disclosure for Investments in Certain Entities That Calculate Net Asset per Share (or Its Equivalent)" related to measuring the fair value of certain investments using the net assets value per share of the investment. The amendments removed the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also removed the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. This guidance was effective for the annual period beginning after December 15, 2016, retrospectively, and for annual periods thereafter. Earlier application was permitted. In 2016, the district adopted this guidance, which did not have a significant impact on the district's financial statements. See Note 11, "Employee Benefit Plans," for additional information.

In May 2014, the FASB issued guidance entitled, "Revenue from Contracts with Customers." The guidance governs revenue recognition from contracts with customers and requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Financial instruments and other contractual rights within the scope of other guidance issued by the FASB are excluded from the scope of this new revenue recognition guidance. In this regard, a majority of our contracts would be excluded from the scope of this new guidance. In August 2015, the FASB issued an update that deferred

this guidance by one year, which resulted in the new revenue standard becoming effective for interim and annual reporting periods beginning after December 15, 2017. The district has determined that the effect of adoption is not material to the combined financial condition or results of operations and will not change its current recognition practices.

#### L. Off-Balance-Sheet Credit Exposures:

Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. Commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These letters of credit are issued to facilitate commerce and typically result in the commitment being funded when the underlying transaction is consummated between the customer and third party. The credit risk associated with commitments to extend credit and commercial letters of credit is essentially the same as that involved with extending loans to customers and is subject to normal credit policies. Collateral may be obtained based on management's assessment of the customer's creditworthiness.

#### M. Merger Accounting:

The authoritative guidance on business combinations applies to all transactions in which an entity obtains control of one or more businesses and requires the acquirer to use the acquisition method of accounting and recognize assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date.

For System institutions, because the stock in each association is fixed in value, the stock issued pursuant to the merger provides no basis for estimating the fair value of the consideration transferred pursuant to the merger. In the absence of a purchase price determination, the acquiring association would identify and estimate the acquisition date fair value of the equity interests (net assets) of the acquired association instead of the acquisition date fair value of the equity interests transferred as consideration. The fair value of the assets acquired, including specific intangible assets and liabilities assumed, are measured based on various estimates using assumptions that management believes are reasonable utilizing information currently available. The excess value received, by the acquiring association from the acquired association, over the par value of capital stock and participation certificates issued in the merger is considered to be additional paid-in capital.

## N. Change in Accounting Principle – Debt Issuance Costs:

In April 2015, the FASB issued guidance entitled “Interest — Imputation of Interest.” The guidance required debt issuance costs be presented in the balance sheet as a direct deduction from the carrying value of the debt liability. Prior to the issuance of the standard, debt issuance costs were required to be presented in the balance sheet as a deferred charge (asset). This guidance was to become effective for interim and annual reporting periods beginning after December 15, 2015, with early application permitted. The bank elected to adopt this guidance effective December 31, 2015, with the required retroactive application. The adoption of this guidance resulted in the Balance Sheets reclassification of unamortized debt issuance costs from “Other assets” to offset the balance of the related debt liability, and had no impact on retained earnings or shareholders’ equity and did not result in any change to the Statements of Comprehensive Income. The amounts of unamortized debt issuance costs reclassified from “Other assets” to offset the related debt are summarized below:

|  | 2015             |
|--|------------------|
| Bonds and notes                          | \$ 13,652        |
| Subordinated debt                        | 199              |
| Total reclassification from Other assets | <u>\$ 13,851</u> |

## Note 3 — Investment Securities

The district’s available-for-sale investments (AFS) include a liquidity portfolio and a portfolio of other investments. The liquidity portfolio consists primarily of agency-guaranteed debt instruments, mortgage-backed investments, U.S. Treasury securities, asset-backed investments and corporate debt. At December 31, 2017, the district’s other investments portfolio consisted of AMBS held by district associations in a held-to-maturity portfolio with an amortized cost of \$18.8 million and AMBS held by the bank in an available-for-sale portfolio with a fair value of \$43.3 million. The bank’s AMBS were purchased from district associations as a part of the bank’s Capitalized Participation Pool (CPP) program. In accordance with this program, any positive impact to the net income of the bank can be returned as patronage to the association if declared by the bank’s board of directors. The declared patronage approximates the net earnings of the respective pool, which is eliminated upon combination. In 2017, 2016 and 2015, AMBS patronage totaling \$1.2 million, \$1.4 million and \$1.8 million, respectively, was declared and paid.

Investments in the available-for-sale liquidity portfolio and held-to-maturity investments at December 31:

|   | 2017                |                        |                         |                     |                        |
|---|---------------------|------------------------|-------------------------|---------------------|------------------------|
|   | Amortized Cost      | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value          | Weighted Average Yield |
| <b>AFS liquidity portfolio:</b>                                 |                     |                        |                         |                     |                        |
| Agency-guaranteed debt  | \$ 198,246          | \$ 30                  | \$ (3,028)              | \$ 195,248          | 1.94%                  |
| Corporate debt  | 252,482             | 556                    | (429)                   | 252,609             | 1.84                   |
| <b>Federal agency collateralized mortgage-backed securities</b> |                     |                        |                         |                     |                        |
| GNMA  | 2,012,484           | 706                    | (28,528)                | 1,984,662           | 1.99                   |
| FNMA and FHLMC  | 2,395,248           | 2,061                  | (25,256)                | 2,372,053           | 1.91                   |
| U.S. Treasury securities  | 249,860             | -                      | (653)                   | 249,207             | 0.90                   |
| Asset-backed securities   | 47,914              | 18                     | (43)                    | 47,889              | 1.61                   |
| <b>Total liquidity investments</b>                              | <b>\$ 5,156,234</b> | <b>\$ 3,371</b>        | <b>\$ (57,937)</b>      | <b>\$ 5,101,668</b> | <b>1.88%</b>           |

### Held-to-maturity investments:

|  |                  |              |                 |                  |              |
|--|------------------|--------------|-----------------|------------------|--------------|
| <b>Agricultural mortgage-backed securities</b> | <b>\$ 18,828</b> | <b>\$ 19</b> | <b>\$ (241)</b> | <b>\$ 18,606</b> | <b>4.98%</b> |
|--|------------------|--------------|-----------------|------------------|--------------|

|   | 2016                |                        |                         |                     |                        |
|---|---------------------|------------------------|-------------------------|---------------------|------------------------|
|   | Amortized Cost      | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value          | Weighted Average Yield |
| <b>AFS liquidity portfolio:</b>                                 |                     |                        |                         |                     |                        |
| Agency-guaranteed debt  | \$ 225,457          | \$ 160                 | \$ (3,243)              | \$ 222,374          | 1.80%                  |
| Corporate debt  | 202,365             | 461                    | (423)                   | 202,403             | 1.41                   |
| <b>Federal agency collateralized mortgage-backed securities</b> |                     |                        |                         |                     |                        |
| GNMA  | 1,697,627           | 1,452                  | (16,080)                | 1,682,999           | 1.61                   |
| FNMA and FHLMC  | 2,308,775           | 2,026                  | (20,222)                | 2,290,579           | 1.47                   |
| U.S. Treasury securities  | 249,502             | -                      | (496)                   | 249,006             | 0.90                   |
| Asset-backed securities   | 130,703             | 19                     | (43)                    | 130,679             | 1.10                   |
| <b>Total liquidity investments</b>                              | <b>\$ 4,814,429</b> | <b>\$ 4,118</b>        | <b>\$ (40,507)</b>      | <b>\$ 4,778,040</b> | <b>1.49%</b>           |

### Held-to-maturity investments:

|  |                  |              |                 |                  |              |
|--|------------------|--------------|-----------------|------------------|--------------|
| <b>Agricultural mortgage-backed securities</b> | <b>\$ 25,693</b> | <b>\$ 95</b> | <b>\$ (136)</b> | <b>\$ 25,652</b> | <b>4.65%</b> |
|--|------------------|--------------|-----------------|------------------|--------------|

|   | 2015                |                        |                         |                     |                        |
|---|---------------------|------------------------|-------------------------|---------------------|------------------------|
|   | Amortized Cost      | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value          | Weighted Average Yield |
| <b>AFS liquidity portfolio:</b>                                 |                     |                        |                         |                     |                        |
| Agency-guaranteed debt  | \$ 252,436          | \$ 112                 | \$ (4,193)              | \$ 248,355          | 1.68%                  |
| Corporate debt  | 201,332             | 54                     | (784)                   | 200,602             | 0.97                   |
| <b>Federal agency collateralized mortgage-backed securities</b> |                     |                        |                         |                     |                        |
| GNMA  | 1,740,411           | 3,778                  | (12,433)                | 1,731,756           | 1.51                   |
| FNMA and FHLMC  | 2,008,449           | 2,996                  | (12,776)                | 1,998,669           | 1.31                   |
| Asset-backed securities   | 200,485             | 2                      | (414)                   | 200,073             | 0.85                   |
| <b>Total liquidity investments</b>                              | <b>\$ 4,403,113</b> | <b>\$ 6,942</b>        | <b>\$ (30,600)</b>      | <b>\$ 4,379,455</b> | <b>1.37%</b>           |

### Held-to-maturity investments:

|  |                  |              |                 |                  |              |
|--|------------------|--------------|-----------------|------------------|--------------|
| <b>Agricultural mortgage-backed securities</b> | <b>\$ 30,213</b> | <b>\$ 77</b> | <b>\$ (271)</b> | <b>\$ 30,019</b> | <b>4.54%</b> |
|--|------------------|--------------|-----------------|------------------|--------------|

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

|   | December 31, 2017 |                        |                         |            |                        |
|---|-------------------|------------------------|-------------------------|------------|------------------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
| Agricultural mortgage-backed securities | \$ 45,564         | \$ -                   | \$ (2,247)              | \$ 43,317  | 4.46%                  |
|   | December 31, 2016 |                        |                         |            |                        |
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
| Agricultural mortgage-backed securities | \$ 55,475         | \$ -                   | \$ (2,140)              | \$ 53,335  | 4.23%                  |
|   | December 31, 2015 |                        |                         |            |                        |
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
| Agricultural mortgage-backed securities | \$ 67,268         | \$ -                   | \$ (1,618)              | \$ 65,650  | 4.10%                  |

A summary of contractual maturity, amortized cost, estimated fair value and weighted average yield of the available-for-sale liquidity portfolio at December 31, 2017, follows:

|  | Due In One Year Or Less | Due After One Year Through Five Years | Due After Five Years Through 10 Years | Due After 10 Years  | Total               |
|--|-------------------------|---------------------------------------|---------------------------------------|---------------------|---------------------|
| Agency-guaranteed debt                                   | \$ -                    | \$ 18,532                             | \$ 176,716                            | \$ -                | \$ 195,248          |
| Corporate debt   | 65,010                  | 187,599                               | -                                     | -                   | 252,609             |
| Federal agency collateralized mortgage-backed securities |                         |                                       |                                       |                     |                     |
| GNMA   | 86                      | -                                     | 67,266                                | 1,917,310           | 1,984,662           |
| FNMA and FHLMC   | 1,344                   | 51,742                                | 397,820                               | 1,921,147           | 2,372,053           |
| U.S Treasury securities                                  | 249,207                 | -                                     | -                                     | -                   | 249,207             |
| Asset-backed securities                                  | 1,045                   | 44,529                                | 2,315                                 | -                   | 47,889              |
| <b>Total</b>   | <b>\$ 316,692</b>       | <b>\$ 302,402</b>                     | <b>\$ 644,117</b>                     | <b>\$ 3,838,457</b> | <b>\$ 5,101,668</b> |
| Total amortized cost                                     |                         |                                       |                                       |                     |                     |
| Weighted average yield                                   | 1.09%                   | 1.73%                                 | 1.89%                                 | 1.96%               | 1.88%               |

Collateralized mortgage obligations (CMOs) have stated contractual maturities in excess of 15 years. However, the security structure of the CMOs is designed to produce a relatively short-term life. At December 31, 2017, the CMO portfolio had a weighted average remaining life of 3.5 years.

Investments in the available-for-sale other investments portfolio at December 31, 2017, follows:

|                        | Due After One Year Through Five Years | Due After Five Years Through 10 Years | Total     |
|------------------------|---------------------------------------|---------------------------------------|-----------|
|                        | Fair value                            | \$ 4,056                              | \$ 39,261 |
| Amortized cost         | 4,150                                 | 41,414                                | 45,564    |
| Weighted average yield | 3.91%                                 | 4.52%                                 | 4.46%     |

Investments in the district's held-to-maturity investment portfolio at December 31, 2017, follow:

|                        | Due After One Year Through Five Years | Due After Five Years Through 10 Years | Total    |
|------------------------|---------------------------------------|---------------------------------------|----------|
|                        | Fair value                            | \$ 12,104                             | \$ 6,502 |
| Amortized cost         | 12,152                                | 6,676                                 | 18,828   |
| Weighted average yield | 5.30%                                 | 4.40%                                 | 4.98%    |

The ratings of the eligible investments held for maintaining a liquidity reserve, managing short-term surplus funds and managing interest rate risk must meet the applicable regulatory guidelines, which require these securities to be high-quality, senior class and rated triple-A at the time of purchase.

To achieve the ratings, these securities have a guarantee of timely payment of principal and interest or credit enhancement achieved through overcollateralization and the priority of payments of senior classes over junior classes. The bank performs analysis based on expected behavior of the loans, whereby these loan performance scenarios are applied against each security's credit-support structure to monitor credit-enhancement sufficiency to protect the investment. The model output includes projected cash flows, including any shortfalls in the capacity of the underlying collateral to fully return the original investment, plus accrued interest.

The following table shows the fair value and gross unrealized losses for investments in a loss position aggregated by investment category, and the length of time the securities have been in a continuous unrealized loss position. The continuous loss position is based on the date the impairment occurred. An investment is considered impaired if its fair value is less than its cost.

|  | December 31, 2017   |                    |                        |                    |                     |                    |
|--|---------------------|--------------------|------------------------|--------------------|---------------------|--------------------|
|  | Less Than 12 Months |                    | Greater Than 12 Months |                    | Total               |                    |
|  | Fair Value          | Unrealized Losses  | Fair Value             | Unrealized Losses  | Fair Value          | Unrealized Losses  |
| Agency-guaranteed debt                                   | \$ 68,088           | \$ (460)           | \$ 112,869             | \$ (2,568)         | \$ 180,957          | \$ (3,028)         |
| Corporate debt   | 64,635              | (427)              | 14,998                 | (2)                | 79,633              | (429)              |
| Federal agency collateralized mortgage-backed securities |                     |                    |                        |                    |                     |                    |
| GNMA   | 848,826             | (9,518)            | 880,604                | (19,010)           | 1,729,430           | (28,528)           |
| FNMA and FHLMC   | 692,020             | (5,917)            | 1,045,992              | (19,339)           | 1,738,012           | (25,256)           |
| U.S. Treasury securities                                 | -                   | -                  | 249,207                | (653)              | 249,207             | (653)              |
| Asset-backed securities                                  | 28,999              | (42)               | 2,072                  | (1)                | 31,071              | (43)               |
| <b>Total</b>   | <b>\$ 1,702,568</b> | <b>\$ (16,364)</b> | <b>\$ 2,305,742</b>    | <b>\$ (41,573)</b> | <b>\$ 4,008,310</b> | <b>\$ (57,937)</b> |

|  | December 31, 2016   |                    |                        |                    |                     |                    |
|--|---------------------|--------------------|------------------------|--------------------|---------------------|--------------------|
|  | Less Than 12 Months |                    | Greater Than 12 Months |                    | Total               |                    |
|  | Fair Value          | Unrealized Losses  | Fair Value             | Unrealized Losses  | Fair Value          | Unrealized Losses  |
| Agency-guaranteed debt                                   | \$ 97,764           | \$ (1,380)         | \$ 89,055              | \$ (1,863)         | \$ 186,819          | \$ (3,243)         |
| Corporate debt   | 14,993              | (3)                | 27,098                 | (420)              | 42,091              | (423)              |
| Federal agency collateralized mortgage-backed securities |                     |                    |                        |                    |                     |                    |
| GNMA   | 1,019,022           | (8,613)            | 399,310                | (7,467)            | 1,418,332           | (16,080)           |
| FNMA and FHLMC   | 1,343,532           | (14,666)           | 511,743                | (5,556)            | 1,855,275           | (20,222)           |
| U.S. Treasury securities                                 | 249,006             | (496)              | -                      | -                  | 249,006             | (496)              |
| Asset-backed securities                                  | 47,705              | (39)               | 8,649                  | (4)                | 56,354              | (43)               |
| <b>Total</b>   | <b>\$ 2,772,022</b> | <b>\$ (25,197)</b> | <b>\$ 1,035,855</b>    | <b>\$ (15,310)</b> | <b>\$ 3,807,877</b> | <b>\$ (40,507)</b> |

|  | December 31, 2015   |                    |                        |                    |                     |                    |
|--|---------------------|--------------------|------------------------|--------------------|---------------------|--------------------|
|  | Less Than 12 Months |                    | Greater Than 12 Months |                    | Total               |                    |
|  | Fair Value          | Unrealized Losses  | Fair Value             | Unrealized Losses  | Fair Value          | Unrealized Losses  |
| Agency-guaranteed debt                                   | \$ 128,784          | \$ (1,413)         | \$ 95,370              | \$ (2,780)         | \$ 224,154          | \$ (4,193)         |
| Corporate debt   | 144,151             | (637)              | 12,398                 | (147)              | 156,549             | (784)              |
| Federal agency collateralized mortgage-backed securities |                     |                    |                        |                    |                     |                    |
| GNMA   | 406,962             | (1,775)            | 571,789                | (10,658)           | 978,751             | (12,433)           |
| FNMA and FHLMC   | 1,366,070           | (7,925)            | 138,358                | (4,851)            | 1,504,428           | (12,776)           |
| Asset-backed securities                                  | 175,092             | (393)              | 14,979                 | (21)               | 190,071             | (414)              |
| <b>Total</b>   | <b>\$ 2,221,059</b> | <b>\$ (12,143)</b> | <b>\$ 832,894</b>      | <b>\$ (18,457)</b> | <b>\$ 3,053,953</b> | <b>\$ (30,600)</b> |

As more fully discussed in Note 2, "Summary of Significant Accounting Policies," the guidance for other-than-temporarily impaired contemplates numerous factors in determining whether an impairment is other-than-temporary, including: (i) whether or not an entity intends to sell the security; (ii) whether it is more likely than not that an entity would be required to sell the security before recovering its costs; or (iii) whether an entity does not expect to recover the security's entire amortized cost basis (even if it does not intend to sell).

The bank and associations perform a quarterly evaluation on a security-by-security basis considering all available information. If the bank or an association intends to sell the security or it is more likely than not that it would be required to sell the security, the impairment loss equals the entire difference between amortized cost and fair value of the security. When the bank or an association does not

intend to sell securities in an unrealized loss position, other-than-temporarily impaired is considered using various factors, including the length of time and the extent to which the fair value is less than cost; adverse conditions specifically related to the industry, geographic area and the condition of the underlying collateral; payment structure of the security; ratings by rating agencies; the creditworthiness of bond insurers; and volatility of the fair value changes. The bank or association uses estimated cash flows over the remaining lives of the underlying collateral to assess whether credit losses exist. In estimating cash flows, the bank and associations consider factors such as expectations of relevant market and economic data, including underlying loan level data for mortgage-backed and asset-backed securities and credit enhancements.

The district held no investment securities designated as other-than-temporarily impaired (OTTI) at December 31, 2017, 2016 and 2015.

## Note 4 — Loans and Allowance for Loan Losses

A summary of the district's loan types at December 31, follows:

|                                       | 2017          | 2016          | 2015          |
|---------------------------------------|---------------|---------------|---------------|
| Real estate mortgage                  | \$ 14,351,578 | \$ 13,462,730 | \$ 12,187,679 |
| Production and intermediate term      | 3,014,067     | 2,736,456     | 2,763,018     |
| Agribusiness                          |               |               |               |
| Loans to cooperatives                 | 429,535       | 390,798       | 233,171       |
| Processing and marketing              | 3,428,261     | 3,146,124     | 3,126,782     |
| Farm-related business                 | 206,441       | 258,477       | 326,641       |
| Communications                        | 437,066       | 465,257       | 465,149       |
| Energy (rural utilities)              | 1,352,129     | 1,433,870     | 1,288,196     |
| Water and waste disposal              | 117,177       | 141,587       | 165,762       |
| Rural residential real estate         | 234,379       | 216,398       | 301,305       |
| Mission-related                       | 109,919       | 126,173       | 265,546       |
| Agricultural export finance           | -             | -             | 9,713         |
| Loans to other financing institutions | 40,107        | 42,078        | 42,598        |
| Lease receivables                     | 25,009        | 6,169         | 6,258         |
| Total                                 | \$ 23,745,668 | \$ 22,426,117 | \$ 21,181,818 |

The FCA previously approved a program that allows the bank and its associations to purchase investments in debt instruments called "Rural America Bonds." This program is intended to help meet the growing financing needs of agriculture and rural America, improve the income and economic well-being of American farmers and ranchers, and enhance the economic vibrancy of rural areas that support agriculture. Loans related to this initiative are included in "mission-related" loans in the previous table.

The bank's capital markets loan portfolio predominantly includes participations, syndications and purchased whole loans, along with other financing structures within our lending authorities. The bank also refers to the capital markets portfolio as participations purchased. In addition to purchasing loans from our district associations, which may exceed their hold limits, the bank seeks the purchase of participations and syndications originated outside of the district's territory by other System institutions, commercial banks and other lenders. These loans may be held as earning assets of the bank or subparticipated to the associations or to other System entities.

The bank and associations purchase or sell participation interests with other parties in order to diversify risk, manage loan volume and comply with FCA regulations. The following table presents information on loan participations, excluding syndications, at December 31, 2017:

|   | Other Farm Credit Institutions<br>(Outside of Texas District) |                | Non-Farm Credit Institutions |                | Total          |                |
|---|---|----------------|------------------------------|----------------|----------------|----------------|
|   | Participations  | Participations | Participations               | Participations | Participations | Participations |
|   | Purchased   | Sold           | Purchased                    | Sold           | Purchased      | Sold           |
| Real estate mortgage                              | \$ 195,862  | \$ 356,549     | \$ 295,288                   | \$ 5,576       | \$ 491,150     | \$ 362,125     |
| Production and intermediate term                  | 626,834   | 659,130        | 19,039                       | 60,399         | 645,873        | 719,529        |
| Agribusiness                                      | 2,054,094   | 60,211         | 3,691                        | 1,173          | 2,057,785      | 61,384         |
| Communications                                    | 437,858   | -              | -                            | -              | 437,858        | -              |
| Energy (rural utilities)                          | 1,352,609   | -              | -                            | -              | 1,352,609      | -              |
| Water and waste disposal                          | 117,490   | -              | -                            | -              | 117,490        | -              |
| Lease receivables                                 | 24,768  | -              | -                            | -              | 24,768         | -              |
| Loans to other financing institutions             | -   | 1,500          | -                            | -              | -              | 1,500          |
| Direct note receivable from district associations | -   | 3,850,000      | -                            | -              | -              | 3,850,000      |
| Mission-related                                   | 4,702   | -              | 4,105                        | -              | 8,807          | -              |
| Total   | \$ 4,814,217  | \$ 4,927,390   | \$ 322,123                   | \$ 67,148      | \$ 5,136,340   | \$ 4,994,538   |

At December 31, 2017, the bank had a total of \$3.85 billion of direct notes from district associations sold to another System bank. These sales provide diversification benefits between Farm Credit entities.

The bank has elected the fair value option for certain callable loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial assets. The fair value of loans held under the fair value option totaled \$9,908 at December 31, 2017. Fair

value is used for both the initial and subsequent measurement of the designated instrument, with the changes in fair value recognized in net income. On these instruments, the related contractual interest income and premium amortization are recorded as Interest Income in the Statements of Comprehensive Income. The remaining changes in fair value on these instruments are recorded as net gains (losses) in Noninterest Income on the Statements of Comprehensive Income. The fair value of these instruments is included in Level 2 in the fair value hierarchy for assets recorded at fair value on a recurring basis.

The following is a summary of the transactions on loans for which the fair value option has been elected for the twelve months ended December 31, 2017:

|  |                 |
|--|-----------------|
| Balance at January 1, 2017                                 | \$ 16,311       |
| Maturities, repayments and calls by issuers                | (5,665)         |
| Net gains on financial instruments under fair value option | (300)           |
| Change in premium amortization                             | (438)           |
| Balance at December 31, 2017                               | <u>\$ 9,908</u> |

The bank has purchased loan participations from two district associations in CPP transactions. As a condition of the transactions, the bank redeemed stock in the amount of 2.0 percent of the par value of the loans purchased, and the associations bought bank stock equal to 8.0 percent of the purchased loans' par value. The respective stock purchases and retirements between the bank and the two district associations are eliminated upon combination. CPP loans held by the bank at December 31, 2017, totaled \$34,926.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loans. Interest income recognized and cash payments received on nonaccrual impaired loans are applied in a similar manner as for nonaccrual loans, as described in Note 2, "Summary of Significant Accounting Policies."

The following table presents information concerning nonaccrual loans, accruing restructured loans and accruing loans 90 days or more past due. Restructured loans are loans whose terms have been modified and on which concessions have been granted because of borrower financial difficulties.

|                              | December 31,      |            |            |
|------------------------------|-------------------|------------|------------|
|                              | 2017              | 2016       | 2015       |
| Nonaccrual loans             |                   |            |            |
| Current as to                |                   |            |            |
| principal and interest       | \$ 78,927         | \$ 89,724  | \$ 54,999  |
| Past due                     | 47,308            | 55,984     | 58,427     |
| Total nonaccrual loans       | <u>126,235</u>    | 145,708    | 113,426    |
| Accrual loans                |                   |            |            |
| Restructured                 | 30,533            | 32,348     | 50,099     |
| 90 days or more past due     | 3,025             | 6,430      | 2,053      |
| Total impaired accrual loans | <u>33,558</u>     | 38,778     | 52,152     |
| Total impaired loans         | <u>\$ 159,793</u> | \$ 184,486 | \$ 165,578 |

There were \$3,964 in commitments to lend additional funds to borrowers whose loans were classified as nonaccrual or restructured at December 31, 2017.

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

|  | December 31,      |            |            |
|--|-------------------|------------|------------|
|  | 2017              | 2016       | 2015       |
| <b>Nonaccrual loans</b>                        |                   |            |            |
| Real estate mortgage                           | \$ 85,488         | \$ 91,651  | \$ 89,067  |
| Production and intermediate term               | 34,700            | 42,225     | 15,962     |
| Agribusiness                                   | 3,175             | 4,283      | 2,088      |
| Rural residential real estate                  | 1,178             | 2,103      | 1,116      |
| Lease receivables                              | 58                | 91         | 16         |
| Mission-related loans                          | 1,636             | 5,355      | 5,177      |
| Total nonaccrual loans                         | <u>126,235</u>    | 145,708    | 113,426    |
| <b>Accruing restructured loans</b>             |                   |            |            |
| Real estate mortgage                           | 18,496            | 24,569     | 20,123     |
| Production and intermediate term               | 6,236             | 1,816      | 23,702     |
| Rural residential real estate                  | 160               | 169        | 340        |
| Mission-related loans                          | 5,641             | 5,794      | 5,934      |
| Total accruing restructured loans              | <u>30,533</u>     | 32,348     | 50,099     |
| <b>Accruing loans 90 days or more past due</b> |                   |            |            |
| Real estate mortgage                           | 108               | 3,014      | 498        |
| Production and intermediate term               | 2,897             | 3,416      | 603        |
| Agribusiness                                   | 20                | -          | -          |
| Rural residential real estate                  | -                 | -          | 223        |
| Mission-related loans                          | -                 | -          | 729        |
| Total accruing loans 90 days or more past due  | <u>3,025</u>      | 6,430      | 2,053      |
| Total nonperforming loans                      | <u>159,793</u>    | 184,486    | 165,578    |
| Other property owned                           | 15,569            | 19,354     | 18,744     |
| Total nonperforming assets                     | <u>\$ 175,362</u> | \$ 203,840 | \$ 184,322 |

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

- Acceptable — assets expected to be fully collectible and represent the highest quality
- Other assets especially mentioned (OAEM) — assets are currently collectible but exhibit some potential weakness
- Substandard — assets exhibit some serious weakness in repayment capacity, equity and/or collateral pledged on the loan
- Doubtful — assets exhibit similar weaknesses to substandard assets; however, doubtful assets have additional weaknesses in existing factors, conditions and values that make collection in full highly questionable, and
- Loss — assets are considered uncollectible

The following table presents loans and related accrued interest classified under the Uniform Loan Classification System as a percentage of total loans and related accrued interest receivable by loan type as of December 31:

|   | 2017          | 2016          | 2015          |
|---|---------------|---------------|---------------|
| <b>Real estate mortgage:</b>                  |               |               |               |
| Acceptable                                    | 96.9%         | 97.2%         | 97.2%         |
| OAEM  | 1.6           | 1.5           | 1.5           |
| Substandard/Doubtful                          | 1.5           | 1.3           | 1.3           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Production and intermediate term:</b>      |               |               |               |
| Acceptable                                    | 92.3%         | 93.0%         | 96.4%         |
| OAEM  | 4.3           | 3.1           | 1.8           |
| Substandard/Doubtful                          | 3.4           | 3.9           | 1.8           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Agribusiness:</b>                          |               |               |               |
| Acceptable                                    | 99.2%         | 98.6%         | 97.7%         |
| OAEM  | 0.1           | 0.5           | 1.7           |
| Substandard/Doubtful                          | 0.7           | 0.9           | 0.6           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Energy and water/waste disposal:</b>       |               |               |               |
| Acceptable                                    | 98.0%         | 93.9%         | 98.2%         |
| OAEM  | 0.9           | 6.1           | 1.8           |
| Substandard/Doubtful                          | 1.1           | -             | -             |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Communications:</b>                        |               |               |               |
| Acceptable                                    | 100.0%        | 99.0%         | 99.7%         |
| OAEM  | -             | -             | -             |
| Substandard/Doubtful                          | -             | 1.0           | 0.3           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Rural residential real estate:</b>         |               |               |               |
| Acceptable                                    | 98.1%         | 97.8%         | 97.7%         |
| OAEM  | 0.8           | 0.8           | 1.1           |
| Substandard/Doubtful                          | 1.1           | 1.4           | 1.2           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Agricultural export finance:</b>           |               |               |               |
| Acceptable                                    | -             | -             | 100.0%        |
| OAEM  | -             | -             | -             |
| Substandard/Doubtful                          | -             | -             | -             |
|   | <b>-</b>      | <b>-</b>      | <b>100.0%</b> |
| <b>Lease receivables:</b>                     |               |               |               |
| Acceptable                                    | 99.6%         | 97.2%         | 99.7%         |
| OAEM  | 0.2           | 1.3           | -             |
| Substandard/Doubtful                          | 0.2           | 1.5           | 0.3           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Loans to other financing institutions:</b> |               |               |               |
| Acceptable                                    | 100.0%        | 100.0%        | 100.0%        |
| OAEM  | -             | -             | -             |
| Substandard/Doubtful                          | -             | -             | -             |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Mission-related:</b>                       |               |               |               |
| Acceptable                                    | 98.5%         | 95.8%         | 98.1%         |
| OAEM  | -             | -             | -             |
| Substandard/Doubtful                          | 1.5           | 4.2           | 1.9           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |
| <b>Total loans:</b>                           |               |               |               |
| Acceptable                                    | 96.9%         | 96.7%         | 97.3%         |
| OAEM  | 1.6           | 1.8           | 1.6           |
| Substandard/Doubtful                          | 1.5           | 1.5           | 1.1           |
|   | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |

The following table provides an age analysis of past due loans (including accrued interest) as of December 31, 2017:

|                                  | 30-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Not Past Due or<br>Less Than 30<br>Days Past Due | Total<br>Loans       | Recorded Investment<br>Greater Than 90 Days<br>Past Due and Accruing |
|----------------------------------|---------------------------|--------------------------------|-------------------|--|----------------------|--|
| Real estate mortgage             | \$ 68,437                 | \$ 27,282                      | \$ 95,719         | \$ 14,389,960                                    | \$ 14,485,679        | \$ 108   |
| Production and intermediate term | 17,208                    | 13,255                         | 30,463            | 3,017,492  | 3,047,955            | 2,897  |
| Agribusiness                     | 9,837                     | 20                             | 9,857             | 4,070,021  | 4,079,878            | 20   |
| Energy and water/waste disposal  | -                         | -                              | -                 | 1,476,998  | 1,476,998            | -  |
| Communications                   | -                         | -                              | -                 | 437,666  | 437,666              | -  |
| Rural residential real estate    | 1,273                     | 253                            | 1,526             | 233,627  | 235,153              | -  |
| Lease receivables                | -                         | 59                             | 59                | 25,087   | 25,146               | -  |
| Loans to OFIs                    | -                         | -                              | -                 | 40,187   | 40,187               | -  |
| Mission-related                  | 98                        | 1,636                          | 1,734             | 108,988  | 110,722              | -  |
| <b>Total</b>                     | <b>\$ 96,853</b>          | <b>\$ 42,505</b>               | <b>\$ 139,358</b> | <b>\$ 23,800,026</b>                             | <b>\$ 23,939,384</b> | <b>\$ 3,025</b>  |

The following table provides an age analysis of past due loans (including accrued interest) as of December 31, 2016:

|                                  | 30-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Not Past Due or<br>Less Than 30<br>Days Past Due | Total<br>Loans       | Recorded Investment<br>Greater Than 90 Days<br>Past Due and Accruing |
|----------------------------------|---------------------------|--------------------------------|-------------------|--|----------------------|--|
| Real estate mortgage             | \$ 47,594                 | \$ 30,084                      | \$ 77,678         | \$ 13,506,745                                    | \$ 13,584,423        | \$ 3,014   |
| Production and intermediate term | 36,716                    | 13,119                         | 49,835            | 2,716,403  | 2,766,238            | 3,416  |
| Agribusiness                     | 5,078                     | -                              | 5,078             | 3,803,833  | 3,808,911            | -  |
| Energy and water/waste disposal  | 14,590                    | -                              | 14,590            | 1,568,854  | 1,583,444            | -  |
| Communications                   | -                         | -                              | -                 | 465,502  | 465,502              | -  |
| Rural residential real estate    | 1,495                     | 1,028                          | 2,523             | 214,521  | 217,044              | -  |
| Lease receivables                | -                         | -                              | -                 | 6,248  | 6,248                | -  |
| Loans to OFIs                    | -                         | -                              | -                 | 42,143   | 42,143               | -  |
| Mission-related                  | 491                       | -                              | 491               | 126,539  | 127,030              | -  |
| <b>Total</b>                     | <b>\$ 105,964</b>         | <b>\$ 44,231</b>               | <b>\$ 150,195</b> | <b>\$ 22,450,788</b>                             | <b>\$ 22,600,983</b> | <b>\$ 6,430</b>  |

The following table provides an age analysis of past due loans (including accrued interest) as of December 31, 2015:

|                                  | 30-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Not Past Due or<br>Less Than 30<br>Days Past Due | Total<br>Loans       | Recorded Investment<br>Greater Than 90 Days<br>Past Due and Accruing |
|----------------------------------|---------------------------|--------------------------------|-------------------|--|----------------------|--|
| Real estate mortgage             | \$ 40,516                 | \$ 32,245                      | \$ 72,761         | \$ 12,224,166                                    | \$ 12,296,927        | \$ 498   |
| Production and intermediate term | 21,945                    | 9,251                          | 31,196            | 2,758,027  | 2,789,223            | 603  |
| Agribusiness                     | 6,633                     | 143                            | 6,776             | 3,694,602  | 3,701,378            | -  |
| Energy and water/waste disposal  | -                         | -                              | -                 | 1,459,502  | 1,459,502            | -  |
| Communications                   | -                         | -                              | -                 | 465,457  | 465,457              | -  |
| Rural residential real estate    | 1,737                     | 288                            | 2,025             | 300,578  | 302,603              | 223  |
| Agricultural export finance      | -                         | -                              | -                 | 9,735  | 9,735                | -  |
| Lease receivables                | 8                         | -                              | 8                 | 6,330  | 6,338                | -  |
| Loans to OFIs                    | -                         | -                              | -                 | 42,647   | 42,647               | -  |
| Mission-related                  | 227                       | 5,906                          | 6,133             | 261,884  | 268,017              | 729  |
| <b>Total</b>                     | <b>\$ 71,066</b>          | <b>\$ 47,833</b>               | <b>\$ 118,899</b> | <b>\$ 21,222,928</b>                             | <b>\$ 21,341,827</b> | <b>\$ 2,053</b>  |

Note: The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges or acquisition costs and may also reflect a previous direct write-down of the investment.

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

As of December 31, 2017, the total recorded investment of troubled debt restructured loans was \$43.3 million including \$12.8 million classified as nonaccrual and \$30.5 million classified as accrual, with specific allowance for loan losses of \$1.2 million. As of December 31, 2017, commitments to lend funds to borrowers whose loan terms have been modified in a troubled debt restructuring were \$330.

The following tables present additional information regarding troubled debt restructurings, which includes both accrual and nonaccrual loans with troubled debt restructuring designation, that occurred during the years ended December 31, 2017, 2016 and 2015. The premodification outstanding recorded investment represents the recorded investment of the loans as of the quarter end prior to the restructuring. The postmodification outstanding recorded investment represents the recorded investment of the loans as of the quarter end the restructuring occurred.

For the year ended December 31, 2017:

|                                      | Premodification<br>Outstanding<br>Recorded Investment* | Postmodification<br>Outstanding<br>Recorded Investment* |
|--------------------------------------|--|---|
| <b>Troubled debt restructurings:</b> |  |   |
| Real estate mortgage                 | \$ 4,450   | \$ 4,488  |
| Production and intermediate term     | 11,006   | 9,735   |
| <b>Total</b>                         | <b>\$ 15,456</b>                                       | <b>\$ 14,223</b>  |

For the year ended December 31, 2016:

|                                      | Premodification<br>Outstanding<br>Recorded Investment* | Postmodification<br>Outstanding<br>Recorded Investment* |
|--------------------------------------|--|---|
| <b>Troubled debt restructurings:</b> |  |   |
| Real estate mortgage                 | \$ 2,558   | \$ 2,564  |
| Production and intermediate term     | 825  | 827   |
| Mission-related                      | 5,581  | 5,428   |
| <b>Total</b>                         | <b>\$ 8,964</b>  | <b>\$ 8,819</b>   |

The following table provides information on outstanding loans restructured in troubled debt restructurings at period end. These loans are included as impaired loans in the impaired loan table:

|                                  | Total Loans Modified as TDRs |                      |                      |
|----------------------------------|------------------------------|----------------------|----------------------|
|                                  | December 31,<br>2017         | December 31,<br>2016 | December 31,<br>2015 |
| Real estate mortgage             | \$ 27,175                    | \$ 31,846            | \$ 31,424            |
| Production and intermediate term | 7,998                        | 2,906                | 24,174               |
| Agribusiness                     | 406                          | 1,373                | 1,788                |
| Rural residential real estate    | 449                          | 498                  | 546                  |
| Mission-related                  | 7,277                        | 11,149               | 5,934                |
| <b>Total</b>                     | <b>\$ 43,305</b>             | <b>\$ 47,772</b>     | <b>\$ 63,866</b>     |

For the year ended December 31, 2015:

|                                      | Premodification<br>Outstanding<br>Recorded Investment* | Postmodification<br>Outstanding<br>Recorded Investment* |
|--------------------------------------|--|---|
| <b>Troubled debt restructurings:</b> |  |   |
| Real estate mortgage                 | \$ 6,437   | \$ 6,026  |
| Production and intermediate term     | 4,723  | 5,010   |
| Rural residential real estate        | 402  | 426   |
| Mission-related                      | 941  | 955   |
| <b>Total</b>                         | <b>\$ 12,503</b>                                       | <b>\$ 12,417</b>  |

\*Note: Premodification represents the recorded investment prior to restructuring, and postmodification represents the recorded investment following the restructuring. The recorded investment is the face amount of the receivable increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges or acquisition costs and may also reflect a previous direct write-down of the investment.

A payment default is defined as a payment that is 30 days past due after the date the loan was restructured. The following table presents information regarding troubled debt restructurings that occurred within the previous twelve months and for which there was a payment default during the period:

|  | Recorded<br>Investment at<br>December 31,<br>2017 | Recorded<br>Investment at<br>December 31,<br>2016 | Recorded<br>Investment at<br>December 31,<br>2015 |
|--|---|---|---|
| <b>Troubled debt restructurings<br/>that subsequently defaulted:</b> |   |   |   |
| Real estate mortgage   | \$ -  | \$ 88   | \$ -  |
| <b>Total</b>   | <b>\$ -</b>                                       | <b>\$ 88</b>                                      | <b>\$ -</b>                                       |

Additional impaired loan information at December 31, 2017, is as follows:

|   | Recorded Investment | Unpaid Principal Balance* | Related Allowance | Average Impaired Loans | Interest Income Recognized |
|---|---------------------|---------------------------|-------------------|------------------------|----------------------------|
| <b>Impaired loans with a related allowance for credit losses</b>  |                     |                           |                   |                        |                            |
| Real estate mortgage  | \$ 5,530            | \$ 5,620                  | \$ 1,075          | \$ 7,502               | \$ 224                     |
| Production and intermediate term                                  | 4,969               | 6,255                     | 1,738             | 10,254                 | 65                         |
| Processing and marketing  | 2,736               | 2,735                     | 368               | 2,822                  | 335                        |
| Farm-related business   | 308                 | 4,232                     | 111               | 586                    | -                          |
| Rural residential real estate                                     | 39                  | 39                        | 5                 | 191                    | 4                          |
| Mission-related   | 429                 | 429                       | 198               | 1,438                  | 187                        |
| <b>Total</b>  | <b>\$ 14,011</b>    | <b>\$ 19,310</b>          | <b>\$ 3,495</b>   | <b>\$ 22,793</b>       | <b>\$ 815</b>              |
| <b>Impaired loans with no related allowance for credit losses</b> |                     |                           |                   |                        |                            |
| Real estate mortgage  | \$ 98,562           | \$ 102,071                | \$ -              | \$ 106,709             | \$ 10,618                  |
| Production and intermediate term                                  | 38,864              | 54,124                    | -                 | 29,369                 | 1,627                      |
| Loans to cooperatives   | -                   | -                         | -                 | 381                    | 34                         |
| Processing and marketing  | 151                 | 9,345                     | -                 | 483                    | -                          |
| Farm-related business   | -                   | 89                        | -                 | -                      | 50                         |
| Energy and water/waste disposal                                   | -                   | 7,623                     | -                 | -                      | -                          |
| Rural residential real estate                                     | 1,299               | 1,572                     | -                 | 1,793                  | 63                         |
| Lease receivables   | 58                  | 82                        | -                 | 83                     | 13                         |
| Mission-related   | 6,848               | 6,848                     | -                 | 8,968                  | 325                        |
| <b>Total</b>  | <b>\$ 145,782</b>   | <b>\$ 181,754</b>         | <b>\$ -</b>       | <b>\$ 147,786</b>      | <b>\$ 12,730</b>           |
| <b>Total impaired loans</b>                                       |                     |                           |                   |                        |                            |
| Real estate mortgage  | \$ 104,092          | \$ 107,691                | \$ 1,075          | \$ 114,211             | \$ 10,842                  |
| Production and intermediate term                                  | 43,833              | 60,379                    | 1,738             | 39,623                 | 1,692                      |
| Loans to cooperatives   | -                   | -                         | -                 | 381                    | 34                         |
| Processing and marketing  | 2,887               | 12,080                    | 368               | 3,305                  | 335                        |
| Farm-related business   | 308                 | 4,321                     | 111               | 586                    | 50                         |
| Energy and water/waste disposal                                   | -                   | 7,623                     | -                 | -                      | -                          |
| Rural residential real estate                                     | 1,338               | 1,611                     | 5                 | 1,984                  | 67                         |
| Lease receivables   | 58                  | 82                        | -                 | 83                     | 13                         |
| Mission-related   | 7,277               | 7,277                     | 198               | 10,406                 | 512                        |
| <b>Total</b>  | <b>\$ 159,793</b>   | <b>\$ 201,064</b>         | <b>\$ 3,495</b>   | <b>\$ 170,579</b>      | <b>\$ 13,545</b>           |

\*Unpaid principal balance represents the contractual obligations of the loans.

Additional impaired loan information at December 31, 2016, is as follows:

|   | Recorded Investment | Unpaid Principal Balance* | Related Allowance | Average Impaired Loans | Interest Income Recognized |
|---|---------------------|---------------------------|-------------------|------------------------|----------------------------|
| <b>Impaired loans with a related allowance for credit losses</b>  |                     |                           |                   |                        |                            |
| Real estate mortgage  | \$ 7,475            | \$ 7,646                  | \$ 1,032          | \$ 9,841               | \$ 286                     |
| Production and intermediate term                                  | 15,534              | 16,139                    | 3,959             | 11,932                 | 445                        |
| Processing and marketing  | 2,868               | 2,868                     | 368               | 473                    | 15                         |
| Farm-related business   | 812                 | 4,736                     | 111               | 839                    | -                          |
| Rural residential real estate                                     | 125                 | 129                       | 22                | 167                    | 5                          |
| Mission-related   | 2,484               | 2,484                     | 190               | 2,508                  | 228                        |
| <b>Total</b>  | <b>\$ 29,298</b>    | <b>\$ 34,002</b>          | <b>\$ 5,682</b>   | <b>\$ 25,760</b>       | <b>\$ 979</b>              |
| <b>Impaired loans with no related allowance for credit losses</b> |                     |                           |                   |                        |                            |
| Real estate mortgage  | \$ 111,759          | \$ 117,599                | \$ -              | \$ 115,753             | \$ 6,203                   |
| Production and intermediate term                                  | 31,923              | 45,813                    | -                 | 29,098                 | 1,606                      |
| Processing and marketing  | 603                 | 21,065                    | -                 | 838                    | 15                         |
| Farm-related business   | -                   | 147                       | -                 | -                      | 15                         |
| Energy and water/waste disposal                                   | -                   | 9,043                     | -                 | -                      | 5                          |
| Rural residential real estate                                     | 2,148               | 2,290                     | -                 | 1,765                  | 30                         |
| Lease receivables   | 91                  | 92                        | -                 | 24                     | 5                          |
| Mission-related   | 8,664               | 8,664                     | -                 | 8,927                  | 227                        |
| <b>Total</b>  | <b>\$ 155,188</b>   | <b>\$ 204,713</b>         | <b>\$ -</b>       | <b>\$ 156,405</b>      | <b>\$ 8,106</b>            |
| <b>Total impaired loans</b>                                       |                     |                           |                   |                        |                            |
| Real estate mortgage  | \$ 119,234          | \$ 125,245                | \$ 1,032          | \$ 125,594             | \$ 6,489                   |
| Production and intermediate term                                  | 47,457              | 61,952                    | 3,959             | 41,030                 | 2,051                      |
| Processing and marketing  | 3,471               | 23,933                    | 368               | 1,311                  | 30                         |
| Farm-related business   | 812                 | 4,883                     | 111               | 839                    | 15                         |
| Energy and water/waste disposal                                   | -                   | 9,043                     | -                 | -                      | 5                          |
| Rural residential real estate                                     | 2,273               | 2,419                     | 22                | 1,932                  | 35                         |
| Lease receivables   | 91                  | 92                        | -                 | 24                     | 5                          |
| Mission-related   | 11,148              | 11,148                    | 190               | 11,435                 | 455                        |
| <b>Total</b>  | <b>\$ 184,486</b>   | <b>\$ 238,715</b>         | <b>\$ 5,682</b>   | <b>\$ 182,165</b>      | <b>\$ 9,085</b>            |

\*Unpaid principal balance represents the contractual obligations of the loans.

Additional impaired loan information at December 31, 2015, is as follows:

|   | Recorded<br>Investment | Unpaid Principal<br>Balance* | Related<br>Allowance | Average<br>Impaired Loans | Interest Income<br>Recognized |
|---|------------------------|------------------------------|----------------------|---------------------------|-------------------------------|
| <b>Impaired loans with a related allowance for credit losses</b>  |                        |                              |                      |                           |                               |
| Real estate mortgage  | \$ 14,105              | \$ 14,724                    | \$ 2,649             | \$ 16,921                 | \$ 825                        |
| Production and intermediate term                                  | 6,742                  | 6,832                        | 2,534                | 4,138                     | 106                           |
| Processing and marketing  | -                      | -                            | -                    | 262                       | -                             |
| Farm-related business   | 934                    | 4,858                        | 121                  | 921                       | -                             |
| Energy and water/waste disposal                                   | -                      | -                            | -                    | 1,714                     | -                             |
| Rural residential real estate                                     | 51                     | 51                           | 10                   | 46                        | 2                             |
| Mission-related   | 2,549                  | 2,549                        | 184                  | 3,199                     | 586                           |
| Total   | \$ 24,381              | \$ 29,014                    | \$ 5,498             | \$ 27,201                 | \$ 1,519                      |
| <b>Impaired loans with no related allowance for credit losses</b> |                        |                              |                      |                           |                               |
| Real estate mortgage  | \$ 95,583              | \$ 105,816                   | \$ -                 | \$ 114,126                | \$ 9,133                      |
| Production and intermediate term                                  | 33,525                 | 47,230                       | -                    | 31,747                    | 6,551                         |
| Processing and marketing  | 1,008                  | 26,748                       | -                    | 2,654                     | 27                            |
| Farm-related business   | 146                    | 563                          | -                    | 161                       | 32                            |
| Energy and water/waste disposal                                   | -                      | 22,730                       | -                    | 1,687                     | -                             |
| Rural residential real estate                                     | 1,628                  | 1,823                        | -                    | 1,434                     | 90                            |
| Lease receivables   | 16                     | 16                           | -                    | 24                        | -                             |
| Mission-related   | 9,291                  | 12,482                       | -                    | 3,936                     | 638                           |
| Total   | \$ 141,197             | \$ 217,408                   | \$ -                 | \$ 155,769                | \$ 16,471                     |
| <b>Total impaired loans</b>                                       |                        |                              |                      |                           |                               |
| Real estate mortgage  | \$ 109,688             | \$ 120,540                   | \$ 2,649             | \$ 131,047                | \$ 9,958                      |
| Production and intermediate term                                  | 40,267                 | 54,062                       | 2,534                | 35,885                    | 6,657                         |
| Processing and marketing  | 1,008                  | 26,748                       | -                    | 2,916                     | 27                            |
| Farm-related business   | 1,080                  | 5,421                        | 121                  | 1,082                     | 32                            |
| Energy and water/waste disposal                                   | -                      | 22,730                       | -                    | 3,401                     | -                             |
| Rural residential real estate                                     | 1,679                  | 1,874                        | 10                   | 1,480                     | 92                            |
| Lease receivables   | 16                     | 16                           | -                    | 24                        | -                             |
| Mission-related   | 11,840                 | 15,031                       | 184                  | 7,135                     | 1,224                         |
| Total   | \$ 165,578             | \$ 246,422                   | \$ 5,498             | \$ 182,970                | \$ 17,990                     |

\*Unpaid principal balance represents the contractual obligations of the loans.

Interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans were as follows at December 31:

|  | 2017      | 2016      | 2015      |
|--|-----------|-----------|-----------|
| Interest income which would have been recognized under the original loan terms | \$ 22,782 | \$ 20,958 | \$ 29,706 |
| Less: Interest income recognized   | 13,545    | 8,718     | 17,769    |
| Foregone interest income   | \$ 9,237  | \$ 12,240 | \$ 11,937 |

A summary of changes in the allowance for loan losses and period end recorded investment (including accrued interest) in loans follows:

|   | Real Estate<br>Mortgage | Production and<br>Intermediate<br>Term | Agribusiness | Communications | Energy and<br>Water/Waste<br>Disposal | Rural<br>Residential<br>Real Estate | Lease<br>Receivables | Loans to<br>OFIs | Mission-<br>Related | Total         |
|---|-------------------------|--|--------------|----------------|---------------------------------------|-------------------------------------|----------------------|------------------|---------------------|---------------|
| <b>Allowance for Loan Losses:</b>                               |                         |  |              |                |                                       |                                     |                      |                  |                     |               |
| Balance at  |                         |  |              |                |                                       |                                     |                      |                  |                     |               |
| December 31, 2016   | \$ 35,559               | \$ 25,341                              | \$ 13,036    | \$ 1,393       | \$ 5,686                              | \$ 479                              | \$ 42                | \$ -             | \$ 201              | \$ 81,737     |
| Charge-offs   | (266)                   | (7,812)                                | -            | -              | -                                     | (32)                                | (22)                 | -                | -                   | (8,132)       |
| Recoveries  | 895                     | 903                                    | 670          | -              | 1,420                                 | 28                                  | -                    | -                | 16                  | 3,932         |
| Provision for (negative provision) loan losses                  | 4,237                   | 3,906                                  | (1,578)      | (232)          | (1,279)                               | (17)                                | 36                   | -                | (8)                 | 5,065         |
| Other*  | 1,205                   | 874                                    | (1,134)      | (335)          | 12                                    | 74                                  | (21)                 | -                | (9)                 | 666           |
| Balance at  |                         |  |              |                |                                       |                                     |                      |                  |                     |               |
| December 31, 2017   | \$ 41,630               | \$ 23,212                              | \$ 10,994    | \$ 826         | \$ 5,839                              | \$ 532                              | \$ 35                | \$ -             | \$ 200              | \$ 83,268     |
| Individually evaluated for impairment                           | \$ 1,334                | \$ 1,740                               | \$ 478       | \$ -           | \$ -                                  | \$ 27                               | \$ -                 | \$ -             | \$ 189              | \$ 3,768      |
| Collectively evaluated for impairment                           | 40,296                  | 21,472                                 | 10,516       | 826            | 5,839                                 | 505                                 | 35                   | -                | 11                  | 79,500        |
| Loans acquired with deteriorated credit quality                 | -                       | -                                      | -            | -              | -                                     | -                                   | -                    | -                | -                   | -             |
| Balance at  |                         |  |              |                |                                       |                                     |                      |                  |                     |               |
| December 31, 2017   | \$ 41,630               | \$ 23,212                              | \$ 10,994    | \$ 826         | \$ 5,839                              | \$ 532                              | \$ 35                | \$ -             | \$ 200              | \$ 83,268     |
| <b>Recorded Investments in Loans Outstanding:</b>               |                         |  |              |                |                                       |                                     |                      |                  |                     |               |
| Balance at  |                         |  |              |                |                                       |                                     |                      |                  |                     |               |
| December 31, 2017   | \$ 14,485,679           | \$ 3,047,955                           | \$ 4,079,878 | \$ 437,666     | \$ 1,476,998                          | \$ 235,153                          | \$ 25,146            | \$ 40,187        | \$ 110,722          | \$ 23,939,384 |
| Ending Balance: loans individually evaluated for impairment     | \$ 109,057              | \$ 43,447                              | \$ 3,194     | \$ -           | \$ -                                  | \$ 1,827                            | \$ 59                | \$ -             | \$ 7,246            | \$ 164,830    |
| Ending Balance: loans collectively evaluated for impairment     | \$ 14,376,379           | \$ 3,004,500                           | \$ 4,076,684 | \$ 437,666     | \$ 1,476,998                          | \$ 233,326                          | \$ 25,087            | \$ 40,187        | \$ 103,476          | \$ 23,774,303 |
| Ending Balance: loans acquired with deteriorated credit quality | \$ 243                  | \$ 8                                   | \$ -         | \$ -           | \$ -                                  | \$ -                                | \$ -                 | \$ -             | \$ -                | \$ 251        |

\*Reserve for losses on letters of credit and unfunded commitments recorded in other liabilities.

|   | Real Estate<br>Mortgage | Production and<br>Intermediate<br>Term | Agribusiness | Communications | Energy and<br>Water/Waste<br>Disposal | Rural<br>Residential<br>Real Estate | Agricultural<br>Export<br>Finance | Lease<br>Receivables | Loans to<br>OFIs | Mission-<br>Related | Total         |
|---|-------------------------|--|--------------|----------------|---------------------------------------|-------------------------------------|-----------------------------------|----------------------|------------------|---------------------|---------------|
| <b>Allowance for Loan Losses:</b>                               |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2015   | \$ 39,195               | \$ 17,461                              | \$ 8,262     | \$ 1,087       | \$ 3,442                              | \$ 620                              | \$ 3                              | \$ 43                | \$ -             | \$ 237              | \$ 70,350     |
| Charge-offs   | (1,225)                 | (2,326)                                | (73)         | -              | -                                     | -                                   | -                                 | -                    | -                | -                   | (3,624)       |
| Recoveries  | 1,973                   | 393                                    | 1,434        | 1,833          | -                                     | 14                                  | -                                 | -                    | -                | -                   | 5,647         |
| Provision for (negative provision) loan losses                  | (4,237)                 | 11,272                                 | 3,686        | (1,523)        | 2,490                                 | (156)                               | (3)                               | (1)                  | -                | (36)                | 11,492        |
| Other*  | (147)                   | (1,459)                                | (273)        | (4)            | (246)                                 | 1                                   | -                                 | -                    | -                | -                   | (2,128)       |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2016   | \$ 35,559               | \$ 25,341                              | \$ 13,036    | \$ 1,393       | \$ 5,686                              | \$ 479                              | \$ -                              | \$ 42                | \$ -             | \$ 201              | \$ 81,737     |
| Individually evaluated for impairment                           |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 1,303                | \$ 3,959                               | \$ 480       | \$ -           | \$ -                                  | \$ 22                               | \$ -                              | \$ -                 | \$ -             | \$ 190              | \$ 5,954      |
| Collectively evaluated for impairment                           |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | 34,256                  | 21,382                                 | 12,556       | 1,393          | 5,686                                 | 457                                 | -                                 | 42                   | -                | 11                  | 75,783        |
| Loans acquired with deteriorated credit quality                 |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | -                       | -                                      | -            | -              | -                                     | -                                   | -                                 | -                    | -                | -                   | -             |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2016   | \$ 35,559               | \$ 25,341                              | \$ 13,036    | \$ 1,393       | \$ 5,686                              | \$ 479                              | \$ -                              | \$ 42                | \$ -             | \$ 201              | \$ 81,737     |
| <b>Recorded Investments in Loans Outstanding:</b>               |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2016   | \$ 13,584,423           | \$ 2,766,238                           | \$ 3,808,911 | \$ 465,502     | \$ 1,583,444                          | \$ 217,043                          | \$ -                              | \$ 6,248             | \$ 42,143        | \$ 127,030          | \$ 22,600,982 |
| Ending Balance: loans individually evaluated for impairment     |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 120,792              | \$ 47,486                              | \$ 4,283     | \$ -           | \$ -                                  | \$ 2,751                            | \$ -                              | \$ 92                | \$ -             | \$ 11,117           | \$ 186,521    |
| Ending Balance: loans collectively evaluated for impairment     |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 13,463,091           | \$ 2,718,728                           | \$ 3,804,628 | \$ 465,502     | \$ 1,583,444                          | \$ 214,292                          | \$ -                              | \$ 6,156             | \$ 42,143        | \$ 115,913          | \$ 22,413,897 |
| Ending Balance: loans acquired with deteriorated credit quality |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 540                  | \$ 24                                  | \$ -         | \$ -           | \$ -                                  | \$ -                                | \$ -                              | \$ -                 | \$ -             | \$ -                | \$ 564        |

\*Reserve for losses on letters of credit and unfunded commitments recorded in other liabilities.

|   | Real Estate<br>mortgage | Production and<br>Intermediate<br>Term | Agribusiness | Communications | Energy and<br>Water/Waste<br>Disposal | Rural<br>Residential<br>Real Estate | Agricultural<br>Export<br>Finance | Lease<br>Receivables | Loans to<br>OFIs | Mission-<br>Related | Total         |
|---|-------------------------|--|--------------|----------------|---------------------------------------|-------------------------------------|-----------------------------------|----------------------|------------------|---------------------|---------------|
| <b>Allowance for Loan Losses:</b>                               |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2014   | \$ 38,137               | \$ 10,404                              | \$ 6,215     | \$ 716         | \$ 8,155                              | \$ 472                              | \$ -                              | \$ 44                | \$ -             | \$ 214              | \$ 64,357     |
| Charge-offs   | (1,795)                 | (1,010)                                | (14)         | -              | (2,065)                               | (23)                                | -                                 | -                    | -                | -                   | (4,907)       |
| Recoveries  | 4,735                   | 1,851                                  | 1,566        | 190            | -                                     | 200                                 | -                                 | -                    | -                | -                   | 8,542         |
| Provision for (negative provision) loan losses                  | (1,042)                 | 8,056                                  | 1,038        | 206            | (2,609)                               | (23)                                | 3                                 | (1)                  | -                | 25                  | 5,653         |
| Adjustment due to merger  | (1,013)                 | (1,223)                                | (125)        | -              | -                                     | (2)                                 | -                                 | -                    | -                | -                   | (2,363)       |
| Other*  | 173                     | (617)                                  | (418)        | (25)           | (39)                                  | (4)                                 | -                                 | -                    | -                | (2)                 | (932)         |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2015   | \$ 39,195               | \$ 17,461                              | \$ 8,262     | \$ 1,087       | \$ 3,442                              | \$ 620                              | \$ 3                              | \$ 43                | \$ -             | \$ 237              | \$ 70,350     |
| Individually evaluated for impairment                           |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 2,965                | \$ 2,570                               | \$ 844       | \$ -           | \$ -                                  | \$ 6                                | \$ -                              | \$ -                 | \$ -             | \$ 184              | \$ 6,569      |
| Collectively evaluated for impairment                           |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | 36,230                  | 14,891                                 | 7,418        | 1,087          | 3,442                                 | 614                                 | 3                                 | 43                   | -                | 53                  | 63,781        |
| Loans acquired with deteriorated credit quality                 |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | -                       | -                                      | -            | -              | -                                     | -                                   | -                                 | -                    | -                | -                   | -             |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2015   | \$ 39,195               | \$ 17,461                              | \$ 8,262     | \$ 1,087       | \$ 3,442                              | \$ 620                              | \$ 3                              | \$ 43                | \$ -             | \$ 237              | \$ 70,350     |
| <b>Recorded Investments in Loans Outstanding:</b>               |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| Balance at  |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
| December 31, 2015   | \$ 12,296,927           | \$ 2,789,223                           | \$ 3,701,378 | \$ 465,457     | \$ 1,459,502                          | \$ 302,603                          | \$ 9,735                          | \$ 6,338             | \$ 42,647        | \$ 268,017          | \$ 21,341,827 |
| Ending Balance: loans individually evaluated for impairment     |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 112,734              | \$ 40,865                              | \$ 4,107     | \$ -           | \$ -                                  | \$ 1,743                            | \$ -                              | \$ 16                | \$ -             | \$ 11,808           | \$ 171,273    |
| Ending Balance: loans collectively evaluated for impairment     |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 12,183,511           | \$ 2,748,320                           | \$ 3,697,128 | \$ 465,457     | \$ 1,459,502                          | \$ 300,860                          | \$ 9,735                          | \$ 6,322             | \$ 42,647        | \$ 256,209          | \$ 21,169,691 |
| Ending Balance: loans acquired with deteriorated credit quality |                         |  |              |                |                                       |                                     |                                   |                      |                  |                     |               |
|   | \$ 682                  | \$ 38                                  | \$ 143       | \$ -           | \$ -                                  | \$ -                                | \$ -                              | \$ -                 | \$ -             | \$ -                | \$ 863        |

\*Reserve for losses on letters of credit and unfunded commitments recorded in other liabilities

## Note 5 — Premises and Equipment

Premises and equipment for the bank and associations comprised the following at:

|                            | December 31, |            |            |
|----------------------------|--------------|------------|------------|
|                            | 2017         | 2016       | 2015       |
| Land                       | \$ 20,890    | \$ 19,942  | \$ 18,090  |
| Buildings and improvements | 74,033       | 69,794     | 63,614     |
| Furniture and equipment    | 120,140      | 104,422    | 85,988     |
|                            | 215,063      | 194,158    | 167,692    |
| Accumulated depreciation   | (80,446)     | (71,513)   | (62,652)   |
| Total                      | \$ 134,617   | \$ 122,645 | \$ 105,040 |

On September 30, 2003, the bank entered into a lease for approximately 102,500 square feet of office space to house its headquarters facility. The lease was effective September 30, 2003, and its term was from September 1, 2003, to August 31, 2013. On November 16, 2010, the bank entered into a lease amendment which extended the

term of the lease to August 31, 2024. In addition, the lease amendment included expansion of the leased space to approximately 111,500 square feet of office space. Under the terms of the lease amendment, the bank will pay annual base rental ranging from \$18 per square foot in the first year to \$26 per square foot in the last year. Annual lease expenses for the facility, including certain operating expenses passed through from the landlord, were \$3.9 million, \$3.8 million and \$3.5 million for 2017, 2016 and 2015, respectively.

On July 31, 2015, the bank entered into a lease of computer network storage equipment, the terms of which provide for payments of \$32 per month for 36 months. In that the present value of the minimum lease payments is greater than 90 percent of the fair value of the asset at the inception of the lease, the lease has been capitalized. At December 31, 2017, the capitalized lease had a book value of \$249, net of depreciation totaling \$873, and a related liability of \$281. Interest on the capital lease obligation totaled \$7 during 2017.

Following is a schedule of the minimum lease payments remaining for the bank and district associations on building and computer equipment leases:

|                              | <u>Minimum Lease Payments</u> |
|------------------------------|-------------------------------|
| 2018                         | <b>\$6,248</b>                |
| 2019                         | <b>5,136</b>                  |
| 2020                         | <b>4,111</b>                  |
| 2021                         | <b>3,302</b>                  |
| 2022                         | <b>2,784</b>                  |
| Thereafter                   | <b>4,692</b>                  |
| Total minimum lease payments | <b><u>\$26,273</u></b>        |

## Note 6 — Other Property Owned

OPO consisting of real and personal property acquired through foreclosure or deed in lieu of foreclosure, is recorded at fair value, based on appraisal, less estimated selling costs upon acquisition. OPO totaled \$15,569, \$19,354 and \$18,744 at December 31, 2017, 2016 and 2015, respectively. The \$15,569 balance of OPO at December 31, 2017, was held entirely by the district associations.

Net gain (loss) on OPO consists of the following for the years ended:

|   | <u>December 31,</u> |             |             |
|---|---------------------|-------------|-------------|
|   | <u>2017</u>         | <u>2016</u> | <u>2015</u> |
| Gain (loss) on sale, net                | <b>\$ 1,390</b>     | \$ (475)    | \$ 4,597    |
| Carrying value adjustments              | <b>(965)</b>        | (1,284)     | (1,486)     |
| Operating expense, net                  | <b>(117)</b>        | (420)       | (126)       |
| Net gain (loss) on other property owned | <b>\$ 308</b>       | \$ (2,179)  | \$ 2,985    |

## Note 7 — Other Assets and Other Liabilities

Other assets comprised the following at December 31:

|                                   | <u>2017</u>       | <u>2016</u> | <u>2015</u> |
|-----------------------------------|-------------------|-------------|-------------|
| Investment in another System bank | <b>\$ 127,527</b> | \$ 112,939  | \$ 105,135  |
| Other accounts receivable         | <b>28,227</b>     | 28,537      | 24,316      |
| Loan held for sale                | -                 | -           | 4,850       |
| RBIC investments                  | <b>23,362</b>     | 13,579      | 7,551       |
| Fair value of derivatives         | <b>8,932</b>      | 8,074       | 504         |
| Deferred tax assets, net          | <b>1,226</b>      | 1,850       | 1,904       |
| Other                             | <b>34,860</b>     | 32,223      | 22,457      |
| Total                             | <b>\$ 224,134</b> | \$ 197,202  | \$ 166,717  |

Other liabilities comprised the following at December 31:

|                                    | <u>2017</u>       | <u>2016</u> | <u>2015</u> |
|------------------------------------|-------------------|-------------|-------------|
| Pension liability                  | <b>\$ 125,152</b> | \$ 120,949  | \$ 125,971  |
| Accounts payable                   | <b>95,436</b>     | 79,731      | 96,223      |
| Postretirement benefits obligation | <b>76,886</b>     | 67,752      | 65,017      |
| Advance conditional payments       | <b>16,208</b>     | 19,837      | 19,551      |
| Bank draft payable                 | <b>9,454</b>      | 24,096      | 26,167      |
| FCSIC premium payable              | <b>26,306</b>     | 34,206      | 19,167      |
| Deferred tax liabilities           | <b>242</b>        | 289         | 306         |
| Other                              | <b>28,037</b>     | 34,938      | 20,167      |
| Total                              | <b>\$ 377,721</b> | \$ 381,798  | \$ 372,569  |

## Note 8 — Bonds and Notes

### Systemwide Debt Securities and Notes Payable:

The System, unlike commercial banks and other depository institutions, obtains funds for its lending operations primarily from the sale of Systemwide debt securities issued by the banks through the Funding Corporation. Certain conditions must be met before the bank can participate in the issuance of Systemwide debt securities. The bank is required by the Farm Credit Act and FCA regulations to maintain specified eligible assets at least equal in value to the total amount of debt obligations outstanding for which it is primarily liable as a condition for participation in the issuance of Systemwide debt securities, or bank and other bonds, with a security interest in any assets of the banks.

The System banks and the Funding Corporation have entered into the third amended and restated Market Access Agreement (MAA), which establishes criteria and procedures for the banks to provide certain information to the Funding Corporation and, under certain circumstances, for restricting or prohibiting an individual bank's participation in Systemwide debt issuances, thereby reducing other System banks' exposure to statutory joint and several liability. At December 31, 2017, the bank was, and currently remains, in compliance with the conditions and requirements of the MAA. In general, each bank determines its participation in each issue of Systemwide debt securities based on its funding and operating requirements, subject to the availability of eligible assets as described above and subject to Funding Corporation determinations and FCA approval. At December 31, 2017, the bank had such specified eligible assets totaling \$22.58 billion, and obligations and accrued interest payable totaling \$21.01 billion, resulting in excess eligible assets of \$1.57 billion.

Each issuance of Systemwide debt securities ranks equally, in accordance with the FCA regulations, with other unsecured Systemwide debt securities. Systemwide debt securities are not issued under an indenture, and no trustee is provided with respect to these securities. Systemwide debt securities are not subject to acceleration prior to maturity upon the occurrence of any default or similar event.

The district's participation in Systemwide debt securities and notes payable to another System bank at December 31, 2017, follows (*dollars in thousands*):

| Year of Maturity | Systemwide           |   |                     |   | Notes Payable to<br>Other System Bank |                                 | Total                |                                 |
|------------------|----------------------|---|---------------------|---|---------------------------------------|---------------------------------|----------------------|---------------------------------|
|                  | Bonds                |   | Discount Notes      |   | Amount                                | Weighted<br>Average<br>Interest | Amount               | Weighted<br>Average<br>Interest |
|                  | Amount               | Weighted<br>Average<br>Interest<br>Rate | Amount              | Weighted<br>Average<br>Interest<br>Rate |                                       |                                 |                      |                                 |
| 2018             | \$ 5,337,408         | 1.22%                                   | \$ 2,335,527        | 1.27%                                   | \$ 3,850,000                          | 1.72%                           | \$ 11,522,935        | 1.40%                           |
| 2019             | 4,450,642            | 1.38                                    | -                   | -                                       | -                                     | -                               | 4,450,642            | 1.38                            |
| 2020             | 2,296,451            | 1.58                                    | -                   | -                                       | -                                     | -                               | 2,296,451            | 1.58                            |
| 2021             | 1,711,009            | 1.94                                    | -                   | -                                       | -                                     | -                               | 1,711,009            | 1.94                            |
| 2022             | 1,578,671            | 1.98                                    | -                   | -                                       | -                                     | -                               | 1,578,671            | 1.98                            |
| Subsequent years | 3,241,515            | 2.71                                    | -                   | -                                       | -                                     | -                               | 3,241,515            | 2.71                            |
| <b>Total</b>     | <b>\$ 18,615,696</b> | <b>1.69%</b>                            | <b>\$ 2,335,527</b> | <b>1.27%</b>                            | <b>\$ 3,850,000</b>                   | <b>1.72%</b>                    | <b>\$ 24,801,223</b> | <b>1.66%</b>                    |

Discount notes are issued with maturities ranging from one to 365 days. The average maturity of discount notes at December 31, 2017, was 135 days.

The bank's Systemwide debt includes callable debt, consisting of the following at December 31, 2017 (*dollars in thousands*):

| Year of Maturity | Amount               | Range of First Call Dates |
|------------------|----------------------|---------------------------|
| 2018             | \$ 1,294,000         | 1/2/2018-1/28/2018        |
| 2019             | 1,751,984            | 1/1/2018-1/29/2018        |
| 2020             | 1,993,797            | 1/1/2018-9/14/2018        |
| 2021             | 1,405,111            | 1/1/2018-11/15/2018       |
| 2022             | 1,348,122            | 1/1/2018-3/27/2018        |
| Subsequent years | 2,709,673            | 1/1/2018-11/15/2018       |
| <b>Total</b>     | <b>\$ 10,502,687</b> | 1/1/2018-11/15/2018       |

Callable debt may be called on the first call date and, generally, every day thereafter with seven business days' notice. Expenses associated with the exercise of call options on debt issuances are included in interest expense.

As described in Note 1, "Organization and Operations," the Insurance Fund is available to ensure the timely payment of principal and interest on bank bonds and Systemwide debt securities (insured debt) of insured System banks to the extent that net assets are available in the Insurance Fund. All other liabilities in the combined financial statements are uninsured. At December 31, 2017, the assets of the Insurance Fund aggregated \$4.85 billion; however, due to the other authorized uses of the Insurance Fund, there is no assurance that the amounts in the Insurance Fund will be sufficient to fund the timely payment of principal and interest on an insured debt obligation in the event of a default by any System bank having primary liability thereon.

FCSIC has an agreement with the Federal Financing Bank, a federal instrumentality subject to the supervision and direction of the U.S. Treasury, pursuant to which the Federal Financing Bank would advance funds to FCSIC. Under its existing statutory authority, FCSIC may use these funds to provide assistance to the System banks in demanding market circumstances which threaten the banks' ability to pay maturing debt obligations. The agreement provides for advances of up to \$10.00 billion and terminates on September 30, 2018, unless otherwise renewed. The decision whether to seek funds

from the Federal Financing Bank is in the discretion of FCSIC, and each funding obligation of the Federal Financing Bank is subject to various terms and conditions and, as a result, there can be no assurance that funding will be available if needed by the System.

#### Subordinated Debt:

In September 2008, the bank issued \$50.0 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 FCA regulations and for general corporate purposes. Due to regulatory limitations on third-party capital (including preferred stock and subordinated debt) instituted upon the issuance of the bank's Class B Series 1 Noncumulative Subordinated Perpetual Preferred Stock, subordinated debt was no longer qualified for inclusion in permanent capital or total surplus. This debt was unsecured and subordinate to all other categories of creditors, including general creditors, and senior to all classes of shareholders. Interest was payable semi-annually on March 15 and September 15. In accordance with FCA's approval of the bank's subordinated debt offering, the bank's minimum net collateral ratio for all regulatory purposes while any subordinated debt was outstanding was 104.0 percent, instead of the 103.0 percent stated by regulation.

On March 10, 2016, the FCA approved a final rule to modify the regulatory capital requirements for System banks and associations, effective January 1, 2017. The final rule to modify regulatory capital requirements changed the favorable capital treatment of the subordinated debt, and, therefore, qualified as a regulatory event triggering a right of redemption under the terms of the subordinate debt. On March 30, 2016, the bank's board approved a resolution authorizing the redemption of all outstanding debt at par. The redemption occurred on June 6, 2016.

#### Other:

At December 31, 2017, the bank had a total of \$3.85 billion of direct notes sold to another System bank. These sales provide diversification benefits between Farm Credit entities. At the district level the sold portion is reflected as notes payable to another System bank.

## Note 9 — Members' Equity

During the third quarter, the association Class A common stockholders approved an amendment to the bank's capitalization bylaws. The amended bylaws became effective September 15, 2017, and were made to conform to the FCA's updated capital adequacy regulations, which were effective January 1, 2017. The amendment included the following updates:

- The bank's board of directors must adopt an annual capital resolution and obtain prior approval by the FCA prior to a distribution of allocated surplus. The distribution of allocated surplus must also meet the minimum permanent capital adequacy standards of the FCA capital adequacy regulation.
- A distribution of attributed unallocated surplus must obtain prior approval by the FCA.
- Preferred stock dividends would be declared in accordance with the applicable provisions of the FCA's capital adequacy regulations.
- The retirement of Class A voting common stock shall be made in accordance with the minimum holding periods set forth in the bank's board of directors' annual capital resolution and with prior approval by the FCA.
- The definition of patrons has been added to include associations, OFIs and other System institutions doing business with the bank on a patronage basis.
- No patronage distributions will be paid to any patrons if any stock is in violation of the annual resolution adopted by the board or FCA's capital adequacy regulations.

The amendments did not result in significant changes to the regulatory capital requirements as of December 31, 2017.

Descriptions of the bank's and associations' capitalization requirements, regulatory capitalization requirements, and restrictions and equities are provided below.

### A. Capitalization Requirements:

As a condition of borrowing, in accordance with the Farm Credit Act, each borrower is required to invest in common stock (in the case of mortgage or agricultural loans) or participation certificates (in the case of rural residence or farm-related business loans) of their respective association. Capitalization bylaws of the associations establish minimum and maximum stock purchase requirements for borrowers. The initial investment requirement of the associations ranges from the statutory minimum of \$1,000 to 2 percent of the loan amount, and in some cases, \$1,000 to 2 percent per customer. The capitalization bylaws also limit the capital contributions that an institution can require from its borrowers to 10 percent of defined borrowings for associations. If necessary, each association's board of directors may modify, within the range defined in their bylaws, the capitalization requirements to meet the association's capital needs.

A borrower obtaining a mortgage or agricultural loan purchases voting common stock which entitles the holder to a single vote, regardless of the number of shares held in the respective association. Within two years after a borrower's loan is repaid in full, any voting common stock held by the borrower will be converted to nonvoting common stock. A borrower obtaining a rural residence or farm-related business loan purchases participation certificates which provide no voting rights to their owner.

Each class of nonvoting stock must approve, as a class, the adoption of future revisions of capitalization bylaws if the class of stock is affected by a change in the preference provided for in the proposed capitalization bylaws.

Capitalization bylaws for each association provide for the amount of voting common stock or participation certificates that are required to be purchased by a borrower as a percentage of the loan obtained. The borrower acquires ownership of the common stock or participation certificates at the time the loan is made, but usually does not make a cash investment; the aggregate par value is added to the principal amount of the related loan obligation. The bank and the associations have a first lien on the stock or participation certificates owned by borrowers. Retirement of such equities will be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates.

### B. Regulatory Capitalization Requirements and Restrictions:

The FCA sets minimum regulatory capital requirements for banks and associations. Effective January 1, 2017, new regulatory capital requirements for banks and associations were adopted. These new requirements replaced the core surplus and total surplus requirements with common equity tier 1, tier 1 capital and total capital risk-based capital ratio requirements. The new requirements also replaced the existing net collateral ratio for System Banks with a tier 1 leverage ratio and an unallocated retained earnings (URE) and unallocated retained earnings equivalents (UREE) leverage ratio that are applicable to both the banks and associations. The permanent capital ratio continues to remain in effect; however, the risk-adjusted assets are calculated differently than in the past.

The Farm Credit Act has defined permanent capital to include all capital except stock and other equities that may be retired upon the repayment of the holder's loan or otherwise at the option of the holder, or is otherwise not at risk. Risk-adjusted assets have been defined by regulations as the balance sheet assets and off-balance-sheet commitments adjusted by various percentages ranging from 0 to 1,250 percent, depending on the level of risk inherent in the various types of assets. The primary changes which generally have the impact of increasing risk-adjusted assets (decreasing risk-based regulatory capital ratios) were as follows:

- Inclusion of off-balance-sheet commitments less than 14 months
- Increased risk-weighting of most loans 90 days past due or in nonaccrual status
- Inclusion of unfunded commitments for direct notes receivable from district associations (bank only)

The bank and associations are prohibited from reducing permanent capital by retiring stock or by making certain other distributions to stockholders unless the minimum permanent capital standard is met.

The ratios are based on a three-month average daily balance in accordance with FCA regulations and are calculated as follows:

- Common equity tier 1 ratio is statutory minimum purchased borrower stock, other required borrower stock held for a minimum of 7 years, allocated equities held for a minimum of 7 years or not subject to revolvment, unallocated retained earnings, paid-in capital, less certain regulatory required deductions including the amount of allocated investments in other System institutions, and the amount of purchased investments in other System institutions under the corresponding deduction approach, divided by average risk-adjusted assets.
- Tier 1 capital ratio is common equity tier 1 plus noncumulative perpetual preferred stock, divided by average risk-adjusted assets.
- Total capital is tier 1 capital plus other required borrower stock held for a minimum of 5 years, allocated equities held for a minimum of 5 years, subordinated debt and limited-life preferred stock greater than 5 years to maturity at issuance subject to certain limitations, allowance and reserve for credit losses under certain limitations less certain investments in other System institutions under the corresponding deduction approach, divided by average risk-adjusted assets.
- Permanent capital ratio (PCR) is all at-risk borrower stock, any allocated excess stock, unallocated retained earnings, paid-in capital, subordinated debt and preferred subject to certain limitations, less certain allocated and purchased investments in other System institutions, divided by PCR risk-adjusted assets.
- Tier 1 leverage ratio is tier 1 capital, including regulatory deductions, divided by average assets less regulatory deductions subject to tier 1 capital.
- UREE leverage ratio is unallocated retained earnings, paid-in capital, allocated surplus not subject to revolvment less certain regulatory required deductions including the amount of allocated investments in other System institutions divided by average assets less regulatory deductions subject to tier 1 capital.

If the capital ratios fall below the total requirements, including the buffer amounts, capital distributions and discretionary executive bonuses are restricted or prohibited without prior FCA approval.

The bank's capital ratio at December 31, 2017 exceeded FCA standards. All associations currently meet the minimum capital standard established by FCA regulations. All associations are currently able to retire stock or distribute earnings in accordance with the Farm Credit Act and FCA regulatory restrictions. Bank and association bylaws generally permit stock and participation certificates to be retired at the discretion of the each institution's board of directors and in accordance with their respective capitalization plans, provided the prescribed regulatory capital standards have been met. Classes of association stock are generally transferable to other customers who are eligible to hold such classes of stock as long as the institution meets the regulatory minimum capital requirements.

The following table sets forth the ranges of capital standards for the district at December 31, 2017:

|                                   | Bank   | FLCA   | ACAs            | Total Regulatory Requirement* |
|-----------------------------------|--------|--------|-----------------|-------------------------------|
| Permanent capital ratio ranges    | 16.60% | 17.15% | 13.20% - 23.00% | 7.00%                         |
| Common equity tier 1 ratio ranges | 10.52  | 17.10  | 12.27 - 22.81   | 7.00                          |
| Tier 1 capital ratio ranges       | 16.59  | 17.10  | 12.27 - 22.81   | 8.50                          |
| Total capital ratio ranges        | 16.68  | 17.41  | 13.53 - 23.63   | 10.50                         |
| Tier 1 leverage ratio ranges      | 7.33   | 17.74  | 10.76 - 21.68   | 5.00                          |
| UREE leverage ratio ranges        | 3.08   | 18.86  | 9.23 - 22.76    | 1.50                          |

\*Includes conservation and leverage buffers

### C. Description of Associations' Equities:

The following is a summary of the associations' stock and participation certificates outstanding:

| Stock and Participation Certificates                           | Par Value | Number of Shares at December 31, |            |            |
|--|-----------|----------------------------------|------------|------------|
|  |           | 2017                             | 2016       | 2015       |
| <b>Stock</b>   |           |                                  |            |            |
| Preferred – nonvoting (eligible for dividends, nonconvertible) | \$ 1.00   | 20,000,000                       | -          | -          |
| Common – voting (eligible for dividends, convertible)          | \$ 5.00   | 12,339,574                       | 11,849,504 | 11,694,491 |
| Common – nonvoting (eligible for dividends, convertible)       | \$ 5.00   | 74,097                           | 52,546     | 47,642     |
| <b>Participation certificates</b>                              |           |                                  |            |            |
| – nonvoting (eligible for dividends, convertible)              | \$ 5.00   | 587,036                          | 550,474    | 529,037    |

In the event of the liquidation or dissolution of an association, any assets of the association remaining after payment or retirement of all liabilities shall be distributed to stockholders in the following order:

- First, holders of preferred stock at par value, if any;
- Second, ratably to holders of all classes of common stock and participation certificates at par value or face amount;
- Third, ratably to the holders of allocated retained earnings on the basis of oldest allocations first;
- Fourth, ratably to the holders of nonqualified written notices of allocation on the basis of the oldest allocations first;
- Then, the remainder of assets ratably to all holders of common stock and participation certificates, in proportion to the aggregate patronage of each such holder to the total patronage of all holders.

ACA bylaws provide for operation as cooperatives which qualify for tax treatment under Subchapter T of the Internal Revenue Code. Under cooperative operations, earnings of the ACA may be distributed to borrowers. Patronage distributions are generally in the form of allocated retained earnings and cash. At least 20 percent of the total patronage distribution must be paid in cash. Amounts not distributed are retained as unallocated retained earnings, unless a plan of revolvment exists.

#### D. Description of Bank Equities:

**Class B Series 1 Noncumulative Subordinated Perpetual Preferred Stock (Class B-1 preferred stock)** – On August 26, 2010, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, representing 300,000 shares at \$1,000 per share par value for net proceeds of \$296.6 million. The net proceeds of the issuance were used to increase the bank's capital and for general corporate purposes. Dividends on the preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable semi-annually in arrears on the fifteenth day of June and December in each year, commencing December 15, 2010, at an annual fixed rate of 10 percent of par value of \$1,000 per share. The Class B-1 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank after the dividend payment date in June 2020. The Class B-1 preferred stock ranks senior, both as to dividends and upon liquidation, to all outstanding capital stock. Class B-1 preferred stock dividends are required by "dividend/patronage stopper" clauses to be declared and accrued before payment of bank investment and direct note patronage to associations and OFIs can be paid. In 2017, 2016 and 2015, Class B-1 preferred stock dividends totaling \$30.0 million were declared and paid for each respective year. At December 31, 2017, dividends payable on Class B-1 preferred stock totaled \$15.0 million.

**Class B Series 2 Noncumulative Subordinated Perpetual Preferred Stock (Class B-2 preferred stock)** – On July 23, 2013, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, Series 2, representing three million shares at \$100 per share par value, for net proceeds of \$296.0 million. Dividends on the Class B-2 preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable quarterly in arrears on the fifteenth day of March, June, September and December in each year, commencing September 15, 2013, at an annual fixed rate of 6.75 percent of par value of \$100 per share up to, but excluding September 15, 2023, from and after which date will be paid at an annual rate of the 3-Month USD LIBOR plus 4.01 percent. The Class B-2 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank on any dividend payment date on or after September 15, 2023. The Class B-2 preferred stock ranks, both as to dividends and upon liquidation, pari passu with respect to the existing Class B-1 preferred stock, and senior to all other classes of the bank's outstanding capital stock. Class B-2 preferred stock dividends are required by "dividend/patronage stopper" clauses to be declared and accrued before payment of bank investment and direct note patronage to associations and OFIs can be paid. In 2017, 2016 and 2015, Class B-2 preferred stock dividends totaling \$20.2 million were declared and paid for each respective year. At December 31, 2017, dividends payable on Class B-2 preferred stock totaled \$5.1 million.

**Class A Voting Common Stock** – According to the bank's by-laws, the minimum and maximum stock investments that the bank may require of the ACAs and FLCA are 2 percent (or one thousand dollars, whichever is greater) and 5 percent. The investments in the bank are required to be in the form of Class A voting common stock (with a par value of \$5 per share) and allocated retained earnings. The current investment required of the associations is 2 percent of their average borrowings from the bank. Under the CPP program, the stock investment that the bank requires is 1.6 percent of each AMBS pool and 8 percent of each loan pool. No Class A voting common stock may be retired except at the sole discretion of the bank's board of directors, and provided that after such retirement, the bank shall meet minimum capital adequacy standards as may from time to time be promulgated by the FCA or such higher level as the board may from time to time establish in the bank's Capital Plan. There were 60.1 million shares, 56.6 million shares and 50.9 million shares of Class A voting common stock issued and outstanding at December 31, 2017, 2016 and 2015, respectively. These intercompany balances and transactions are eliminated in combination.

**Class A Nonvoting Common Stock** – The bank requires OFIs to make cash purchases of Class A nonvoting common stock (with a par value of \$5 per share) in the bank based on a minimum and maximum of 2 percent (or one thousand dollars, whichever is greater) and 5 percent. No Class A nonvoting common stock may be retired except at the sole discretion of the bank's board of directors, and provided that after such retirement, the bank shall meet minimum capital adequacy standards as may from time to time be promulgated by the FCA or such higher level as the board may from time to time establish in the bank's Capital Plan. The bank has a first lien on these equities for the repayment of any indebtedness to the bank. There were 196 thousand shares, 232 thousand shares and 220 thousand shares of Class A nonvoting common stock issued and outstanding at December 31, 2017, 2016 and 2015, respectively.

#### E. Additional Paid-in-Capital

The \$224,625 in additional paid-in-capital represents the excess value received by acquiring associations from acquired associations over the par value of capital stock issued in association mergers. Additional paid-in-capital is considered unallocated surplus for purposes of shareholder distributions. Generally, patronage is paid out of current year earnings and as such, this would not be paid out in the form of patronage. In the case of liquidation, additional paid-in-capital would be treated as unallocated surplus and distributed to shareholders after other obligations of the association had been satisfied.

F. Accumulated Other Comprehensive Loss:

Following is a summary of the components of accumulated other comprehensive (loss) income (AOCL) and the changes occurring during the year ended December 31, 2017:

|   | Total        | Unrealized<br>Loss on<br>Securities | Retirement<br>Benefit<br>Plans | Cash Flow<br>Derivative<br>Instruments |
|---|--------------|-------------------------------------|--------------------------------|--|
| <b>Balance, January 1, 2017</b>                                     | \$ (157,982) | \$ (38,529)                         | \$ (125,874)                   | \$ 6,421                               |
| <b>Change in unrealized losses on available-for-sale securities</b> |              |                                     |                                |  |
| Net change in unrealized losses on investment securities            | (18,283)     | (18,283)                            |                                |  |
| Net change in unrealized losses on securities                       | (18,283)     | (18,283)                            |                                |  |
| <b>Change in retirement benefit plans</b>                           |              |                                     |                                |  |
| Actuarial losses  | (3,897)      |                                     | (3,897)                        |  |
| <b>Amounts amortized into net periodic expense:</b>                 |              |                                     |                                |  |
| Amortization of prior service credits                               | (864)        |                                     | (864)                          |  |
| Amortization of net losses  | 17,861       |                                     | 17,861                         |  |
| Net change in retirement benefit plans                              | 13,100       |                                     | 13,100                         |  |
| <b>Change in cash flow derivative instruments</b>                   |              |                                     |                                |  |
| Unrealized losses on cash flow derivative instruments               | (666)        |                                     |                                | (666)                                  |
| Reclassification of loss recognized in interest expense             | 971          |                                     |                                | 971                                    |
| Net change in cash flow derivative instruments                      | 305          |                                     |                                | 305                                    |
| <b>Total other comprehensive (loss) income</b>                      | (4,878)      | (18,283)                            | 13,100                         | 305                                    |
| <b>Balance, December 31, 2017</b>                                   | \$ (162,860) | \$ (56,812)                         | \$ (112,774)                   | \$ 6,726                               |

Following is a summary of the components of accumulated other comprehensive (loss) income (AOCL) and the changes occurring during the year ended December 31, 2016:

|   | Total        | Unrealized<br>Loss on<br>Securities | Retirement<br>Benefit<br>Plans | Cash Flow<br>Derivative<br>Instruments |
|---|--------------|-------------------------------------|--------------------------------|--|
| <b>Balance, January 1, 2016</b>                                     | \$ (156,944) | \$ (25,276)                         | \$ (129,761)                   | \$ (1,907)                             |
| <b>Change in unrealized losses on available-for-sale securities</b> |              |                                     |                                |  |
| Net change in unrealized losses on investment securities            | (13,253)     | (13,253)                            |                                |  |
| Net change in unrealized losses on securities                       | (13,253)     | (13,253)                            |                                |  |
| <b>Change in retirement benefit plans</b>                           |              |                                     |                                |  |
| Actuarial losses  | (12,813)     |                                     | (12,813)                       |  |
| <b>Amounts amortized into net periodic expense:</b>                 |              |                                     |                                |  |
| Amortization of prior service credits                               | (941)        |                                     | (941)                          |  |
| Amortization of net losses  | 17,641       |                                     | 17,641                         |  |
| Net change in retirement benefit plans                              | 3,887        |                                     | 3,887                          |  |
| <b>Change in cash flow derivative instruments</b>                   |              |                                     |                                |  |
| Unrealized losses on cash flow derivative instruments               | 6,507        |                                     |                                | 6,507                                  |
| Reclassification of loss recognized in interest expense             | 1,821        |                                     |                                | 1,821                                  |
| Net change in cash flow derivative instruments                      | 8,328        |                                     |                                | 8,328                                  |
| <b>Total other comprehensive (loss) income</b>                      | (1,038)      | (13,253)                            | 3,887                          | 8,328                                  |
| <b>Balance, December 31, 2016</b>                                   | \$ (157,982) | \$ (38,529)                         | \$ (125,874)                   | \$ 6,421                               |

Following is a summary of the components of accumulated other comprehensive (loss) income (AOCL) and the changes occurring during the year ended December 31, 2015:

|  | Total        | Unrealized Loss on Securities | Retirement Benefit Plans | Cash Flow Derivative Instruments |
|--|--------------|-------------------------------|--------------------------|----------------------------------|
| Balance, January 1, 2015                                     | \$ (166,791) | \$ (16,100)                   | \$ (147,996)             | \$ (2,695)                       |
| Change in unrealized losses on available-for-sale securities |              |                               |                          |                                  |
| Net change in unrealized losses on investment securities     | (9,176)      | (9,176)                       |                          |                                  |
| Net change in unrealized losses on securities                | (9,176)      | (9,176)                       |                          |                                  |
| Change in retirement benefit plans                           |              |                               |                          |                                  |
| Actuarial losses   | (128)        |                               | (128)                    |                                  |
| Changes due to effect of merger                              | 216          |                               | 216                      |                                  |
| Amounts amortized into net periodic expense:                 |              |                               |                          |                                  |
| Amortization of prior service credits                        | (935)        |                               | (935)                    |                                  |
| Amortization of net losses                                   | 19,082       |                               | 19,082                   |                                  |
| Net change in retirement benefit plans                       | 18,235       |                               | 18,235                   |                                  |
| Change in cash flow derivative instruments                   |              |                               |                          |                                  |
| Unrealized losses on interest rate caps                      | (586)        |                               |                          | (586)                            |
| Reclassification of loss recognized in interest expense      | 1,374        |                               |                          | 1,374                            |
| Net change in cash flow derivative instruments               | 788          |                               |                          | 788                              |
| Total other comprehensive income (loss)                      | 9,847        | (9,176)                       | 18,235                   | 788                              |
| Balance, December 31, 2015                                   | \$ (156,944) | \$ (25,276)                   | \$ (129,761)             | \$ (1,907)                       |

The following table summarizes amounts reclassified out of accumulated other comprehensive loss to current earnings:

| Description                           | Amount Reclassified from Accumulated Other Comprehensive Loss |                    |                    | Location of Gain (Loss) Recognized in Statement of Comprehensive Income |
|---------------------------------------|---|--------------------|--------------------|---|
|                                       | 2017  | 2016               | 2015               |   |
| Retirement Benefit Plans              |   |                    |                    |   |
| Amortization of prior service credits | 864   | 941                | 935                | Salaries and employee benefits  |
| Amortization of net actuarial losses  | (17,861)  | (17,641)           | (19,082)           | Salaries and employee benefits  |
| Cash Flow Derivative Instruments      |   |                    |                    |   |
| Losses on cash flow derivatives       | (971)   | (1,821)            | (1,374)            | Interest expense  |
|                                       | <b>\$ (17,968)</b>  | <b>\$ (18,521)</b> | <b>\$ (19,521)</b> |   |

## Note 10 — Income Taxes

The enactment of federal tax legislation in late December 2017, among other things, lowered the federal corporate tax rate from 35 percent to 21 percent beginning in 2018. In accordance with GAAP, the change to the lower corporate tax rate led to a revaluation of the district associations' deferred tax liabilities and deferred tax assets in the period of enactment (2017). The provision for income taxes in 2017 was mainly due to a decrease in deferred tax assets without a corresponding valuation allowance resulting from the enactment of the federal tax legislation.

Only the district's ACAs have taxable income, as the bank, the FLCA and the FLCA subsidiaries of ACAs are exempt from federal and other income taxes.

The provision for (benefit from) income taxes follows for years ended December 31:

|   | 2017          | 2016         | 2015           |
|---|---------------|--------------|----------------|
| Current   |               |              |                |
| Federal   | \$ (96)       | \$ 54        | \$ (16)        |
| State   | -             | -            | -              |
| Total current                                   | (96)          | 54           | (16)           |
| Deferred  |               |              |                |
| Federal   | 586           | 50           | (84)           |
| State   | (8)           | (13)         | 25             |
| Total deferred                                  | 578           | 37           | (59)           |
| Total provision for (benefit from) income taxes | <b>\$ 482</b> | <b>\$ 91</b> | <b>\$ (75)</b> |

The provision for (benefit from) income tax differs from the amount of income tax determined by applying the statutory federal income tax rate to district pretax income as a result of the following differences for years ended December 31:

|   | 2017          | 2016         | 2015           |
|---|---------------|--------------|----------------|
| Federal tax at statutory rate                   | \$ 153,957    | \$ 151,735   | \$ 149,367     |
| State tax, net                                  | (100)         | (13)         | 24             |
| Nontaxable bank income                          | (68,595)      | (67,342)     | (67,284)       |
| Other nontaxable entities                       | (78,987)      | (80,077)     | (78,458)       |
| Valuation allowance                             | (14,900)      | 4,499        | 3,467          |
| Patronage distributions                         | (8,461)       | (8,542)      | (7,425)        |
| Tax rate change                                 | 17,695        | -            | -              |
| Other, net                                      | (127)         | (169)        | 234            |
| Total provision for (benefit from) income taxes | <b>\$ 482</b> | <b>\$ 91</b> | <b>\$ (75)</b> |

Deferred tax assets and liabilities comprised the following elements at December 31:

|   | 2017          | 2016            | 2015            |
|---|---------------|-----------------|-----------------|
| Allowance for loan losses                       | \$ 5,896      | \$ 10,206       | \$ 7,380        |
| Carrying value adjustment for acquired property | 169           | 80              | 60              |
| Postretirement benefits                         | 830           | 1,420           | 1,575           |
| Net operating loss carryforward                 | 31,636        | 42,523          | 40,330          |
| Other   | 68            | (95)            | 206             |
| Gross deferred tax assets                       | 38,599        | 54,134          | 49,551          |
| Less valuation allowance                        | (36,908)      | (51,809)        | (47,310)        |
| Adjusted gross deferred tax assets              | 1,691         | 2,325           | 2,241           |
| Other   | (708)         | (764)           | (642)           |
| Gross deferred tax liabilities                  | (708)         | (764)           | (642)           |
| Net deferred tax assets                         | <b>\$ 983</b> | <b>\$ 1,561</b> | <b>\$ 1,599</b> |

There were no uncertain tax positions and related liabilities for unrecognized tax benefits recorded at December 31, 2017. Any penalties

and interest related to income taxes would be accounted for as an adjustment to income tax expense.

## Note 11 — Employee Benefit Plans

Employees of the district participate in either the district's defined benefit retirement plan (DB plan) or in a non-elective defined contribution feature (DC plan) within the Farm Credit Benefits Alliance 401(k) plan. In addition, all employees may participate in the Farm Credit Benefits Alliance 401(k) plan.

The DB plan is noncontributory, and benefits are based on salary and years of service. The legal name of the plan is Farm Credit Bank of Texas Pension Plan; its employer identification number is 74-1110170. The "projected unit credit" actuarial method is used for both financial reporting and funding purposes. District employers have the option of providing enhanced retirement benefits, under certain conditions, within the DB plan in 1998 and beyond, to facilitate reorganization and/or restructuring. Under authoritative accounting guidance, there were no pension plan termination benefits recognized resulting from employees who qualified for an early retirement option under a retention plan at December 31, 2017, 2016 and 2015.

Participants in the DC plan generally include employees who elected to transfer from the DB plan prior to January 1, 1996, and employees hired on or after January 1, 1996. Participants in the non-elective pension feature of the DC plan direct the placement of their employers' contributions made on their behalf into various investment alternatives.

The district also participates in the Farm Credit Benefits Alliance 401(k) plan, which offers a pre-tax and after-tax and Roth compensation deferral feature. Employers match 100 percent of employee contributions for the first 3 percent of eligible compensation and then match 50 percent of employee contributions on the next 2 percent of eligible compensation, for a maximum employer contribution of 4 percent of eligible compensation. Employer contributions for the DC plan and the 401(k) plan totaled \$11.6 million, \$11.8 million and \$10.8 million for the years ended December 31, 2017, 2016 and 2015, respectively.

Certain executive or highly compensated employees in the district are eligible to participate in a separate nonqualified supplemental 401(k) plan, named the Farm Credit Benefits Alliance Nonqualified Supplemental 401(k) Plan (Supplemental 401(k) Plan). This plan allows district employers to elect to participate in any or all of the following benefits:

- Restored Employer Contributions – to allow "make-up" contributions for eligible employees whose benefits to the qualified 401(k) plan were limited by the Internal Revenue Code during the year
- Elective Deferrals – to allow eligible employees to make pre-tax deferrals of compensation above and beyond any deferrals into the qualified 401(k) plan
- Discretionary Contributions – to allow participating employers to make a discretionary contribution to an eligible employee's account in the plan, and to designate a vesting schedule

Contributions of \$333, \$238 and \$508 were made to this plan for the years ended December 31, 2017, 2016 and 2015. The present value of accumulated benefits and funded balance in the plan totaled \$8,124 at December 31, 2017.

The bank and associations also provide certain health care benefits to eligible retired employees, beneficiaries and directors (retiree medical plan). These benefits are not characterized as multiemployer and, consequently, the liability for these benefits is included in other liabilities. Bank employees hired on or after January 1, 2004, may be eligible for retiree medical benefits for themselves and their spouses at their expense and will be responsible for 100 percent of the related premiums. The following table reflects the benefit obligation, cost and actuarial assumptions for the district's DB pension plan and other postretirement benefit plans:

|   | Pension Benefits    |              |              | Other Postretirement Benefits |             |             |
|---|---------------------|--------------|--------------|-------------------------------|-------------|-------------|
|   | 2017                | 2016         | 2015         | 2017                          | 2016        | 2015        |
| <i>(dollars in thousands)</i>   |                     |              |              |                               |             |             |
| <b>Accumulated benefit obligation, end of year</b>                    | <b>\$ 391,560</b>   | \$ 377,464   | \$ 363,098   | <b>\$ -</b>                   | \$ -        | \$ -        |
| <b>Change in projected benefit obligation</b>                         |                     |              |              |                               |             |             |
| Projected benefit obligation, beginning of year                       | \$ 401,484          | \$ 393,654   | \$ 410,832   | \$ 67,753                     | \$ 64,976   | \$ 69,466   |
| Service cost  | 4,045               | 4,692        | 5,327        | 1,287                         | 1,281       | 1,548       |
| Interest cost   | 16,298              | 16,835       | 15,877       | 3,071                         | 3,010       | 3,117       |
| Plan participants' contributions                                      | -                   | -            | -            | 548                           | 549         | 581         |
| Plan amendments   | -                   | -            | -            | -                             | -           | -           |
| Curtailment loss  | -                   | -            | -            | -                             | -           | -           |
| Actuarial loss (gain)   | 14,939              | 14,669       | (12,372)     | 6,707                         | 375         | (7,002)     |
| Benefits paid   | (24,203)            | (28,366)     | (26,010)     | (2,480)                       | (2,438)     | (2,734)     |
| Projected benefit obligation, end of year                             | <b>\$ 412,563</b>   | \$ 401,484   | \$ 393,654   | <b>\$ 76,886</b>              | \$ 67,753   | \$ 64,976   |
| <b>Change in plan assets</b>  |                     |              |              |                               |             |             |
| Plan assets at fair value, beginning of year                          | \$ 266,416          | \$ 263,122   | \$ 277,415   | \$ -                          | \$ -        | \$ -        |
| Actual return on plan assets  | 33,620              | 19,875       | 1,059        | -                             | -           | -           |
| Company contributions   | 11,578              | 11,785       | 10,658       | 1,931                         | 1,889       | 2,153       |
| Plan participants' contributions                                      | -                   | -            | -            | 549                           | 549         | 581         |
| Benefits paid   | (24,203)            | (28,366)     | (26,010)     | (2,480)                       | (2,438)     | (2,734)     |
| Plan assets at fair value, end of year                                | <b>\$ 287,411</b>   | \$ 266,416   | \$ 263,122   | <b>\$ -</b>                   | \$ -        | \$ -        |
| <b>Funded status at end of year</b>                                   | <b>\$ (125,152)</b> | \$ (135,068) | \$ (130,532) | <b>\$ (76,886)</b>            | \$ (67,753) | \$ (64,976) |
| <b>Amounts recognized in the combined balanced sheets consist of:</b> |                     |              |              |                               |             |             |
| Retirement plan liability   | \$ (125,152)        | \$ (135,068) | \$ (130,532) | \$ (76,886)                   | \$ (67,753) | \$ (64,976) |
| Accumulated other comprehensive loss                                  | 100,419             | 120,949      | 125,971      | 12,346                        | 4,901       | 3,779       |
| <b>Amounts recognized in accumulated other comprehensive income</b>   |                     |              |              |                               |             |             |
| Net actuarial loss  | \$ 100,419          | \$ 120,949   | \$ 125,971   | \$ 12,983                     | \$ 6,418    | \$ 6,224    |
| Prior service cost (credit)   | -                   | -            | -            | (637)                         | (1,517)     | (2,445)     |
| Total   | <b>\$ 100,419</b>   | \$ 120,949   | \$ 125,971   | <b>\$ 12,346</b>              | \$ 4,901    | \$ 3,779    |

The funding policy establishes contribution requirements for the district's DB plan if plan assets are less than the accumulated benefit obligation at year end. The policy calls for contributions equal to the value of the additional benefits expected to be earned by employees during the year. The plan sponsor is the board of directors of the Farm Credit Bank of Texas. In accordance with this policy, contributions of \$11,578, \$11,785 and \$10,658 were made to the plan in January 2017, January 2016 and January 2015, respectively.

The following table discloses the excess of the DB plan's accumulated benefit obligation over its plan assets at December 31:

| <i>(dollars in thousands)</i>  | Pension Benefits |            |             | Other Postretirement Benefits |          |            |
|--|------------------|------------|-------------|-------------------------------|----------|------------|
|  | 2017             | 2016       | 2015        | 2017                          | 2016     | 2015       |
| District DB plan projected benefit obligation  | \$ 412,563       | \$ 401,484 | \$ 393,654  |                               |          |            |
| District DB plan assets at fair value  | 287,411          | 266,416    | 263,122     |                               |          |            |
| Accumulated benefit obligation (ABO) of district DB plan   | 391,560          | 377,464    | 363,098     |                               |          |            |
| Funding shortfall (plan assets to ABO)   | (104,149)        | (111,048)  | (99,976)    |                               |          |            |
| <b>Net periodic benefit cost</b>   |                  |            |             |                               |          |            |
| Service cost   | \$ 4,045         | \$ 4,692   | \$ 5,327    | \$ 1,287                      | \$ 1,280 | \$ 1,548   |
| Interest cost  | 16,298           | 16,835     | 15,877      | 3,071                         | 3,010    | 3,117      |
| Expected return on plan assets   | (15,871)         | (17,645)   | (20,560)    | -                             | -        | -          |
| Amortization of:   |                  |            |             |                               |          |            |
| Prior service cost   | -                | -          | 4           | (880)                         | (928)    | (979)      |
| Net actuarial loss   | 17,719           | 17,461     | 18,210      | 142                           | 181      | 872        |
| Net periodic benefit cost  | \$ 22,191        | \$ 21,343  | \$ 18,858   | \$ 3,620                      | \$ 3,543 | \$ 4,558   |
| Curtailment expense  | -                | -          | -           | -                             | -        | -          |
| Settlement expense   | -                | -          | -           | -                             | -        | -          |
| Special termination benefits   | -                | -          | -           | -                             | -        | -          |
| Total benefit cost   | \$ 22,191        | \$ 21,343  | \$ 18,858   | \$ 3,620                      | \$ 3,543 | \$ 4,558   |
| <b>Other changes to plan assets and projected benefit obligations recognized in other comprehensive income</b> |                  |            |             |                               |          |            |
| Net actuarial (gain) loss in the current period  | \$ (2,810)       | \$ 12,439  | \$ 7,129    | \$ 6,707                      | \$ 375   | \$ (7,001) |
| Settlement expense   | -                | -          | -           | -                             | -        | -          |
| Prior service costs  | -                | -          | -           | -                             | -        | -          |
| Amortization of prior service costs  | -                | -          | (4)         | 880                           | 928      | 979        |
| Amortization of net actuarial loss   | (17,719)         | (17,461)   | (18,210)    | (142)                         | (181)    | (872)      |
| Net change   | \$ (20,529)      | \$ (5,022) | \$ (11,085) | \$ 7,445                      | \$ 1,122 | \$ (6,894) |
| <b>AOCI amounts expected to be amortized in 2018</b>   |                  |            |             |                               |          |            |
| Prior service cost (credit)  | \$ -             |            |             | \$ (637)                      |          |            |
| Net actuarial loss   | 13,477           |            |             | 675                           |          |            |
| Total  | \$ 13,477        |            |             | \$ 38                         |          |            |

|  | Pension Benefits |            |            | Other Postretirement Benefits |             |             |
|--|------------------|------------|------------|-------------------------------|-------------|-------------|
|  | 2017             | 2016       | 2015       | 2017                          | 2016        | 2015        |
| <b>Weighted-average assumptions used to determine benefit obligation at year end</b> |                  |            |            |                               |             |             |
| Measurement date   | 12/31/2017       | 12/31/2016 | 12/31/2015 | 12/31/2017                    | 12/31/2016  | 12/31/2015  |
| Discount rate  | 3.65%            | 4.20%      | 4.45%      | 4.00%                         | 4.60%       | 4.70%       |
| Expected long-term rate of return  | 6.00%            | 6.00%      | 7.50%      | N/A                           | N/A         | N/A         |
| Rate of compensation increase  | 4.00%            | 4.50%      | 5.50%      | N/A                           | N/A         | N/A         |
| Health care cost trend rate assumed for next year (pre/post-65)                      |                  |            |            | 7.70%/6.90%                   | 6.75%/6.50% | 7.00%/6.50% |
| Ultimate health care cost trend rate   |                  |            |            | 4.50%                         | 4.50%       | 4.50%       |
| Year that the rate reaches the ultimate trend rate                                   |                  |            |            | 2026                          | 2025        | 2025        |
| <b>Weighted-average assumptions used to determine net periodic cost for the year</b> |                  |            |            |                               |             |             |
| Measurement date   | 12/31/2016       | 12/31/2015 | 12/31/2014 | 12/31/2016                    | 12/31/2015  | 12/31/2014  |
| Discount rate  | 4.20%            | 4.45%      | 4.00%      | 4.60%                         | 4.70%       | 4.55%       |
| Expected return on plan assets   | 6.00%            | 6.80%      | 7.50%      | N/A                           | N/A         | N/A         |
| Rate of compensation increase  | 4.50%            | 5.50%      | 5.50%      | N/A                           | N/A         | N/A         |
| Health care cost trend rate assumed for next year (pre/post-65)                      |                  |            |            | 6.75%/6.50%                   | 7.00%/6.50% | 7.25%/6.75% |
| Ultimate health care cost trend rate   |                  |            |            | 4.50%                         | 4.50%       | 5.00%       |
| Year that the rate reaches the ultimate trend rate                                   |                  |            |            | 2025                          | 2025        | 2024        |
| <b>Effect of Change in Assumed Health Care Cost Trend Rates</b>                      |                  |            |            |                               |             |             |
| <b>Effect on total service cost and interest cost components</b>                     |                  |            |            |                               |             |             |
| One-percentage-point increase  |                  |            |            | \$ 950                        | \$ 913      | \$ 895      |
| One-percentage-point decrease  |                  |            |            | (738)                         | (710)       | (696)       |
| <b>Effect on year-end postretirement benefit obligation</b>                          |                  |            |            |                               |             |             |
| One-percentage-point increase  |                  |            |            | \$ 14,301                     | \$ 12,500   | \$ 11,935   |
| One-percentage-point decrease  |                  |            |            | (11,342)                      | (9,908)     | (9,460)     |

#### Plan Assets

The trustees of the district DB plan set investment policies and strategies for the plan, including target allocation percentages for each category of plan asset. Generally, the funding objectives of the DB plan are to achieve and maintain plan assets in accordance with the funding policy mentioned previously and to provide competitive investment returns and reasonable risk levels when measured against appropriate benchmarks. Plan trustees develop asset allocation policies based on plan objectives, characteristics of pension liabilities, capital market expectations and asset-liability projections. District postretirement health care plans have no plan assets and are funded on a current basis by employer contributions and retiree premium payments.

|  | Pension Benefits |           |      |      | Other Postretirement Benefits |  |
|--|------------------|-----------|------|------|-------------------------------|--|
|  | Target           | 2017      | 2016 | 2015 |                               |  |
| <b>Expected Future Cash Flow Information</b> |                  |           |      |      |                               |  |
| <b>Expected Benefit Payments</b>             |                  |           |      |      |                               |  |
| Fiscal 2018                                  |                  | \$ 29,312 |      |      | \$ 2,379                      |  |
| Fiscal 2019                                  |                  | 27,669    |      |      | 2,682                         |  |
| Fiscal 2020                                  |                  | 28,130    |      |      | 2,871                         |  |
| Fiscal 2021                                  |                  | 29,261    |      |      | 3,108                         |  |
| Fiscal 2022                                  |                  | 27,660    |      |      | 3,366                         |  |
| Fiscal 2023 – 2027                           |                  | 125,544   |      |      | 18,235                        |  |
| <b>Expected Contributions</b>                |                  |           |      |      |                               |  |
| Fiscal 2018                                  |                  | \$ 9,774  |      |      | \$ 2,379                      |  |
| <b>Plan Assets</b>                           |                  |           |      |      |                               |  |
| Asset Category                               | Target           | 2017      | 2016 | 2015 |                               |  |
| Equity securities                            | 60%              | 60%       | 60%  | 60%  |                               |  |
| Debt securities                              | 40               | 40        | 40   | 40   |                               |  |
| Cash/other                                   | -                | -         | -    | -    |                               |  |
| Total  | 100%             | 100%      | 100% | 100% |                               |  |

As disclosed in the preceding table, the expected total contribution for pension benefits for 2018 is \$9.8 million.

Notwithstanding current investment market conditions, the expected long-term rate of return assumption is determined independently for each defined benefit pension plan and for each other postretirement benefit plan. Generally, plan trustees use historical return information to establish a best-estimate range for each asset class in which the plans are invested. DB plan trustees select the most appropriate rate for each plan from the best-estimate range, taking into consideration the duration of plan benefit liabilities and plan sponsor investment policies.

The DB plan's investments consist of common collective trust funds which, under ordinary market conditions, provide daily market liquidity to the plan. All funds are priced daily, so there would be no delay on full redemption if the DB plan were to initiate a full redemption. The redemption frequencies and notice periods for the funds as of December 31, 2017 are summarized below:

| <i>(dollars in thousands)</i>   | Fair value        | Unfunded<br>Commitments | Frequency<br>(if Currently<br>Eligible) |
|---------------------------------|-------------------|-------------------------|---|
| <b>Assets</b>                   |                   |                         |   |
| Russell Multi Asset Core Fund   | \$ 192,761        | none                    | daily                                   |
| Russell Multi-Manager Bond Fund | 93,161            | none                    | daily                                   |
| Receivable for investment sold  | 1,489             | none                    | daily                                   |
| Total                           | <u>\$ 287,411</u> |                         |   |

The redemption frequencies and notice periods for the funds as of December 31, 2016 are summarized below:

| <i>(dollars in thousands)</i>   | Fair value        | Unfunded<br>Commitments | Frequency<br>(if Currently<br>Eligible) |
|---------------------------------|-------------------|-------------------------|---|
| <b>Assets</b>                   |                   |                         |   |
| Russell Multi Asset Core Fund   | \$ 185,330        | none                    | daily                                   |
| Russell Multi-Manager Bond Fund | 91,283            | none                    | daily                                   |
| Payable for investment purchase | (10,197)          | none                    | daily                                   |
| Total                           | <u>\$ 266,416</u> |                         |   |

In 2016, the district DB plan adopted "Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share," which required retroactive reclassification of investments for which fair value is measured using the net asset value per share practical expedient, consistent with current year presentation. These assets are no longer required to be categorized within the fair value hierarchy and only certain assets in the qualified pension plan were impacted. Pension assets were \$287.4 million as of December 31, 2017. During 2016, pension assets of \$266.4 million and \$263.1 million were reclassified as of December 31, 2016 and 2015, respectively, based on the adoption of the new guidance.

## Note 12 — Related Party Transactions

In the ordinary course of business, the associations have entered into loan transactions with directors, officers and employees of associations and other organizations with which such persons may be associated. Total loans to such persons at December 31, 2017, 2016 and 2015 amounted to \$207.0 million, \$197.9 million and \$198.7 million, respectively. In the opinion of management, such loans outstanding to directors, officers and employees at December 31, 2017, did not involve more than a normal risk of collectability, were subject to approval requirements contained in FCA regulations, and were made on the same terms, including interest rates, amortization schedules and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers. Disclosures on individual associations' officers and directors are found in the associations' individual annual reports.

## Note 13 — Commitments and Contingencies

The district has various outstanding commitments and contingent liabilities as discussed elsewhere in these notes.

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 other System banks. The total bank and consolidated Systemwide debt obligations of the System at December 31, 2017, were \$265.17 billion.

In the normal course of business, district entities incur a certain amount of claims, litigation, and other legal and administrative proceedings, all of which are considered incidental to the normal conduct of business. The bank and district associations believe they have meritorious defenses to the claims currently asserted against them, and, with respect to such legal proceedings, intend to defend themselves vigorously, litigating or settling cases according to management's judgment as to what is in the best interest of the entity and its shareholders.

On a regular basis, district entities assess their liabilities and contingencies in connection with outstanding legal proceedings utilizing the latest information available. For those matters where it is probable that the entity would incur a loss and the amount of the loss could be reasonably estimated, the entity would record a liability in its financial statements. These liabilities would be increased or decreased to reflect any relevant developments on a quarterly basis. For other matters, where a loss is not probable or the amount of the loss is not estimable, the district entities do not record a liability.

Currently, other actions are pending against the district in which claims for monetary damages are asserted. Upon the basis of current information, management and legal counsel are of the opinion that any resulting losses are not probable, and that the ultimate liability, if any, resulting from a lawsuit and other pending actions will not be material in relation to the financial position, results of operations or cash flows of the district.

## Note 14 — Financial Instruments With Off-Balance-Sheet Risk

The bank and associations may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of their borrowers and to manage their exposure to interest rate risk. In the normal course of business, various commitments are made to customers, including commitments to extend credit and letters of credit, which represent credit-related financial instruments with off-balance-sheet risk.

At any time, the bank and associations have outstanding a significant number of commitments to extend credit. The bank and associations also provide letters of credit to guarantee the performance of customers to third parties. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. Credit-related financial instruments have off-balance-sheet credit risk, because only origination fees (if any) are recognized in the combined balance sheets (as other liabilities) for these instruments until the commitments are fulfilled or expire. Since many of the commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. The district's commitments to extend credit totaled \$5.07 billion, \$5.01 billion and \$4.98 billion at December 31, 2017, 2016

and 2015, respectively. At December 31, 2017, the district had \$103.2 million in outstanding letters of credit, issued primarily in conjunction with participation loans. Outstanding letters of credit generally have expiration dates ranging from 2017 to 2027.

The credit risk involved in issuing commitments and letters of credit is essentially the same as that involved in extending loans to customers, and the same credit policies are applied by management. In the event of funding, the credit risk amounts are equal to the contract amounts, assuming that counterparties fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the counterparty.

## Note 15 — Fair Value Measurements

Authoritative accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market for the asset or liability. See Note 2, "Summary of Significant Accounting Policies," for additional information.

Assets and liabilities measured at fair value on a recurring basis at December 31, 2017, for each of the fair value hierarchy values are summarized below:

|  | Fair Value Measurement |   |  |  |
|--|------------------------|---|--|--|
|  | Total                  | Quoted Prices<br>in Active Markets<br>for Identical Assets<br>(Level 1) | Significant<br>Other Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Assets:</b>   |                        |   |  |  |
| Federal funds  | \$ 246,888             | \$ -  | \$ 246,888   | \$ -   |
| Investments available-for-sale:                          |                        |   |  |  |
| Corporate debt   | 252,609                | -   | 252,609  | -  |
| U.S. Treasury securities                                 | 249,207                | -   | 249,207  | -  |
| Agency-guaranteed debt                                   | 195,248                | -   | 195,248  | -  |
| Mortgage-backed securities                               | 4,356,715              | -   | 4,356,715  | -  |
| Asset-backed securities                                  | 47,889                 | -   | 47,889   | -  |
| Mission-related and other available-for-sale investments | 43,317                 | -   | -  | 43,317   |
| Loans valued under the fair value option                 | 9,908                  | -   | 9,908  | -  |
| Derivative assets  | 8,932                  | -   | 8,932  | -  |
| Assets held in nonqualified benefit trusts               | 8,084                  | 8,084   | -  | -  |
| <b>Total assets</b>                                      | <b>\$ 5,418,797</b>    | <b>\$ 8,084</b>   | <b>\$ 5,367,396</b>                                    | <b>\$ 43,317</b>                                   |
| <b>Liabilities:</b>                                      |                        |   |  |  |
| Letters of credit  | \$ 1,038               | \$ -  | \$ -   | \$ 1,038   |
| Derivative liabilities                                   | 248                    | -   | 248  | -  |
| <b>Total liabilities</b>                                 | <b>\$ 1,286</b>        | <b>\$ -</b>   | <b>\$ 248</b>  | <b>\$ 1,038</b>                                    |

The table below represents a reconciliation of all Level 3 assets and liabilities measured at fair value on a recurring basis for the year ended December 31, 2017:

|   | <u>Assets</u>   | <u>Liabilities</u>           |                  |
|---|---|------------------------------|------------------|
|   | <b>Agricultural<br/>Mortgage-<br/>Backed<br/>Securities</b> | <b>Letters of<br/>Credit</b> | <b>Total</b>     |
| Balance at January 1, 2017                              | \$ 53,335   | \$ 711                       | \$ 52,624        |
| Net (losses) gains included in other comprehensive loss | (106)   | -                            | (106)            |
| Purchases, issuances and settlements                    | (9,912)   | 327                          | (10,239)         |
| Balance at December 31, 2017                            | <u>\$ 43,317</u>  | <u>\$ 1,038</u>              | <u>\$ 42,279</u> |

There were no transfers of assets or liabilities into or out of Level 1 from other levels during the year ended December 31, 2017. Agricultural mortgage-backed securities are included in Level 3 due to limited activity or less transparency around inputs to their valuation. The liability for letters of credit is included in Level 3 because their valuation, based on fees currently charged for similar agreements, may not

closely correlate to a fair value for instruments that are not regularly traded in the secondary market.

Assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2017, for each of the fair value hierarchy values are summarized below:

|                      | <u>Fair Value Measurement</u> |   |  |  |
|----------------------|-------------------------------|---|--|--|
|                      | <u>Total</u>                  | <u>Quoted Prices<br/>in Active<br/>Markets for<br/>Identical Assets<br/>(Level 1)</u> | <u>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</u> | <u>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</u> |
| Assets:              |                               |   |  |  |
| Loans                | \$ 10,516                     | \$ -  | \$ -   | \$ 10,516  |
| Other property owned | 17,298                        | -   | -  | 17,298   |
| Total assets         | <u>\$ 27,814</u>              | <u>\$ -</u>   | <u>\$ -</u>  | <u>\$ 27,814</u>   |

Assets and liabilities measured at fair value on a recurring basis at December 31, 2016, for each of the fair value hierarchy values are summarized below:

|  | <u>Fair Value Measurement</u> |   |  |  |
|--|-------------------------------|---|--|--|
|  | <u>Total</u>                  | <u>Quoted Prices<br/>in Active Markets<br/>for Identical Assets<br/>(Level 1)</u> | <u>Significant<br/>Other Observable<br/>Inputs<br/>(Level 2)</u> | <u>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</u> |
| Assets:  |                               |   |  |  |
| Federal funds  | \$ 22,901                     | \$ -  | \$ 22,901  | \$ -   |
| Investments available-for-sale:                          |                               |   |  |  |
| Corporate debt   | 202,403                       | -   | 202,403  | -  |
| U.S. Treasury securities                                 | 249,006                       | -   | 249,006  | -  |
| Agency-guaranteed debt                                   | 222,374                       | -   | 222,374  | -  |
| Mortgage-backed securities                               | 3,973,578                     | -   | 3,973,578  | -  |
| Asset-backed securities                                  | 130,679                       | -   | 130,679  | -  |
| Mission-related and other available-for-sale investments | 53,335                        | -   | -  | 53,335   |
| Loans valued under the fair value option                 | 16,311                        | -   | 16,311   | -  |
| Derivative assets  | 8,074                         | -   | 8,074  | -  |
| Assets held in nonqualified benefit trusts               | 7,003                         | 7,003   | -  | -  |
| Total assets   | <u>\$ 4,885,664</u>           | <u>\$ 7,003</u>   | <u>\$ 4,825,326</u>  | <u>\$ 53,335</u>   |
| Liabilities:   |                               |   |  |  |
| Letters of credit  | \$ 711                        | \$ -  | \$ -   | \$ 711   |
| Total liabilities  | <u>\$ 711</u>                 | <u>\$ -</u>   | <u>\$ -</u>  | <u>\$ 711</u>  |

The table below represents a reconciliation of all Level 3 assets measured at fair value on a recurring basis for the year ended December 31, 2016:

|   | Assets                     |   |                    | Liabilities       |            |
|---|----------------------------|---|--------------------|-------------------|------------|
|   | Mortgage-Backed Securities | Agricultural Mortgage-Backed Securities | Loan Held For Sale | Letters of Credit | Total      |
| Balance at January 1, 2016                              | \$ 50,250                  | \$ 65,650                               | \$ 4,850           | \$ 967            | \$ 119,783 |
| Net (losses) gains included in other comprehensive loss | -                          | (523)                                   | -                  | -                 | (523)      |
| Purchases, issuances and settlements                    | -                          | (11,792)                                | (4,850)            | (256)             | (16,386)   |
| Transfers out of Level 3                                | (50,250)                   | -                                       | -                  | -                 | (50,250)   |
| Balance at December 31, 2016                            | \$ -                       | \$ 53,335                               | \$ -               | \$ 711            | \$ 52,624  |

There were no transfers of assets or liabilities into or out of Level 1 from other levels during the year ended December 31, 2016. Agricultural mortgage-backed securities are included in Level 3 due to limited activity or less transparency around inputs to their valuation. The liability for letters of credit is included in Level 3 as their valuation, based on fees currently charged for similar agreements,

may not closely correlate to a fair value for instruments that are not regularly traded in the secondary market.

Assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2016, for each of the fair value hierarchy values are summarized below:

|                      | Fair Value Measurement |  |   |   |
|----------------------|------------------------|--|---|---|
|                      | Total                  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets:              |                        |  |   |   |
| Loans                | \$ 26,355              | \$ -   | \$ -  | \$ 26,355                                 |
| Other property owned | 21,504                 | -  | -   | 21,504                                    |
| Total assets         | \$ 47,859              | \$ -   | \$ -  | \$ 47,859                                 |

The district revised fair value measurements, for the reporting of certain loans measured at fair value on a nonrecurring basis using Level 3 at December 31, 2016 and 2015. The disclosure was revised to report impaired loans with specific reserves only. The Level 3 fair value was disclosed at \$148,782 on the 2016 Annual Report, for the December 31, 2016 disclosures, and has been revised to \$26,355. The Level 3 fair value was disclosed at \$115,468 on the 2016 Annual Report, for December 31, 2015 disclosures, and has been revised to \$20,684.

Management has evaluated the impact of these corrections and concluded that the amounts are immaterial to previously issued financial statements; however, it has elected to revise the combined financial statements in order to correctly present such amounts in the comparative financial statements. The correction had no effect on the statement of comprehensive income, earnings or the financial ratios.

Assets and liabilities measured at fair value on a recurring basis at December 31, 2015, for each of the fair value hierarchy values are summarized below:

|  | Fair Value Measurement |  |   |   |
|--|------------------------|--|---|---|
|  | Total                  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets:  |                        |  |   |   |
| Federal funds  | \$ 22,413              | \$ -   | \$ 22,413                                     | \$ -                                      |
| Investments available-for-sale:                          |                        |  |   |   |
| Corporate debt   | 200,602                | -  | 200,602                                       | -   |
| Agency-guaranteed debt                                   | 248,355                | -  | 248,355                                       | -   |
| Mortgage-backed securities                               | 3,730,425              | -  | 3,680,175                                     | 50,250                                    |
| Asset-backed securities                                  | 200,073                | -  | 200,073                                       | -   |
| Mission-related and other available-for-sale investments | 65,650                 | -  | -   | 65,650                                    |
| Loans valued under the fair value option                 | 27,506                 | -  | 27,506  | -   |
| Loans held for sale in other assets                      | 4,850                  | -  | -   | 4,850                                     |
| Derivative assets  | 504                    | -  | 504   | -   |
| Assets held in nonqualified benefit trusts               | 6,399                  | 6,399  | -   | -   |
| Total assets   | \$ 4,506,777           | \$ 6,399   | \$ 4,379,628                                  | \$ 120,750                                |
| Liabilities:   |                        |  |   |   |
| Letters of credit  | \$ 967                 | \$ -   | \$ -  | \$ 967                                    |
| Total liabilities  | \$ 967                 | \$ -   | \$ -  | \$ 967                                    |

The table below represents a reconciliation of all Level 3 assets measured at fair value on a recurring basis for the year ended December 31, 2015:

|   | Assets                     |   |                    | Liabilities       | Total      |
|---|----------------------------|---|--------------------|-------------------|------------|
|   | Mortgage-Backed Securities | Agricultural Mortgage-Backed Securities | Loan Held For Sale | Letters of Credit |            |
| Balance at January 1, 2015                              | \$ 7                       | \$ 80,583                               | \$ -               | \$ 993            | \$ 79,597  |
| Net (losses) gains included in other comprehensive loss | (171)                      | 338                                     | -                  | -                 | 167        |
| Purchases, issuances and settlements                    | 50,414                     | (15,271)                                | -                  | (26)              | 35,169     |
| Transfers out of Level 3                                | -                          | -                                       | 4,850              | -                 | 4,850      |
| Balance at December 31, 2015                            | \$ 50,250                  | \$ 65,650                               | \$ 4,850           | \$ 967            | \$ 119,783 |

There were no transfers of assets or liabilities into or out of Level 1 from other levels during the year ended December 31, 2015. Agricultural mortgage-backed securities are included in Level 3 due to limited activity or less transparency around inputs to their valuation. At December 31, 2015, Level 3 investments included one agency MBS and one loan held for sale due to the fact that their valuations were based on Level 3 criteria (broker quotes). The liability for letters of

credit is included in Level 3 as their valuation, based on fees currently charged for similar agreements, may not closely correlate to a fair value for instruments that are not regularly traded in the secondary market.

Assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2015, for each of the fair value hierarchy values are summarized below:

|                      | Fair Value Measurement |  |   |   |
|----------------------|------------------------|--|---|---|
|                      | Total                  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets:              |                        |  |   |   |
| Loans                | \$ 20,684              | \$ -   | \$ -  | \$ 20,684                                 |
| Other property owned | 20,826                 | -  | -   | 20,826                                    |
| Total assets         | \$ 41,510              | \$ -   | \$ -  | \$ 41,510                                 |

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

|  | December 31, 2017             |  |   |   |                      |
|--|-------------------------------|--|---|---|----------------------|
|  | Fair Value Measurements Using |  |   |   |                      |
|  | Total Carrying Amount         | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value     |
| <b>Assets:</b>   |                               |  |   |   |                      |
| Cash   | \$ 66,953                     | \$ 66,953  | \$ -  | \$ -                                      | \$ 66,953            |
| Mission-related and other held-to-maturity investments | 18,828                        | -  | -   | 18,606                                    | 18,606               |
| Net loans  | 23,662,400                    | -  | -   | 23,517,247                                | 23,517,247           |
| <b>Total assets</b>                                    | <b>\$ 23,748,181</b>          | <b>\$ 66,953</b>   | <b>\$ -</b>                                   | <b>\$ 23,535,853</b>                      | <b>\$ 23,602,806</b> |
| <b>Liabilities:</b>                                    |                               |  |   |   |                      |
| Systemwide debt securities and other notes             | \$ 24,801,223                 | \$ -   | \$ -  | \$ 24,745,299                             | \$ 24,745,299        |
| <b>Total liabilities</b>                               | <b>\$ 24,801,223</b>          | <b>\$ -</b>  | <b>\$ -</b>                                   | <b>\$ 24,745,299</b>                      | <b>\$ 24,745,299</b> |

|  | December 31, 2016             |  |   |   |                      |
|--|-------------------------------|--|---|---|----------------------|
|  | Fair Value Measurements Using |  |   |   |                      |
|  | Total Carrying Amount         | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value     |
| <b>Assets:</b>   |                               |  |   |   |                      |
| Cash   | \$ 207,229                    | \$ 207,229   | \$ -  | \$ -                                      | \$ 207,229           |
| Mission-related and other held-to-maturity investments | 25,693                        | -  | -   | 25,652                                    | 25,652               |
| Net loans  | 22,179,287                    | -  | -   | 21,981,996                                | 21,981,996           |
| <b>Total assets</b>                                    | <b>\$ 22,412,209</b>          | <b>\$ 207,229</b>  | <b>\$ -</b>                                   | <b>\$ 22,007,648</b>                      | <b>\$ 22,214,877</b> |
| <b>Liabilities:</b>                                    |                               |  |   |   |                      |
| Systemwide debt securities and other notes             | \$ 23,240,663                 | \$ -   | \$ -  | \$ 23,234,907                             | \$ 23,234,907        |
| <b>Total liabilities</b>                               | <b>\$ 23,240,663</b>          | <b>\$ -</b>  | <b>\$ -</b>                                   | <b>\$ 23,234,907</b>                      | <b>\$ 23,234,907</b> |

|  | December 31, 2015             |  |   |   |                      |
|--|-------------------------------|--|---|---|----------------------|
|  | Fair Value Measurements Using |  |   |   |                      |
|  | Total Carrying Amount         | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value     |
| <b>Assets:</b>   |                               |  |   |   |                      |
| Cash   | \$ 550,852                    | \$ 550,852   | \$ -  | \$ -                                      | \$ 550,852           |
| Mission-related and other held-to-maturity investments | 30,213                        | -  | -   | 30,019                                    | 30,019               |
| Net loans  | 20,968,494                    | -  | -   | 20,946,692                                | 20,946,692           |
| <b>Total assets</b>                                    | <b>\$ 21,549,559</b>          | <b>\$ 550,852</b>  | <b>\$ -</b>                                   | <b>\$ 20,976,711</b>                      | <b>\$ 21,527,563</b> |
| <b>Liabilities:</b>                                    |                               |  |   |   |                      |
| Systemwide debt securities and other notes             | \$ 22,056,726                 | \$ -   | \$ -  | \$ 22,112,446                             | \$ 22,112,446        |
| Subordinated debt                                      | 49,801                        | -  | -   | 52,972                                    | 52,972               |
| <b>Total liabilities</b>                               | <b>\$ 22,106,527</b>          | <b>\$ -</b>  | <b>\$ -</b>                                   | <b>\$ 22,165,418</b>                      | <b>\$ 22,165,418</b> |

## Valuation Techniques

As more fully discussed in Note 2, "Summary of Significant Accounting Policies," authoritative 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 by the bank and associations for assets and liabilities:

### Cash

For cash, the carrying amount is a reasonable estimate of fair value.

### 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 that utilize observable inputs, quoted prices for similar securities received from pricing services or discounted cash flows. Generally, these securities would be classified as Level 2.

Among other securities, this would include certain mortgage-backed securities and asset-backed securities. Where there is limited activity or less transparency around inputs to the valuation, the securities are classified as Level 3. Level 3 assets at December 31, 2017, include the bank's AMBS portfolio, which is valued by the bank using a model that incorporates underlying rates and current yield curves.

As permitted under FCA regulations, the banks are authorized to hold eligible investments. The regulations define eligible investments by specifying credit rating criteria, final maturity limit and percentage of portfolio limit for each investment type. At the time of purchase, mortgage-backed and asset-backed securities must be triple-A rated by at least one Nationally Recognized Statistical Rating Organization. The triple-A rating requirement puts the banks in a position to hold the senior tranches of securitizations. The underlying loans for mortgage-backed securities are residential mortgages, while the underlying loans for asset-backed securities are home equity lines of credit, small business loans, equipment loans, auto loans or student loans.

To estimate the fair value of the majority of the investments held, the bank obtains prices from third-party pricing services.

#### *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*

Exchange-traded derivatives valued using quoted prices would be classified within Level 1 of the valuation hierarchy. However, few classes of derivative contracts are listed on an exchange; thus, the majority of the 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 interest rate caps and cash flow interest rate swaps.

The models used to determine the fair value of derivative assets and liabilities use an income approach based on observable market inputs, primarily the LIBOR swap curve and volatility assumptions about future interest rate movements.

#### *Letters of Credit*

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

#### *Loans*

Fair value is estimated by discounting the expected future cash flows using the banks' and/or the associations' current interest rates at which similar loans would be made to borrowers with similar credit risk. The discount rates are based on the banks' and/or the associations' current loan origination rates as well as management's estimates of credit risk. Management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale and could be less.

For purposes of estimating fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics. Expected future cash flows, primarily based on contractual terms, and interest rates reflecting appropriate credit risk are separately determined for each individual pool.

The fair value of loans in nonaccrual status that are current as to principal and interest is estimated as described above, with appropriately higher interest rates which reflect the uncertainty of continued cash flows. For collateral-dependent impaired loans, it is assumed that collection will result only from the disposition of the underlying collateral.

#### *Loans Evaluated for Impairment*

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

The bank has elected the fair value option for certain callable loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial assets. Fair value is used for both the initial and subsequent measurement of the designated instrument, with the changes in fair value recognized in net income. The fair value of securities is estimated using pricing models that utilize observable inputs, quoted prices for similar securities received from pricing services or discounted cash flows. Accordingly, these assets are classified within Level 2.

#### *Bonds and Notes*

Systemwide debt securities are not all traded in the secondary market and those that are traded may not have readily available quoted market prices. Therefore, the fair value of the instruments is estimated by calculating the discounted value of the expected future cash flows. The discount rates used are based on the sum of quoted market yields for the Treasury yield curve and an estimated yield-spread relationship between System debt instruments and Treasury securities. We estimate an appropriate yield-spread, taking into consideration selling group member (banks and securities dealers) yield indications, observed new government-sponsored enterprise debt security pricing and pricing levels in the related U.S. dollar interest rate swap market.

#### *Other Property Owned*

OPO is generally classified as Level 3. The process for measuring the fair value of OPO involves the use of appraisals or other market-based information. Costs to sell represent transaction costs and are not included as a component of the asset's fair value.

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

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

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

Quoted market prices may not be available for the instruments presented below. Accordingly, fair values are based on internal models that consider judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

### *Information About Recurring and Nonrecurring Level 3 Fair Value Measurements*

|                             | <b>Valuation Technique(s)</b> | <b>Unobservable Input</b> | <b>Range of inputs</b> |
|-----------------------------|-------------------------------|---------------------------|------------------------|
| Mission-related investments | Discounted cash flow          | Prepayment rates          | 2.1% - 41.6%           |
| Loan held for sale          | Quoted prices                 | priced for similar loans  |                        |

With regard to impaired loans and OPO, it is not practicable to provide specific information on inputs as each collateral property is unique. System institutions utilize appraisals to value these loans and OPO and take into account unobservable inputs such as income and expense, comparable sales, replacement cost and comparability adjustments.

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

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

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

|                            | <b>Valuation Technique(s)</b> | <b>Input</b>   |
|----------------------------|-------------------------------|--|
| Cash                       | Carrying value                | Actual balance   |
| Loans                      | Discounted cash flow          | Prepayment forecasts<br>Appropriate interest rate yield curve<br>Probability of default<br>Loss severity |
| Systemwide debt securities | Discounted cash flow          | Benchmark yield curve<br>Counterparty credit risk<br>Volatility  |

## Note 16 — Derivative Instruments and Hedging Activity

The bank maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments 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 liabilities so that the net interest margin is not adversely affected by movements in interest rates. The bank considers its 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 has interest rate caps and pay fixed interest rate swaps in order to reduce the impact of rising interest rates on its floating-rate assets. At December 31, 2017, the bank held interest rate caps with a notional amount of \$195,000 and a fair value of \$396, and pay fixed interest rate swaps with a notional amount of \$250,000 and a fair value of \$8,288. The primary types of derivative instruments used and the amount of activity (notional amount of derivatives) during the year ended December 31, 2017, is summarized in the following table (*dollars in thousands*):

|   | Pay Fixed<br>Swaps | Interest<br>Rate<br>Caps | Total             |
|---|--------------------|--------------------------|-------------------|
| Balance at<br>January 1, 2017           | \$ 200,000         | \$ 170,000               | \$ 370,000        |
| Additions                               | 50,000             | 75,000                   | 125,000           |
| Maturities/Amortizations                | -                  | (50,000)                 | (50,000)          |
| <b>Balance at<br/>December 31, 2017</b> | <b>\$ 250,000</b>  | <b>\$ 195,000</b>        | <b>\$ 445,000</b> |

The table below presents the credit ratings of counterparties to whom the bank has credit exposure at December 31, 2017:

|                       | Remaining Years to Maturity    |                         |       | Maturity<br>Distribution<br>Netting | Exposure | Collateral<br>Held | Exposure<br>Net of<br>Collateral |
|-----------------------|--------------------------------|-------------------------|-------|-------------------------------------|----------|--------------------|----------------------------------|
|                       | Less Than One<br>to Five Years | More Than<br>Five Years | Total |                                     |          |                    |                                  |
| Moody's Credit Rating |                                |                         |       |                                     |          |                    |                                  |
| A1                    | \$ -                           | \$ 24                   | \$ 24 | \$ -                                | \$ 24    | \$ -               | \$ 24                            |
| Aa2                   | 1                              | -                       | 1     | -                                   | 1        | -                  | 1                                |
| Aa3                   | 3                              | 8,656                   | 8,659 | -                                   | 8,659    | -                  | 8,659                            |

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 ALCO is responsible for approving hedging strategies that are developed through its analysis of data derived from financial simulation models

### Fair Value of Derivative Instruments:

The following table represents the fair value of derivative instruments as of December 31:

|                    | Balance Sheet<br>Location | Fair Value<br>2017 | Fair Value<br>2016 | Fair Value<br>2015 | Balance Sheet<br>Location | Fair Value<br>2017 | Fair Value<br>2016 | Fair Value<br>2015 |
|--------------------|---------------------------|--------------------|--------------------|--------------------|---------------------------|--------------------|--------------------|--------------------|
| Interest rate caps | Other assets              | \$ 396             | \$ 414             | \$ 504             | Other liabilities         | \$ -               | \$ -               | \$ -               |
| Pay fixed swaps    | Other assets              | 8,536              | 7,660              | -                  | Other liabilities         | (248)              | -                  | -                  |

By using derivative instruments, 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 of the derivative. Generally, when the fair value of a derivative contract is positive, this indicates that the counterparty owes the bank, thus creating a repayment 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 maintains collateral agreements to limit exposure to agreed-upon thresholds; the bank deals with counterparties that have an investment grade or better credit rating from a major rating agency; and the bank also monitors the credit standing of, and levels of exposure to, individual 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. At December 31, 2017, the bank had credit exposure to counterparties totaling \$8,684, as compared with \$8,074 at December 31, 2016 and \$500 at December 31, 2015.

and other internal and industry sources. The resulting hedging strategies are then incorporated into the district's overall interest rate risk-management strategies. The bank may enter into interest rate swaps classified as fair value hedges primarily to convert a portion of its non-prepayable fixed-rate long-term debt to floating-rate debt.

The following table sets forth the amount of gain (loss) recognized in the Other Comprehensive Income (OCI) for the years ended December 31, 2017, 2016 and 2015:

|                    | Gain (Loss) Recognized in OCI on Derivatives<br>(Effective Portion) at December 31, |         |          |                  | Amount of Gain Reclassified From AOCI<br>Into Income (Effective Portion) at December 31, |          |          |
|--------------------|---|---------|----------|------------------|--|----------|----------|
|                    | 2017  | 2016    | 2015     |                  | 2017   | 2016     | 2015     |
| Interest rate caps | \$ (553)  | \$ (89) | \$ (586) | Interest expense | \$ 192   | \$ 1,089 | \$ 1,374 |
| Pay fixed swaps    | (113)   | 6,596   | -        | Interest expense | 779  | 732      | -        |

The following table provides information about derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, including debt obligations and interest rate swaps. The debt information in the table presents the principal cash

flows and related weighted average interest rates by expected maturity dates. The derivative information in the table represents the notional amounts and weighted average interest rates by expected maturity dates.

| December 31, 2017<br>(dollars in thousands) | Maturities of 2017 Derivative Products and Other Financial Instruments |              |              |              |              |              | Subsequent<br>Years | Total         | Fair<br>Value |
|---|--|--------------|--------------|--------------|--------------|--------------|---------------------|---------------|---------------|
|   | 2018   | 2019         | 2020         | 2021         | 2022         |              |                     |               |               |
| Total Systemwide debt obligations:          |  |              |              |              |              |              |                     |               |               |
| Fixed rate                                  | \$ 5,093,000   | \$ 2,475,786 | \$ 2,246,463 | \$ 1,711,009 | \$ 1,578,671 | \$ 3,241,515 | \$ 16,346,444       | \$ 16,295,512 |               |
| Weighted average interest rate              | 1.16%  | 1.35%        | 1.58%        | 1.94%        | 1.98%        | 2.71%        | 1.72%               |               |               |
| Variable rate                               | \$ 2,579,935   | \$ 1,974,855 | \$ 49,988    | \$ -         | \$ -         | \$ -         | \$ 4,604,778        | \$ 4,606,766  |               |
| Weighted average interest rate              | 1.37%  | 1.42%        | 1.26%        | -            | -            | -            | 1.39%               |               |               |
| Total Systemwide debt obligations:          | \$ 7,672,935   | \$ 4,450,641 | \$ 2,296,451 | \$ 1,711,009 | \$ 1,578,671 | \$ 3,241,515 | \$ 20,951,222       | \$ 20,902,278 |               |
| Weighted average interest rate              | 1.23%  | 1.38%        | 1.57%        | 1.94%        | 1.98%        | 2.71%        | 1.65%               |               |               |
| Derivative instruments:                     |  |              |              |              |              |              |                     |               |               |
| Interest rate caps                          |  |              |              |              |              |              |                     |               |               |
| Notional value                              | \$ -   | \$ -         | \$ 50,000    | \$ -         | \$ 30,000    | \$ 115,000   | \$ 195,000          | \$ 396        |               |
| Weighted average receive rate               | -  | -            | -            | -            | -            | -            | -                   | -             |               |
| Weighted average pay rate                   | -  | -            | -            | -            | -            | -            | -                   | -             |               |
| Pay fixed swaps                             |  |              |              |              |              |              |                     |               |               |
| Notional value                              | \$ -   | \$ -         | \$ -         | \$ -         | \$ -         | \$ 250,000   | \$ 250,000          | \$ 8,288      |               |
| Weighted average receive rate               | -  | -            | -            | -            | -            | 1.49%        | 1.49%               |               |               |
| Weighted average pay rate                   | -  | -            | -            | -            | -            | 1.54%        | 1.54%               |               |               |

## Note 17 — Selected Quarterly Financial Information (Unaudited)

Quarterly results of operations are shown below for the years ended December 31:

|  | 2017       |            |            |            |            |
|--|------------|------------|------------|------------|------------|
|  | First      | Second     | Third      | Fourth     | Total      |
| Net interest income                            | \$ 186,982 | \$ 192,567 | \$ 195,519 | \$ 195,885 | \$ 770,953 |
| Provision (negative provision) for loan losses | 3,336      | 15,201     | 4,360      | (17,832)   | 5,065      |
| Noninterest expense, net                       | 87,757     | 78,226     | 74,835     | 85,675     | 326,493    |
| Net income                                     | \$ 95,889  | \$ 99,140  | \$ 116,324 | \$ 128,042 | \$ 439,395 |

|  | 2016       |            |            |            |            |
|--|------------|------------|------------|------------|------------|
|  | First      | Second     | Third      | Fourth     | Total      |
| Net interest income                            | \$ 176,096 | \$ 180,546 | \$ 182,113 | \$ 188,051 | \$ 726,806 |
| Provision (negative provision) for loan losses | 5,651      | 1,179      | 3,334      | 1,328      | 11,492     |
| Noninterest expense, net                       | 71,845     | 67,907     | 74,660     | 67,462     | 281,874    |
| Net income                                     | \$ 98,600  | \$ 111,460 | \$ 104,119 | \$ 119,261 | \$ 433,440 |

|  | 2015       |            |            |            |            |
|--|------------|------------|------------|------------|------------|
|  | First      | Second     | Third      | Fourth     | Total      |
| Net interest income (Negative provision) | \$ 169,281 | \$ 171,714 | \$ 172,892 | \$ 184,049 | \$ 697,936 |
| provision for loan losses                | 3,460      | (1,322)    | 4,781      | (1,266)    | 5,653      |
| Noninterest expense, net                 | 59,528     | 68,546     | 62,465     | 74,905     | 265,444    |
| Net income                               | \$ 106,293 | \$ 104,490 | \$ 105,646 | \$ 110,410 | \$ 426,839 |

## Note 18 — 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. The multiemployer structure of the district's defined benefit plan results in the recording of this plan only upon combination.

| Balance Sheet Data                           | Year Ended December 31, |                      |                      |
|--|-------------------------|----------------------|----------------------|
|  | 2017                    | 2016                 | 2015                 |
| Cash and federal funds sold                  | \$ 303,071              | \$ 218,380           | \$ 567,503           |
| Investment securities                        | 5,144,985               | 4,831,375            | 4,445,105            |
| Loans  |                         |                      |                      |
| To associations                              | 11,584,236              | 10,625,132           | 9,621,039            |
| To others                                    | 5,500,941               | 5,284,271            | 5,149,967            |
| Less allowance for loan losses               | 7,639                   | 7,650                | 5,833                |
| Net loans                                    | 17,077,538              | 15,901,753           | 14,765,173           |
| Accrued interest receivable                  | 58,330                  | 50,191               | 47,816               |
| Other property owned                         | -                       | -                    | 438                  |
| Other assets                                 | 252,681                 | 220,699              | 163,540              |
| <b>Total assets</b>                          | <b>\$ 22,836,605</b>    | <b>\$ 21,222,398</b> | <b>\$ 19,989,575</b> |
| Bonds and notes                              | \$ 20,951,223           | \$ 19,390,662        | \$ 18,206,726        |
| Subordinated debt                            | -                       | -                    | 49,801               |
| Other liabilities                            | 217,498                 | 209,484              | 179,470              |
| <b>Total liabilities</b>                     | <b>21,168,721</b>       | <b>19,600,146</b>    | <b>18,435,997</b>    |
| Preferred stock                              | 600,000                 | 600,000              | 600,000              |
| Capital stock                                | 301,239                 | 284,038              | 255,823              |
| Allocated retained earnings                  | 39,144                  | 33,171               | 27,203               |
| Unallocated retained earnings                | 779,403                 | 737,622              | 697,883              |
| Accumulated other                            |                         |                      |                      |
| comprehensive loss                           | (51,902)                | (32,579)             | (27,331)             |
| <b>Total members' equity</b>                 | <b>1,667,884</b>        | <b>1,622,252</b>     | <b>1,553,578</b>     |
| <b>Total liabilities and members' equity</b> | <b>\$ 22,836,605</b>    | <b>\$ 21,222,398</b> | <b>\$ 19,989,575</b> |

| Income Statement   | Year Ended December 31, |                   |                   |
|--|-------------------------|-------------------|-------------------|
|  | 2017                    | 2016              | 2015              |
| Interest income  | \$ 547,520              | \$ 480,512        | \$ 428,360        |
| Interest expense   | 296,199                 | 242,191           | 195,892           |
| Net interest income  | 251,321                 | 238,321           | 232,468           |
| (Negative provision) provision for credit losses                           | (1,673)                 | 563               | (2,506)           |
| Net interest income after provision (negative provision) for credit losses | 252,994                 | 237,758           | 234,974           |
| Noninterest income   | 45,204                  | 50,419            | 40,638            |
| Noninterest expense  | 102,212                 | 95,771            | 83,373            |
| Net income   | \$ 195,986              | \$ 192,406        | \$ 192,239        |
| Other comprehensive (loss) income  | (19,323)                | (5,248)           | (7,509)           |
| <b>Comprehensive income</b>  | <b>\$ 176,663</b>       | <b>\$ 187,158</b> | <b>\$ 184,730</b> |

## Note 19 — Association Mergers

Effective January 1, 2015, Great Plains Ag Credit, ACA headquartered in Amarillo, Texas, was acquired by AgTexas Farm Credit Services, ACA headquartered in Lubbock, Texas. The merged association is using the AgTexas Farm Credit Services, ACA name and is headquartered in Lubbock, Texas. The primary reason for the merger was based on a determination that the combined organizations should be financially and operationally stronger than the respective associations on a stand-alone basis. The acquisition method of accounting, required for mergers of cooperatives occurring after January 1, 2009, was used in the merger.

As the accounting acquirer, AgTexas Farm Credit Services, ACA accounted for the transaction by using their historical information and accounting policies and recording the identifiable assets and liabilities of Great Plains Ag Credit, ACA as of the acquisition date of January 1, 2015, at their respective fair values. The association operates for the mutual benefit of their borrowers and other customers and not for the benefit of any other equity investors. As such, their capital stock provides no significant interest in corporate earnings or growth. Specifically, due to restrictions in applicable regulations and their bylaws, the associations can issue stock only at its par value of \$5 per share; the stock is not tradable; and the stock can be retired only for the lesser of par value or book value. In these and other respects, the shares of Great Plains Ag Credit, ACA that were converted into shares of AgTexas Farm Credit Services, ACA had identical rights and attributes. For this reason, the conversion of stock pursuant to the merger occurred at a one-for-one exchange ratio. Association management believes that because the stock in each association is fixed in value, the stock issued pursuant to the merger provides no basis for estimating the fair value of the consideration transferred pursuant to the merger. In the absence of a purchase price determination, AgTexas Farm Credit Services, ACA identified and estimated the acquisition date fair value of the equity interest (net assets) of Great Plains Ag Credit, ACA instead of the acquisition date fair value of the equity interests transferred as consideration. The fair value of the assets acquired, including specific intangible assets and liabilities assumed from Great Plains Ag Credit, ACA, were measured based on various estimates using assumptions that AgTexas Farm Credit Services, ACA management believe are reasonable utilizing information available at the merger date. Use of different estimates and judgments could yield materially different results. This evaluation produced a fair value of identifiable assets acquired and liabilities assumed that was substantially equal to the fair value of the member interests transferred in the merger. As a result, AgTexas Farm Credit Services, ACA management determined goodwill was immaterial and therefore recorded no goodwill. The excess value received by AgTexas Farm Credit Services, ACA from Great Plains Ag Credit, ACA over par value of capital stock and participation certificates issued in the merger is considered to be additional paid-in capital.

The following table summarizes the fair values of the identifiable assets acquired and liabilities AgTexas Farm Credit Services, ACA assumed from Great Plains Ag Credit, ACA upon acquisition:

|   | <b>Fair<br/>Value</b> | <b>Contractual<br/>Amount</b> | <b>Contractual<br/>Amounts not<br/>Expected to<br/>be Collected</b> |
|---|-----------------------|-------------------------------|---|
| Loans   | \$ 521,179            | \$ 525,309                    | \$ 2,363  |
| Total assets                                    | 547,081               | -                             | -   |
| Notes payable                                   | 441,509               | 443,234                       | -   |
| Total liabilities                               | 458,670               | -                             | -   |
| Net assets acquired                             | 88,411                | -                             | -   |
| Impaired loans acquired                         | 5,349                 | 5,304                         | -   |
| Amount of accretable yield<br>on impaired loans | 45                    | -                             | -   |

As Great Plains Ag Credit, ACA (the acquired entity) was an affiliated association of the district prior to the business combination with AgTexas Farm Credit Services, ACA, the Great Plains Ag Credit, ACA financial position and results of operations are included in the

combined district financial statements for the year ending December 31, 2014. Great Plains Ag Credit, ACA results of operations for the pre-merger period were as follows:

|  | <b>2014</b>      |
|--|------------------|
| Net interest income                            | \$ 14,963        |
| Negative provision (provision) for loan losses | 882              |
| Noninterest income                             | 7,987            |
| Noninterest expense                            | (10,816)         |
| Provision for income taxes                     | (427)            |
| Net income                                     | <u>\$ 12,589</u> |

## Note 20 — Subsequent Events

The district has evaluated subsequent events through May 30, 2018, which is the date the financial statements were issued. In March 2018, the Farm Credit System Insurance Corporation (FCSIC) board approved and distributed excess funds to the System. For the Texas district, the excess funds received totaled \$19.3 million. There are no other significant subsequent events requiring disclosure as of May 30, 2018.



# Disclosure Information and Index

DISCLOSURES REQUIRED BY FARM CREDIT ADMINISTRATION REGULATIONS

## DESCRIPTION OF BUSINESS

The Farm Credit Bank of Texas (FCBT or bank), Agricultural Credit Associations (ACAs) and a Federal Land Credit Association (FLCA), collectively referred to as the district, are member-owned cooperatives which provide credit and credit-related services to or for the benefit of eligible borrower-shareholders for qualified agricultural purposes in the states of Alabama, Louisiana, Mississippi, New Mexico and Texas. The district's ACA parent associations, which each contain wholly-owned FLCA and Production Credit Association (PCA) subsidiaries, and the FLCA are collectively referred to as associations. A further description of territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations required to be disclosed in this section are incorporated herein by reference to Note 1, "Organization and Operations," to the accompanying financial statements.

The description of significant developments that had or could have a material impact on results of operations or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting business, seasonal characteristics and concentrations of assets, if any, required to be disclosed in this section are incorporated herein by reference to "Management's Discussion and Analysis" of the district included in this annual report to shareholders.

### *Board of Directors and Bank Senior Officers*

FCBT is governed by a seven-member board of directors. Five directors are farmers or ranchers, who are elected by the customers of the 14 associations that own the bank. Two directors, who are not stockholders of any of the associations, are appointed by the elected board members. The board of directors is responsible for directing the operations of the bank. The bank's senior officers, through the bank's chief executive officer, are accountable to the board of directors and work with the board of directors to set the bank's direction, goals and strategies.

The following represents certain information regarding the board of directors and senior officers of the bank as of December 31, 2017, including business experience during the past five years:

## DIRECTORS

James F. "Jimmy" Dodson, 64, chairman of the board of directors, is from Robstown, Texas. He grows cotton, corn, wheat and milo on four family farm operations and owns a seed sales business. Mr. Dodson serves on the bank's audit and compensation committees and was chairman of the Tenth District Farm Credit Council for 2016. In January 2017, he was elected vice chairman of the Tenth District Farm Credit Council. He is one of the board's designated financial experts on the board audit committee for the bank. He also is vice chairman of the national Farm Credit Council Board of Directors. Mr. Dodson joined the board of directors of FCC Services, an integrated services firm, in January 2017. He is also president of Dodson Farms, Inc. and Dodson Ag, Inc., and is a partner in Legacy Farms and 3-D Farms. He is manager of Weber Station LLC, which is the managing partner of Weber Greene, Ltd., both of which are family farm real estate management firms. Mr. Dodson is a founding member of Cotton

Leads, a responsible cotton production initiative of U.S. and Australian Cotton Producer organizations. He also serves on the boards of Gulf Coast Cooperative, an agricultural retail cooperative, and the Texas Agricultural Cooperative Council, an industry trade association. He is past chairman of the National Cotton Council of America, the American Cotton Producers and the Cotton Foundation, and formerly served as a director of Cotton Incorporated. He is past chairman of the Texas AgFinance, FCS board of directors and a former member of the Texas District's Stockholders Advisory Committee. Mr. Dodson became a director of the bank in 2003 and his current term expired at the end of 2017. He was re-elected to another three-year term effective January 1, 2018.

Lester Little, 67, vice chairman of the board of directors, is from Hallettsville, Texas. He owns and operates a farm and offers custom-farming services, primarily reclaiming farms and handling land preparation. His principal crops are corn, milo, hay and wheat. Mr. Little is a member of the bank's audit and compensation committees. He is also a member of the Tenth District Farm Credit Council. In addition, he is a member of the Farm Bureau, an agriculture trade organization, and served on the Lavaca Regional Water Planning Group, a regional water planning authority in Texas, during 2016. He previously was a board member of the Lavaca Central Appraisal District, a county organization in Texas that hires the chief appraiser for the county for purposes of assigning real estate values for tax assessments, and was board chairman of the Hallettsville Independent School District Board of Trustees. He is former chairman of the Capital Farm Credit board of directors and previously served as vice chairman of the Texas District's Stockholders Advisory Committee. Mr. Little became a director in 2009 and his term expired at the end of 2017. He was re-elected to another three-year term effective January 1, 2018.

Brad C. Bean, 57, is from Gillsburg, Mississippi. He is a dairy farmer with other farming interests, including corn, sorghum and timber. Mr. Bean is chairman of the bank's audit committee and is also a member of the bank's compensation committee. In January 2017, he was elected chairman of the Tenth District Farm Credit Council and was also elected to the national Farm Credit Council Board of Directors as a district representative. Mr. Bean serves on the boards of the Amite County Farm Bureau and the Amite County Cooperative, both of which are trade organizations. Mr. Bean is a former chairman of the Southern AgCredit, ACA Board of Directors and a former vice chairman of the Texas District's Stockholders Advisory Committee. Mr. Bean became a director in 2013 and his term expires at the end of 2018.

Ralph W. "Buddy" Cortese, 71, is from Fort Sumner, New Mexico. He is president of Cortese Farm and Ranch, Inc., a farming and ranching operation. He is chairman of the bank's compensation committee and is a member of the bank's audit committee. Mr. Cortese also is a member of the Tenth District Farm Credit Council board. He currently serves on the board of the Federal Farm Credit Banks Funding Corporation. Mr. Cortese served as chairman of the board of directors of the bank from 2000 through 2011. He is a member of the Texas Agricultural Cooperative Council board of directors, an industry association. From 2003 to 2008, he served on

the board of Federal Agricultural Mortgage Corporation (Farmer Mac), a government agency chartered to create a secondary market for agricultural loans, and is a former board member of the American Land Foundation, a property rights organization. Prior to joining the bank board, he was chairman of the PCA of Eastern New Mexico board of directors. Mr. Cortese became a director in 1995 and his term expired at the end of 2016. He was re-elected to another three-year term effective January 1, 2017.

Linda C. Floerke, 56, was elected to her first term on the board of directors effective January 1, 2017, and her current term expires December 31, 2019. She is a member of the bank's audit and compensation committees and is also a member of the Tenth District Farm Credit Council. In January 2018, she was elected vice chairman of the bank's compensation committee. Ms. Floerke lives near Lampasas, Texas, where she and her husband, Benton, raise cattle, whitetail deer and hay as Buena Vista Ranch, FLP. They also provide consultation and management for AgroTech Partners, LLC, which provides services such as liquid fertilizer, crop chemicals, custom application and cattle protein supplements to area farmers and ranchers. They also own and manage rental property in Uvalde, Real and Williamson counties. She is a co-owner of Casa Floerke LLC, a rental property business, and is the secretary/treasurer and co-owner of Jarrell Farm Supply, Inc. Ms. Floerke serves on the Staff Parish Relations Committee for the Lampasas United Methodist Church and serves on the Texas A&M AgriLife Extension Leadership Advisory Board, which provides oversight of agricultural extension services. She previously served as a trustee of the Lampasas Independent School District. Ms. Floerke was a director of Lone Star Ag Credit, formerly Texas Land Bank, from 2012 through the end of 2016.

Elizabeth G. "Betty" Flores, 73, is from Laredo, Texas, where she served as city mayor from 1998 to 2006. Ms. Flores is one of the two appointed members on the board and serves on the bank's audit and compensation committees. During 2017, she was vice chairman of the bank's compensation committee. She is also a member of the Tenth District Farm Credit Council. Previously, she was senior vice president of the Laredo National Bank. Ms. Flores serves on the boards of the Texas Agricultural Cooperative Council, an industry association, and Laredo Main Street, a nonprofit organization whose goal is to enhance the vibrant, multicultural community of Laredo's historic downtown and to diversify the economics base of the central business district within the framework of historic preservation, and which hosts El Centro de Laredo Farmers Market, a true certified farmers' market. In 2016, she was appointed by the Texas A&M University Chancellor, John Sharp, to serve on the selection committee to identify a new president for Texas A&M International University. Ms. Flores is a graduate of Leadership Texas 1995, a leadership program for women professional and community leaders for the state of Texas, and Leadership America 2008, a national leadership program for women professional and community leaders. In 2010, she was appointed to serve as a member of the Farm Credit System Diversity Workgroup. Ms. Flores is a partner in a ranching and real estate partnership, E.G. Ranch, Ltd. She is a former member of the Federal Reserve Board Consumer Advisory Council. Ms. Flores became a director in 2006 and her term expires at the end of 2018.

M. Philip Guthrie, 72, was appointed effective July 1, 2015, to a term on the board expiring at the end of 2017. He was re-appointed to a new three-year term effective January 1, 2018. He is vice chairman of

the bank's audit committee and also serves on the bank's compensation committee. He is also a member of the Tenth District Farm Credit Council. He is one of the board's designated financial experts on the board audit committee for the bank. Mr. Guthrie is the chief executive officer of Denham Partners LLC, a Dallas-based private investment firm, and the chief executive officer and director for Neuro Holdings International LLC, which is a medical devices firm. He also serves as a director for Neuro Resources Group, a medical devices firm. Early in his career, he was chief financial officer of Southwest Airlines, and later served as chief financial officer of Braniff International during that airline's reorganization. Mr. Guthrie also was managing director of Mason Best Co., a Dallas-based investment firm, for 10 years, and has served as chairman, director or chief executive officer of several private and public financial service companies, both in banking and insurance. A Certified Public Accountant and a Chartered Global Management Accountant, Mr. Guthrie is audit committee-qualified under the guidelines of the Securities and Exchange Commission, the New York Stock Exchange and Nasdaq. He is a stockholder of his family-managed 125-year-old livestock and crop operation in northern Louisiana.

## Committees

The board of directors has established an audit committee and a compensation committee. All members of the board serve on both the audit committee and the compensation committee. As the need arises, a member of the board of directors will also participate in the functions of the bank's credit review committee. The responsibilities of each board committee are set forth in its respective approved charter.

The disclosure of director and senior officer information included in this disclosure information and index was reviewed by the compensation committee prior to the annual report's issuance (including the disclosure information and index).

## Compensation of Directors

Directors of the bank are compensated in cash for service on the bank's board. An annual compensation amount is considered as a retainer for all services performed by the director in an official capacity during the year except for extraordinary services for which additional compensation may be paid. The annual retainer fee is to be paid in equal monthly installments. Compensation for 2017 was paid at the rate of \$58,115 per year, payable at \$4,842.92 per month. In addition to days served at board meetings, directors may serve additional days on other official assignments and under exceptional circumstances where extraordinary time and effort are involved, the board may approve additional compensation, not to exceed 30 percent of the annual maximum allowable by FCA regulations. In this regard, effective July 1, 2017, additional compensation was paid for leadership positions on the board on an annual basis, including the chairman in the amount of \$12,000 and vice chairman in the amount of \$5,000, chairman and vice chairman of each board standing committees as well as to members of each board standing committee. The additional compensation was as follows: audit committee chairman \$10,000, audit committee vice chairman \$5,000, compensation committee chairman \$10,000, compensation vice chairman \$5,000, audit committee membership of \$2,500 and compensation committee membership of \$2,500. No director received non-cash compensation exceeding \$5,000 in 2017. Total cash compensation paid to all directors as a group during 2017 was \$447,805.

Information for each director for the year ended December 31, 2017, is provided below:

| <b>Board Member</b> | <b>Days Served at Board Meetings*</b> | <b>Days Served on Other Official Assignments**</b> | <b>Total Compensation Paid***</b> |
|---------------------|---------------------------------------|--|-----------------------------------|
| James F. Dodson     | 33.25                                 | 32.50  | \$ 66,615                         |
| Lester Little       | 33.00                                 | 30.50  | 63,115                            |
| Brad C. Bean        | 30.50                                 | 28.75  | 65,615                            |
| Ralph W. Cortese    | 32.75                                 | 30.50  | 65,615                            |
| Linda C. Floerke    | 32.75                                 | 29.00  | 60,615                            |
| Elizabeth G. Flores | 30.50                                 | 24.50  | 63,115                            |
| M. Philip Guthrie   | 32.75                                 | 30.50  | 63,115                            |
|                     |                                       |  | <u>\$ 447,805</u>                 |

\*Includes travel time, but does not include time required to prepare for board meetings. Also includes attendance via teleconference.

\*\*Includes audit committee meetings, compensation committee meetings, credit review committee meetings, special assignments, training and travel time.

\*\*\*Reflects regular compensation and additional compensation for year presented.

Directors are reimbursed for reasonable travel, subsistence and other related expenses while conducting bank business. The aggregate amount of expenses reimbursed to directors in 2017, 2016 and 2015 totaled \$177,377, \$122,538 and \$139,053, respectively. A copy of the bank's travel policy is available to shareholders upon request.

## BANK SENIOR OFFICERS

| <b>Name and Title</b>   | <b>Position</b> | <b>Experience – Past Five Years</b>  | <b>Other Business Interests – Past Five Years</b>   |
|---|-----------------|--|---|
| Larry R. Doyle,<br><i>Chief Executive Officer</i>   | 14.5 years      |  | He was appointed to be a member of the board of directors for the Federal Farm Credit Banks Funding Corporation in September of 2016 and was reappointed in March of 2017 for a three-year term. He was chairman of the Farm Credit System Presidents Planning Committee (PPC), currently serves on the PPC executive and business practices committees and is chairman of the PPC finance committee. He serves on the National Council of Farmer Cooperatives Executive Council. He is the managing member of the following organizations: Lone Star Plantation LLC, a family-owned farming and land ownership operation, K&R Farm LLC, a family-owned farming operation and K&R Land Holdings, a family-owned land ownership operation. |
| Kurt Thomas,*<br><i>Senior Vice President,<br/>Chief Credit Officer</i>   | 7.6 years       |  | He served as a member of the board of governors for the Farm Credit System Captive Insurance Corporation until his term expired in February 2011 and served as a member of the Farm Credit System Credit Workgroup. He is the manager of Estancia Maximo, a hunting and ranching business.  |
| John Sloan,<br><i>Senior Vice President,<br/>Chief Credit Officer</i>   | 1 month         | Vice President and Unit Manager, 2014-2017; Vice President and Relationship Manager, prior to 2014, Association Direct Lending Group, FCBT |   |
| Carolyn Owen,<br><i>Senior Vice President,<br/>Corporate Affairs, General Counsel<br/>and Corporate Secretary</i> | 4.8 years       | Vice President, Corporate Affairs, Deputy General Counsel, FCBT  | She serves as a member of the Farm Credit System Capital Workgroup.   |

| <b>Name and Title</b>   | <b>Position</b> | <b>Experience – Past Five Years</b>                         | <b>Other Business Interests – Past Five Years</b>  |
|---|-----------------|---|--|
| Amie Pala,<br><i>Senior Vice President,<br/>Chief Financial Officer</i> | 7.4 years       |   | She serves as a member of the Farm Credit System Capital Workgroup and of the Farm Credit System Disclosure Committee.   |
| Michael Elliott,<br><i>Chief Information Officer</i>                    | 4 years         | Vice President of Information Technology, FCBT<br>2011-2013 |  |
| Stan Ray,<br><i>Chief Administrative Officer</i>                        | 7.4 years       |   | He serves on the AgFirst/FCBT Plan Sponsor Committee, the Texas District Benefits Administration Committee and the Farm Credit System's Reputation Risk Analysis and Planning Workgroup. He is president of the Tenth District Farm Credit Council, a trade organization. He is a member of the board of directors for the following organizations: Texas FFA Foundation, a nonprofit organization promoting youth in agriculture; Texas Agricultural Cooperative Council, an industry association; and Rodeo Austin, a nonprofit organization promoting youth education and Western heritage. |
| Nisha Rocap,<br><i>Chief Audit Executive</i>                            | 2 months        | Risk Assurance Director,<br>PricewaterhouseCoopers          |  |
| Susan Wallar,**<br><i>Vice President, Special Projects</i>              | 1 month         | Chief Audit Executive,<br>FCBT                              | She served as a member of the board of governors and was chairman of the audit committee for the Farm Credit System Captive Insurance Corporation. She was a member of the Farm Credit System Review, Audit and Appraisal Workgroup (RAAW) and the Farm Credit System Internal Controls over Financial Reporting (ICFR) Workgroup.   |

\*Kurt Thomas served as senior vice president, chief credit officer until his retirement effective December 31, 2017.

\*\*Susan Wallar served as vice president, special projects until her retirement effective March 31, 2018.

## Compensation Discussion and Analysis – Senior Officers

### Overview

The board of directors of the Farm Credit Bank of Texas, through its compensation committee, has pursued a compensation philosophy for the bank that promotes leadership in the adoption and administration of a comprehensive compensation program.

A description of the bank's compensation plans is as follows.

### *Base Pay*

Market-based salaries along with the other incentive and benefits described below are critical to attracting and retaining needed talent in a highly competitive job market and at a time of high retirement risks.

### *Defined Benefit Pension Plan*

The Defined Benefit Pension Plan (Pension Plan) is a final average pay plan which was closed to new participants in 1996, and later fully closed to all participants, including rehires who had formerly participated in the plan. The Pension Plan benefits are based on the average monthly eligible compensation over the 60 consecutive months that produce the highest average after 1996 (FAC60). The Pension Plan's benefit formula for a Normal Retirement Pension is the sum of (a) 1.65 percent of FAC60 times "Years of Benefit Service" and (b) 0.50 percent of (i) FAC60 in excess of Social Security covered compensation times (ii) "Years of Benefit Service" (not to exceed 35).

The Pension Plan's benefit formula for the Normal Retirement Pension assumes that the employee's retirement age is 65, that the employee is married on the date the annuity begins, that the spouse is exactly 2 years younger than the employee and that the benefit is payable in the form of a 50 percent joint and survivor annuity. If any of those assumptions are incorrect, the benefit is recalculated to be the actuarial equivalent benefit. The Pension Plan benefit is offset by the pension benefits any employee may have from another Farm Credit System institution.

The Pension Plan was amended in 2013 to allow those retiring after September 1, 2013, to elect a lump-sum distribution option. The plan was also amended to allow participating employers to exclude from pension compensation new long-term incentive plans which began after January 1, 2014.

In 2014 the plan was amended to allow terminated employees with a vested benefit to also elect a lump-sum distribution beginning January 1, 2015.

### *401(k) Plan – Elective*

Farm Credit Benefits Alliance (FCBA) 401(k) Plan is open to all bank employees and includes up to a 4 percent employer match on employee deferrals up to Internal Revenue Service (IRS) directed limits. Employees become fully vested in the plan upon participation. The plan allows for self-directed investment choices by participants.

### *401(k) Plan – Non-Elective Defined Contribution Plan*

FCBA 401(k) Plan's Defined Contribution component is open to employees not participating in the Defined Benefit Pension Plan. Employees become fully vested in the plan upon participation and receive a 5 percent employer contribution each pay period up to IRS-directed limits to the participant's account which is invested in the self-directed investment choices available.

### *Nonqualified Supplemental 401(k) Plan*

With the exception of the CEO, this plan is open to all employees who meet the minimum salary requirements set by the IRS. It has three features: elective deferral of employee compensation; discretionary employer contributions; and restored employer contributions that make an employee "whole" when 401(k) IRS limitations are met. Deferred money is invested with similar investment fund choices as the qualified 401(k) Plan at the participant's direction.

### *Success Sharing Plan*

The purpose of the Farm Credit Bank of Texas Success Sharing Plan (SSP) is to advance the mission of the bank by recognizing employees with variable pay through a discretionary bonus. The SSP (also categorized as a bonus or profit-sharing plan), rewards employees as the overall organization experiences success and performs within the realities of the current market environment and in accordance with business planning goals and objectives. Additionally, it is expected to help to attract, motivate and retain bank staff.

The SSP provides an annual award that is paid after the bank's operational results and strategic objectives are reported and assessed by the compensation committee of the board. The compensation committee has the final authority to determine if a success sharing award is to be paid and what percentage of the award target will be funded. The CEO does not participate in this plan; otherwise, all employees are eligible to participate in the SSP for that year. This program applies the concept of differential factors for all eligible bank participants, and is tiered into five groups according to employee job grades and their accountability level inside the entire organization. Each employee group has its own Success Sharing Award Factor for this plan. This factor is multiplied by the employee's December 31st annualized base compensation to arrive at the Success Sharing Plan award target for the year.

When a promotion or salary adjustment occurs during the year that elevates an employee's job grade into a higher employee group in the plan, the plan's award calculation will be prorated and paid at the separate employee group percentages for the periods the employee was in each of the employee groups. Additionally, when a salary adjustment occurs, the plan's award calculation will be prorated and paid at the separate employee salaries for the periods the employee was at each salary.

### *FCBT Retention Plan*

This is a nonqualified plan for bank employees that provides dollar incentives to remain employed for specific time periods to accomplish important bank initiatives or to aid in leadership succession. It is paid according to the agreement arranged for each participant. The CEO approves and recommends participants to the compensation committee, which approves plan provisions and participant agreements. Several employees were offered and accepted three-year retention plans in 2015. These employees have expertise with current software and systems from which the bank is transitioning to new software/system solutions. In order to retain these employees with critical knowledge, the bank offered retention plans that were accepted by the employees. The three-year retention plans are back loaded. The employees will receive 15 percent payout at the end of the first and second year if employed on December 31 each year. At the end of the third and final year, the employees will receive the last payment of 70 percent of the agreed-upon amount.

### *Spot Awards Program*

This bank program allows for discretionary awards to be paid to employees throughout the year in recognition of outstanding performance events or service provided to the bank's customers. Senior officers do not participate in this program.

### *Bank-Owned Vehicle Program*

Use of bank-owned vehicles is provided to three groups within the bank: the executive group, which is comprised of voting members of the bank's executive committee; the senior management group, which includes members defined by the CEO exclusive of the voting members of the executive committee; and the other group consisting of employees who have been identified by executive committee members as requiring a vehicle for job performance. Any current employee who was in possession of a bank-provided vehicle when vehicle eligibility guidelines were set was grandfathered for their remaining uninterrupted employment term at the bank. Employees assigned use of a bank-owned vehicle are required to maintain written records of their business and personal use. This data is used to annually impute to the employee's taxable wages the personal use value of the vehicle following the IRS lease value rule.

### *Educational and Training Program*

This program was established in recognition that ongoing enrichment of employees' skills, knowledge and expertise is essential not only for the success of the bank and the retention of key employees, but for the realization of employees' personal growth and achievement.

This program is directed to employees at all levels and includes formal orientation of new hires, a continuing education and degree program, and a licensing and certification program. The degree program reimbursement is open to full-time employees who have been with the bank at least six months. This program covers tuition, lab fees, books and registration fees if the employee receives a grade of C or better in undergraduate courses and B or better in graduate-level courses and expenses are in excess of those reimbursable by a scholarship or other sources.

Tuition reimbursement will not normally exceed the cost per semester hour charged at state-supported universities. Expenses incurred above the state-supported university baseline are the responsibility of the employee. Certain positions in the bank must be staffed by employees who hold professional licenses and/or certifications. In these instances, the membership and license fees, training and educational expenses for obtaining and maintaining professional status, licenses and certifications are reimbursable.

### *Compensation, Risk and Performance*

One of the critical strategic goals of the bank is to provide market-driven financial products and support services to add value to our association customers. The bank succeeds at this through robust customer communications and relationships to stay aware of their business needs. Our staff provides technical, credit, operational and marketing support, and offers leadership in talent acquisition, retention and development. Our ability to succeed in these areas is dependent upon having a knowledgeable and experienced customer-service-focused workforce that is responsive but also proactive in meeting our district's business challenges and recognizing and taking advantage of opportunities, including promoting the bank's mission as a government-sponsored enterprise.

Market and higher compensation programs are required to keep Farm Credit competitive in the talent war currently being waged in Austin, Texas. The bank is located in one of the nation's top economic markets. It has become known as the "Silicon Hills" for the large number of technology firms located here that pay top salaries to information technology professionals as well as many other employee classifications. The unemployment rate has for years been lower than the national average (currently less than 3 percent compared to about 4 percent nationally), which makes attracting talent a struggle with not only the aggressive tech sector, but also with competition from major medical, real estate and government employers. Austin is one of the country's fastest growing regions bringing new talent into the market, but also attracts new employers seeking those same resources. All these factors exert an upward pressure on all aspects of the employee value proposition and stress in acquiring and retaining the skilled workforce needed to achieve the bank's goals.

While external factors impact compensation programs, internal measures are in place to make certain there is alignment with the bank's performance. Market-driven base salaries are combined with a bonus program that is at risk each year. The compensation committee of the district board annually determines the structure and the award for the Success Sharing Plan, a short-term bonus plan. This gives them the agility to modify or discontinue the plan in response to changing circumstances. The bank is not locked into an incentive program for any extended period of time.

The SSP in regard to the total compensation mix is not overly significant or significantly larger than the market practice. Multiple performance measures are considered, which include financial and operational metrics. Although awards are based on a single year's performance, because the bank's customers are its cooperative associations, performance in the time period measured is less uncertain than in businesses with larger and lesser known customer bases. The board and compensation committee review the bank's financial and operational performance at each meeting, so SSP decisions are reviewed by the same centralized group who hear those reports all year. Additionally, the compensation committee has external resources to support its oversight and uses that independent compensation consultant to review SSP awards with its annual executive compensation update.

In making its decision on the SSP award at year end, the compensation committee analyzes the bank's performance against the business plan for the year. The business plan is approved by the full composition of the board at the beginning of the year and is monitored all year as the CEO and senior team members deliver management and other reporting on bank performance and respond to director questions. Financial metrics include net income, the associations' direct note volume, allowance for loan losses, nonaccrual loans, capital market and investment income, total asset growth, credit quality, permanent capital ratio, and at year end, the association patronage. Operational accomplishments considered vary but typically include staff outreach to associations, participation and leadership in System workgroups and initiatives, debt issuances, credit and technology products and services delivered, marketing support, talent acquisition and talent management support, and continued progress in diversity and inclusion efforts.

### Chief Executive Officer (CEO) Compensation Table and Policy for Bank

In December 2016, a memorandum of understanding between the bank and the CEO was executed with an effective date of January 1, 2017, which supersedes the previous memorandum of understanding effective January 2, 2014. The memorandum of understanding is effective for a term of three years, until December 31, 2019. The base salary for each year of the three-year term for the CEO will be \$1,375,000. Bonus payments, if any, are at the sole discretion of the compensation committee. The employment relationship between the bank and CEO remains at-will, meaning the bank may terminate the CEO's employment at any time, and the CEO may choose to leave at any time.

As previously mentioned, the CEO bonus is discretionary and subject to the approval of the bank's compensation committee. The compensation committee reviews the same bank financial performance and operational metrics that the committee evaluates for purposes of the SSP. Additionally, for both the CEO and senior officer group, the compensation committee has annual peer market data it reviews with its third-party consultant before making CEO base and bonus pay decisions. The compensation committee also reviews seven dimensions of CEO performance and has discussions about goals set for the current year and successes in meeting those goals. The seven dimensions of CEO performance are: strategy and vision; leadership; innovation/technology; operating metrics; risk management; people management; and external relationships.

The following table summarizes the compensation paid to the CEO of the bank during 2017, 2016 and 2015.

**Summary Compensation Table for the Bank's CEO**

| Name of Chief Executive Officer | Year | Annual       |              |                             |                          |           | Total        |
|---------------------------------|------|--------------|--------------|-----------------------------|--------------------------|-----------|--------------|
|                                 |      | Salary (a)   | Bonus (b)    | Change in Pension Value (c) | Deferred/Perquisites (d) | Other (e) |              |
| Larry R. Doyle                  | 2017 | \$ 1,375,053 | \$ 1,500,000 | \$ 181,118                  | \$ 16,932                | \$ -      | \$ 3,073,103 |
| Larry R. Doyle                  | 2016 | 1,250,048    | 1,375,000    | 102,812                     | 960                      | -         | 2,728,820    |
| Larry R. Doyle                  | 2015 | 1,250,048    | 1,250,000    | (29,609)                    | 9,294                    | -         | 2,479,733    |

- (a) Gross salary for year presented.
- (b) Bonus compensation is presented in the year earned, and bonuses are paid within the first 30 days of the subsequent calendar year. For 2017, bonus compensation was paid in January 2018 of \$1,500,000 based on the performance of the bank during 2017. For 2016, bonus compensation was paid in January 2017 of \$1,375,000 based on the performance of the bank during 2016. For 2015, bonus compensation was paid in January 2016 of \$1,250,000 based on the performance of the bank during 2015.
- (c) For 2017, 2016 and 2015, disclosure of the change in pension value represents the change in the actuarial present value of the accumulated benefit under the defined benefit pension plan, the Farm Credit Bank of Texas Pension Plan, from the pension measurement date used for financial statement reporting purposes with respect to the audited financial statements for the prior completed fiscal year to the pension measurement date used for financial statement reporting purposes with respect to the audited financial statements for the covered fiscal year. For 2017 and 2016, the change in pension value is primarily associated with a decline in the discount rate as compared to the prior years. For 2015, the negative (or decrease) change in pension value is due to the increase in the accounting disclosure rate for 2015 as compared to 2014.
- (d) Deferred/Perquisites for 2017 includes contributions to a 401(k) plan and premiums paid for life insurance. For 2016, the amount includes premiums paid for life insurance. For 2015, the amount reflected includes contributions to a 401(k) plan, automobile benefits and premiums paid for life insurance.
- (e) No values to disclose.

## Compensation of Other Senior Officers for Bank

The following table summarizes the compensation paid to the aggregate number of senior officers, plus one highly compensated individual that is not a senior officer of the bank, during 2017, 2016 and 2015. Amounts reflected in the table are presented in the year the compensation is earned.

**Summary Compensation Table for Other Officers**

| Aggregate Number in Group (excludes CEO) | Year | Annual       |              |                             |                          |           | Total        |
|--|------|--------------|--------------|-----------------------------|--------------------------|-----------|--------------|
|  |      | Salary (a)   | Bonus (b)    | Change in Pension Value (c) | Deferred/Perquisites (d) | Other (e) |              |
| 9 Officers                               | 2017 | \$ 2,195,979 | \$ 1,034,423 | \$ 583,589                  | \$ 274,901               | \$ 51,658 | \$ 4,140,550 |
| 8 Officers                               | 2016 | 2,043,668    | 975,921      | 1,276,074                   | 270,692                  | -         | 4,566,355    |
| 8 Officers                               | 2015 | 1,939,518    | 925,184      | 135,850                     | 260,208                  | -         | 3,260,760    |

(a) Gross salary for year presented.

(b) Bonuses paid within the first 30 days of the subsequent calendar year.

(c) For 2017, 2016 and 2015, disclosure of the change in pension value represents the change in the actuarial present value of the accumulated benefit under the defined benefit pension plan, the Farm Credit Bank of Texas Pension Plan, from the pension measurement date used for financial statement reporting purposes with respect to the audited financial statements for the prior completed fiscal year to the pension measurement date used for financial statement reporting purposes with respect to the audited financial statements for the covered fiscal year. The significant increase in the change in pension value for 2016 is due to an officer attaining the required years of service and age to receive the maximum benefit allowed under the plan.

(d) Deferred/Perquisites include contributions to 401(k) and defined contribution plans, supplemental 401(k) discretionary contributions, automobile benefits and premiums paid for life insurance.

(e) For 2017, Other includes physical fitness compensation, service and retirement rewards, and an annual leave payment to a senior officer who retired at December 31, 2017. For 2016 and 2015, there were no values to disclose.

For 2017, the aggregate number of officers includes one senior officer who retired from the bank effective December 31, 2017.

Disclosure of the compensation paid during 2017 to any senior officer or officer included in the table is available and will be disclosed to shareholders of the bank upon written request.

Senior officers, including the CEO, are reimbursed for reasonable travel, subsistence and other related expenses while conducting bank business. A copy of the bank's travel policy is available to shareholders upon request.

Neither the CEO nor any other senior officer received non-cash compensation exceeding \$5,000 in 2017.

## Pension Benefits Table for the CEO and Senior Officers as a Group for Bank

The following table presents the total annual benefit provided from the defined benefit pension plan applicable to the CEO and senior officers as a group, plus one highly compensated individual that is not a senior officer of the bank, for the year ended December 31, 2017:

| Name  | Plan Name                              | Number of Years Credited Service | Present Value of Accumulated Benefit | Payments During 2017 |
|---|--|----------------------------------|--------------------------------------|----------------------|
| Larry R. Doyle  | Farm Credit Bank of Texas Pension Plan | 44.197                           | \$ 1,924,284                         | \$ -                 |
| Name  | Plan Name                              | Average Years Credited Service   | Present Value of Accumulated Benefit | Payments During 2017 |
| Officers, including Other Highly Compensated Employee | Farm Credit Bank of Texas Pension Plan | 35.289                           | \$ 6,223,337                         | \$ -                 |

## Description of Property

On September 30, 2003, the bank entered into a lease for approximately 102,500 square feet of office space to house its headquarters facility located at 4801 Plaza on the Lake Drive, Austin, Texas. The lease was effective September 30, 2003, and its term was from September 1, 2003, to August 31, 2013. On November 16, 2010, the bank entered into a lease amendment which extended the term of the lease to August 31, 2024. In addition, the lease amendment included expansion of the leased space to approximately 111,500 square feet of office space and an “early out” option to terminate the lease in 2020. The district associations own 12 headquarter locations and lease six locations. There are 127 owned and 64 leased association branch locations. The bank’s and associations’ investment in property is further detailed in Note 5, “Premises and Equipment,” to the accompanying combined financial statements.

## Legal Proceedings

There were no matters that came to the attention of the board of directors or management regarding the involvement of current directors or senior officers of the bank and associations in specified legal proceedings which are required to be disclosed.

There are no legal proceedings pending against the bank and associations, the outcome of which, in the opinion of legal counsel and management, would materially affect the financial position of the bank and associations. Note 13, “Commitments and Contingencies,” to the accompanying financial statements outlines the district’s position with regard to possible contingencies at December 31, 2017.

## Description of Capital Structure

The bank and associations are authorized to issue and retire certain classes of capital stock and retained earnings in the management of their capital structures. Details of the capital structures are described in Note 9, “Members’ Equity,” to the accompanying combined financial statements, and in the “Management’s Discussion and Analysis” of the district included in this annual report to stockholders.

## Description of Liabilities

The district’s debt outstanding is described in Note 8, “Bonds and Notes,” to the accompanying combined financial statements. The district’s contingent liabilities are described in Note 13, “Commitments and Contingencies,” to the accompanying combined financial statements. See also Note 11, “Employee Benefit Plans,” with regard to obligations related to employee retirement plans.

## Selected Financial Data

The selected financial data for the five years ended December 31, 2017, required to be disclosed, is incorporated herein by reference to the “Five-Year Summary of Selected Combined Financial Data” included in this annual report to stockholders.

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

“Management’s Discussion and Analysis,” which precedes the combined financial statements in this annual report, is incorporated herein by reference.

## Transactions With Senior Officers and Directors

The policies on loans to and transactions with the bank’s officers and directors, required to be disclosed in this section, are incorporated herein by reference to Note 12, “Related Party Transactions,” to the accompanying financial statements.

## Related Party Transactions

As discussed in Note 1, “Organization and Operations,” the bank lends funds to the district associations to fund their loan portfolios. Interest income recognized on direct notes receivable from district associations was \$269,064, \$240,132 and \$213,802 for 2017, 2016 and 2015, respectively. Further disclosure regarding these related party transactions is found in Note 4, “Loans and Allowance for Loan Losses,” and Note 9, “Members’ Equity.”

In addition to providing loan funds to district associations, the bank also provides banking and support services to them, such as accounting, information systems, marketing and other services. Income derived by the bank from these activities was \$3,889, \$4,355 and \$4,150 for 2017, 2016 and 2015, respectively, and was included in the bank’s noninterest income.

The bank had no transactions with nor loans to directors or senior officers, their immediate family members, or any organizations with which such senior officers or directors are affiliated, during 2017, 2016 and 2015.

## Relationship With Public Accountants

There were no changes in independent qualified public accountants since the prior annual report to shareholders, and there were no material disagreements with our independent qualified public accountants on any matter of accounting principles or financial statement disclosure during the period.

Fees for professional services paid by the bank during 2017 to PricewaterhouseCoopers LLP, the bank’s independent qualified public accountants, were as follows.

- Audit services of \$941 related to the integrated audit for the bank and annual audit of the financial statements for the district of \$395, additional controls assessment and auditing procedures district associations of \$344, and the completion of the 2016 annual audit of the financial statements of \$178 and \$24 related to out-of-pocket expenses for 2017 and 2016. Engagement letters for audit services for 2017 for the integrated audit for the bank and annual audit of the financial statements for the district reflect an estimated fee of \$683 for the bank and district, plus reasonable out-of-pocket expenses.

- Audit-related services of \$179 of which \$166 was related to procedures completed for the bank's SOC 2 (Service Organization Control 2) assessment, specifically directed at evaluating the suitability of design and operating effectiveness of controls related to credit delivery, accounting, processing and related application hosting system. Of the total, \$13 was associated with an internal controls over financial reporting (ICFR) readiness project for the bank for 2016. An engagement letter estimated the fees for the SOC 2 engagement for 2017 to be \$160 to \$175, plus any out-of-pocket expenses.
- Non-audit services of \$25 associated with cybersecurity training to the bank's board of directors. In addition, the tabulation of ballots for the elections of the FCBT Board of Directors and bank nominating committee members and reporting of the results to the bank was completed by PricewaterhouseCoopers LLP with no fee paid.
- FCBT is exempt from federal and certain other income taxes as provided in the Farm Credit Act. No tax services were provided by PricewaterhouseCoopers LLP to the bank.

Fees paid for the audit of the Farm Credit Benefits Alliance (FCBA) 401(k) plan for 2016 as engaged by the AgFirst/FCBT Plan Fiduciary Committee totaled \$16 and represented the bank's proportionate share of fees paid.

With the exception of the audit of the FCBA 401(k) plan, the non-audit services for the bank listed above required pre-approval of the bank's audit committee, which was obtained.

Information regarding the fees for services rendered by the qualified public accountants for the district associations is disclosed in the individual associations' annual reports.

### Relationships With Unincorporated Business Entities (UBEs)

The bank has a relationship with FCBT BioStar B LLC, which is a limited liability company organized for the purpose of acquiring and managing unusual or complex collateral associated with loans.

The bank and a district association are among the forming limited partners for a \$154.5 million Rural Business Investment Company (RBIC), established on October 3, 2014. Additionally, the bank is among the forming limited partners for a \$31.3 million RBIC, established December 12, 2016. The RBICs will facilitate private equity investments in agriculture-related businesses that will create growth and job opportunities in rural America. Each limited partner has a commitment to contribute up to \$20.0 million and \$5.0 million, respectively, over a 10-year period and, as of December 31, 2017, FCBT has invested \$11.8 million in both RBICs, included in "Other assets" on the Balance Sheets.

Information regarding UBEs for district associations is disclosed in the individual association annual reports.

### Financial Statements

The combined financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated May 30, 2018, and the report of management in this annual report to stockholders, are incorporated herein by reference.

The Farm Credit Bank of Texas' and its affiliated associations' (district) annual and quarterly reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag Agency, P.O. Box 202590, Austin, Texas 78720 or by calling (512) 483-9260.

### Borrower Information Regulations

FCA regulations require that borrower information be held in strict confidence by Farm Credit institutions, their directors, officers and employees. These regulations provide Farm Credit institutions clear guidelines for protecting their borrowers' nonpublic personal information.

On November 10, 1999, the FCA board adopted a policy that requires Farm Credit institutions to formally inform new borrowers at loan closing of the FCA regulations on releasing borrower information and to address this information in the annual report to shareholders. The implementation of these measures ensures that new and existing borrowers are aware of the privacy protections afforded them through FCA regulations and Farm Credit System institution efforts.

### Credit and Services to Young, Beginning and Small Farmers and Ranchers and Producers or Harvesters of Aquatic Products (YBS)

In line with our mission, we have policies and programs for making credit available to young, beginning and small farmers and ranchers.

The definitions for YBS, as prescribed by FCA regulations, are provided below.

*Young Farmer or Rancher* – A farmer, rancher or producer or harvester of aquatic products who was age 35 or younger as of the date the loan was originally made.

*Beginning Farmer or Rancher* – A farmer, rancher or producer or harvester of aquatic products who had 10 years or less of experience at farming, ranching or producing or harvesting aquatic products as of the date the loan was originally made.

*Small Farmer or Rancher* – A farmer, rancher or producer or harvester of aquatic products who normally generated less than \$250,000 in annual gross sales of agricultural or aquatic products at the date the loan was originally made.

For the purposes of YBS, the term "loan" means an extension of, or a commitment to extend, credit authorized under the Farm Credit Act, whether it results from direct negotiations between a lender and a borrower or is purchased from, or discounted for, another lender, including participation interests. A farmer/rancher may be included in multiple categories as they are included in each category in which the definition is met.

The bank and associations' efforts to respond to the credit and related needs of YBS borrowers are evidenced by the following table:

|  | For the year ended<br>December 31, 2017 |               |
|--|---|---------------|
|  | Number of Loans                         | Volume        |
| <i>(dollars in thousands)</i>                                      |   |               |
| Total loans and commitments  | 78,499                                  | \$ 28,929,963 |
| Loans and commitments to young farmers and ranchers                | 14,328                                  | \$ 2,528,311  |
| Percent of loans and commitments to young farmers and ranchers     | 18.25%                                  | 8.74%         |
| Loans and commitments to beginning farmers and ranchers            | 39,361                                  | \$ 8,645,093  |
| Percent of loans and commitments to beginning farmers and ranchers | 50.14%                                  | 29.88%        |

The following table summarizes information regarding new loans to young and beginning farmers and ranchers:

|  | For the year ended<br>December 31, 2017 |              |
|--|---|--------------|
|  | Number of Loans                         | Volume       |
| <i>(dollars in thousands)</i>                                      |   |              |
| Total loans and commitments  | 18,124                                  | \$ 9,031,711 |
| Loans and commitments to young farmers and ranchers                | 3,203                                   | \$ 863,615   |
| Percent of loans and commitments to young farmers and ranchers     | 17.67%                                  | 9.56%        |
| New loans and commitments to beginning farmers and ranchers        | 7,893                                   | \$ 2,531,716 |
| Percent of loans and commitments to beginning farmers and ranchers | 43.55%                                  | 28.03%       |

The following table summarizes information regarding loans to small farmers and ranchers:

|   | At December 31, 2017  |                        |                         |                          |               |
|---|-----------------------|------------------------|-------------------------|--------------------------|---------------|
|   | Loan Size             |                        |                         |                          |               |
|   | \$50 Thousand or Less | \$50 to \$100 Thousand | \$100 to \$250 Thousand | More Than \$250 Thousand | Total         |
| <i>(dollars in thousands)</i>   |                       |                        |                         |                          |               |
| Total number of loans and commitments                                 | 13,787                | 17,191                 | 25,041                  | 22,480                   | 78,499        |
| Number of loans and commitments to small farmers and ranchers         | 10,394                | 13,812                 | 19,667                  | 12,947                   | 56,820        |
| Percent of loans and commitments to small farmers and ranchers        | 75.39%                | 80.34%                 | 78.54%                  | 57.59%                   | 72.38%        |
| Total loans and commitments volume                                    | \$ 2,570,666          | \$ 968,238             | \$ 3,262,026            | \$ 22,129,033            | \$ 28,929,963 |
| Total loans and commitments to small farmers and ranchers volume      | \$ 232,790            | \$ 745,466             | \$ 2,474,008            | \$ 7,121,153             | \$ 10,573,417 |
| Percent of loans and commitments volume to small farmers and ranchers | 9.06%                 | 76.99%                 | 75.84%                  | 32.18%                   | 36.55%        |

The following table summarizes information regarding new loans made to small farmers and ranchers:

|   | At December 31, 2017  |                        |                         |                          |              |
|---|-----------------------|------------------------|-------------------------|--------------------------|--------------|
|   | Loan Size             |                        |                         |                          |              |
|   | \$50 Thousand or Less | \$50 to \$100 Thousand | \$100 to \$250 Thousand | More Than \$250 Thousand | Total        |
| <i>(dollars in thousands)</i>   |                       |                        |                         |                          |              |
| Total new number of loans and commitments                             | 3,844                 | 3,301                  | 4,911                   | 6,068                    | 18,124       |
| Number of new loans and commitments to small farmers and ranchers     | 2,794                 | 2,462                  | 3,517                   | 2,624                    | 11,397       |
| Percent of new loans and commitments to small farmers and ranchers    | 72.68%                | 74.58%                 | 71.61%                  | 43.24%                   | 62.88%       |
| Total new loans and commitments volume                                | \$ 100,851            | \$ 248,854             | \$ 814,792              | \$ 7,867,214             | \$ 9,031,711 |
| Total new loans and commitments to small farmers and ranchers volume  | \$ 77,417             | \$ 186,568             | \$ 588,234              | \$ 1,901,033             | \$ 2,753,252 |
| Percent of loans and commitments volume to small farmers and ranchers | 76.76%                | 74.97%                 | 72.19%                  | 24.16%                   | 30.48%       |

## Texas District Associations

The following associations were affiliated with the Farm Credit Bank of Texas at December 31, 2017:

- Ag New Mexico, Farm Credit Services, ACA
- AgTexas Farm Credit Services
- Alabama Ag Credit, ACA
- Alabama Farm Credit, ACA
- Capital Farm Credit, ACA
- Central Texas Farm Credit, ACA
- Heritage Land Bank, ACA
- Legacy Ag Credit, ACA
- Lone Star, ACA
- Louisiana Land Bank, ACA
- Mississippi Land Bank, ACA
- Plains Land Bank, FLCA
- Southern AgCredit, ACA
- Texas Farm Credit Services