2006

FARM CREDIT ADMINISTRATION

Annual Report on the Farm Credit System

Contents

Statement of the Chairman and CEO

June 2007

Dear Reader,

On behalf of the Board and the dedicated employees of the Farm Credit Administration, I present the 2006 Annual Report on the Farm Credit System.

I am pleased to report that the System continues to be in a sound financial position, with several years of solid growth and performance. This conclusion is based on our examinations, independent ratings, and risk assessments. The System's growth in loan volume reflects the fulfillment of its public policy purpose of providing for the credit needs of agricultural producers and rural America. We believe that agriculture and rural areas will continue to demonstrate a growing need for competitive credit and financially related services. It will take the resources and expertise of all rural lenders to provide for this demand.

In 2006, FCA completed a final rule that established governance standards throughout the Farm Credit System—strengthening the independence, expertise, and committees of System institution boards and fostering the increased involvement of member-borrowers in System governance. The Agency also completed a final rule on disclosure and reporting requirements for FCS institutions that will improve the transparency of published disclosures, strengthen board and management accountability and auditor independence, and increase shareholder and investor confidence in the System.

Also in 2006, the FCA Board continued to support pilot programs in the System that provided funds for investments in rural America. These investments can help fund the economic development, infrastructure improvements, essential community facilities, and revitalization projects that are so important for the vibrancy of agriculture and rural communities.

The System is required to provide credit to young, beginning, and small (YBS) farmers and ranchers. In 2006, lending by the System to YBS producers continued its upward trend. But much still needs to be done to make it feasible and attractive for people to live in rural communities and make farming or ranching their career.

Finally, the unprecedented boom in ethanol and other biofuel poses new opportunities and challenges for the FCS. The industry has the potential for creating prosperity across rural America but also is subject to volatility. FCA will be closely monitoring trends in this burgeoning field as well as the System's ethanol-related loan practices so that the FCS can serve the credit needs of this evolving industry in a safe and sound manner.

The agriculture industry and those of us who are invested in its future are going through exciting and unpredictable times. Through it all, we are mindful of the System's original mandate to be a dependable lender to agriculture and rural America in both good times and bad. As the regulator of the System, FCA remains committed to its responsibility to ensure the System can fulfill its mandate to current and future generations of farmers and ranchers and the rural areas in which they live.

Sincerely,

Nancy C. Pellett

Nancy C. Pellett

Farm Credit Administration

The Mission

The Farm Credit Administration (FCA or Agency) is an independent agency in the executive branch of the U.S. Government. FCA is responsible for regulating and supervising the banks, associations, and related entities in the Farm Credit System (FCS or System), including the Federal Agricultural Mortgage Corporation (Farmer Mac). The FCS is a nationwide network of borrower-owned financial institutions that provide credit to farmers, ranchers, residents of rural communities, and agricultural and rural utility cooperatives.

FCA was created by a 1933 Executive order of President Franklin D. Roosevelt; the Agency now derives its powers and authorities from the Farm Credit Act of 1971, as amended (Farm Credit Act or the Act). The U.S. Senate Committee on Agriculture, Nutrition, and Forestry and the U.S. House of Representatives Committee on Agriculture oversee FCA and the FCS.

FCA is responsible for ensuring that the System remains a dependable source of credit for agriculture and rural America. The Agency does this in two specific ways. One, it conducts examinations of FCS institutions to monitor and oversee the safety and soundness of their ongoing activities. Examiners also evaluate compliance with applicable laws and regulations. Two, FCA approves corporate charter changes and researches, develops, and adopts regulations and other guidelines that govern how System institutions conduct their business and interact with their customers.

If a System institution violates a law or regulation or if its operations are unsafe or unsound, FCA can use its enforcement authority to ensure that the problem is corrected. FCA also protects the rights of borrowers, reports to Congress on the financial condition and performance of the FCS, and approves the issuance of System debt obligations.

The Agency maintains its headquarters and a field office in McLean, Virginia. FCA also has field offices in Bloomington, Minnesota; Dallas, Texas; Denver, Colorado; and Sacramento, California.

The Board

FCA policy and its regulatory agenda are established by a full-time, three-person Board, whose members are appointed by the President of the United States with the advice and consent of the Senate. They serve a six-year term and may not be reappointed after serving a full term or three years of a previous member's term. The President designates one member as Chairman of the Board, who serves until the end of his or her own term. The Chairman also serves as FCA's Chief Executive Officer (CEO).

FCA does not receive a Federal appropriation. The Agency is funded through assessments paid by System institutions and by reimbursable activities.

The Farm Credit Administration ensures a safe, sound, and dependable source of credit and related services for agriculture and rural America.

Nancy C. Pellett

Chairman and CEO

Nancy C. Pellett is Chairman of the Board and CEO of FCA. Ms. Pellett was appointed to a six-year term on the FCA Board by President George W. Bush on November 26, 2002, and she was designated Chairman on May 22, 2004. Her term expires on May 21, 2008.

Ms. Pellett also serves as a member of the board of directors of the Farm Credit System Insurance Corporation, which is responsible for ensuring the timely payment of principal and interest on obligations issued on behalf of FCS banks.

Ms. Pellett brings to her position on the FCA Board extensive experience in production agriculture and agribusiness. In partnership with her husband, she managed Prairie Hills, Ltd., a feedlot, cow-calf, and row-crop operation in Atlantic, Iowa, from 1966 until her appointment to the Board. While she serves her term as FCA Chairman and CEO, her husband, son, and daughter-in-law continue to operate this fifth-generation family farm.

For more than 20 years, she also served as president and treasurer of Fredrechsen Farms, Ltd., a family-owned swine and row-crop operation in Walnut, Iowa.

A long-time beef industry leader, Ms. Pellett held State and national leadership positions in cattle industry organizations. As a member of the National Cattlemen's Beef Association, she served as chairman of the check-off division, as chairman of the consumer marketing group, and most recently as a member of the Cattlemen's Beef Board. She also was president of the Iowa Beef Industry Council.

She is a partner in Premium Quality Foods, Inc., which markets precooked beef entrees. Previously, she served as president and consumer marketing director for the company.

Ms. Pellett served a six-year term as a member of the Board of Regents for the State of Iowa, which oversees the three State universities as well as the University of Iowa Hospital and its affiliated clinics. She was also selected as a member of the Governor's Student Aid Commission.

Dedicated to the future of agriculture, Ms. Pellett worked with 4-H and the National FFA Organization at the local and State levels and served on the Iowa 4-H Foundation board. She is a founding member of the 4-H/FFA "Sale of Champions" committee for the Iowa State Fair.

Ms. Pellett is on the Iowa State University Foundation Board of Governors and was a member of the advisory committees for the College of Agriculture and the College of Family and Consumer Sciences. She is past president of the university's Alumni Association and was awarded the Alumni Medal in 1987. The Pellett family was honored as the "Family of the Year" by the university in 1997.

The Pellett family also received the "Friends of Youth Award" in 2000 from the Knights of AkSarBen, a foundation that supports education, youth programs, and rural development in Nebraska and western Iowa.

A native of Walnut, Iowa, Ms. Pellett holds a B.S. from Iowa State University at Ames. She and her husband have four children.

Leland A. "Lee" Strom

Board Member

Leland A. Strom was appointed to a six-year term on the FCA Board by President George W. Bush on December 12, 2006.[1] His term expires on October 13, 2012.

Mr. Strom also serves as the chairman of the board of directors of the Farm Credit System Insurance Corporation (FCSIC), which is responsible for ensuring the timely payment of principal and interest on obligations issued on behalf of FCS banks.

Mr. Strom has more than 30 years of experience in the agriculture industry. Until recently, he served on the board of 1st Farm Credit Services, an FCS institution in Illinois. He was a member of this board for more than 25 years, serving in a variety of positions, including that of chairman. During the agriculture crisis of the 1980s, he was selected to serve on the Restructuring Task Force of the Sixth Farm Credit District.

From 1996 to 2005, he served on the board of directors of AgriBank, FCB, an FCS bank serving farmers and ranchers in 15 States. Mr. Strom also served on the board of the Farm Credit Council, the national trade organization representing the FCS in Government affairs.

From 2000 to 2006, Mr. Strom served on the Federal Reserve Bank of Chicago's Advisory Council on Agriculture, Labor, and Small Business. His input was frequently sought on issues affecting the agriculture sector. Mr. Strom served for many years on the Agriculture Advisory Committee for Congressman J. Dennis Hastert.

During 2005 and 2006, Mr. Strom served on the Country Mutual Fund Trust Board, an investment fund of the Illinois Farm Bureau and its Country Financial organization. From 1994 to 2006, Mr. Strom was president of Country Home and Land Realty, Inc., a real estate brokerage company in Northern Illinois specializing in agricultural land and investment services. In the early 1980s, he was a board member of Northern F.S., Inc., a multimillion-dollar farm service and supply cooperative in Northern Illinois.

Over the years, Mr. Strom served in several capacities with the Illinois Farm Bureau. He also served on his county Farm Bureau board. As a member of the State Young Farmer Committee from 1981 to 1985, he helped build a better statewide young farmer information network. For his overall involvement in agriculture, he received an Outstanding Young Farmer Award.

In his community of Kane County, Illinois, which lies at the edge of Chicago's suburban sprawl, Mr. Strom helped develop a farmland preservation program. The original Strom Family Farm was the first to be dedicated to permanent agricultural use under the program, and the Strom family set the tone for what has become the first funded, successful county farmland preservation program in the Midwest. His other community involvements included serving as vice president of his local K-12 school district and as chairman of his church council, as well as serving as a 4-H parent leader and coach of various boys' and girls' sports teams.

Mr. Strom studied agriculture business at Kishwaukee College and business administration at Northern Illinois University. He was a member of the Illinois Agricultural Leadership Program Class of 1988. Mr. Strom owns a third-generation family farm in Illinois that produces corn, soybeans, and livestock. He and his wife, Twyla, have two sons and a daughter.

1. Mr. Strom succeeded Douglas L. Flory, who served on the FCA Board from August 2, 2002, to December 13, 2006.

Dallas P. Tonsager

Board Member

Dallas P. Tonsager was appointed to the FCA Board by President George W. Bush on November 30, 2004, for a term that expires May 21, 2010.

Mr. Tonsager also serves as a member of the board of directors of the Farm Credit System Insurance Corporation, which is responsible for ensuring the timely payment of principal and interest on obligations issued on behalf of FCS banks.

Mr. Tonsager brings to his position on the FCA Board extensive experience as an agriculture leader and producer and a commitment to promoting and implementing innovative development strategies to benefit rural residents and their communities. As executive director of the South Dakota Value-Added Agriculture Development Center in Huron from 2002 until his appointment to the FCA Board, he coordinated initiatives to better serve producers interested in developing value-added agricultural projects. Services provided by the center include project facilitation, feasibility studies, business planning, market assessment, technical assistance, and education.

In 1993 he was selected by President William J. Clinton to serve as the State director in South Dakota for rural development for the U.S. Department of Agriculture. Mr. Tonsager oversaw a diversified portfolio of housing, business, and infrastructure loans in South Dakota totaling more than $100 million. In 1999, he was recognized as one of two outstanding State directors in the nation by then USDA Under Secretary Jill Long Thompson. His term concluded in February 2001.

A long-time member of the South Dakota Farmers Union, Mr. Tonsager served two terms as president of the organization from 1988 to 1993. He served on the board of National Farmers Union Insurance from 1989 to 1993, and he was a member of the advisory board of the Commodity Futures Trading Commission from 1990 to 1993.

From 1988 to 1993, Mr. Tonsager was a board member of Green Thumb, Inc., a nationwide job training program for senior citizens. He currently serves on the board of Lutheran Social Services of South Dakota.

Mr. Tonsager grew up on a dairy farm near Oldham, South Dakota. In partnership with his brother, he owns Plainview Farm in Oldham, a family farming operation that includes corn, soybeans, wheat, and hay.

Mr. Tonsager is a graduate of South Dakota State University, where he earned a B.S. in agriculture in 1976. He and his wife, Sharon, have two sons and a daughter-in-law.

Farm Credit System— An Overview of Events and Conditions

FCS Role and Structure

The FCS is a network of borrower-owned cooperative financial institutions and related service organizations. It is the largest single agricultural lender in the country and serves all 50 States and the Commonwealth of Puerto Rico. Created by Congress in 1916 to provide American agriculture with a dependable source of credit,[2] the FCS is the oldest financial Government-sponsored enterprise (GSE).

FCS institutions provide credit and financially related services to farmers, ranchers, producers or harvesters of aquatic products, and farmer-owned cooperatives. They also make credit available for agricultural processing and marketing activities, rural housing, certain farm-related businesses, agricultural and aquatic cooperatives, rural utilities, and foreign and domestic entities in connection with international agricultural trade. The System raises funds by selling securities in the national and international money markets, subject to approval by FCA. These securities are not guaranteed by the U.S. Government. The funds are used to meet the credit needs of rural America through the FCS lending institutions.

As of December 31, 2006, the System was composed of 100 banks and associations. Five Farm Credit banks provide loan funds to 86 Agricultural Credit Association (ACA) parent organizations[3] and 9 Federal Land Credit Associations (FLCAs). ACAs make short-, intermediate-, and long-term loans; FLCAs make only long-term loans; and Production Credit Associations (PCAs), which are subsidiaries of ACAs, make only short- and intermediate-term loans.

One of the five banks is an Agricultural Credit Bank (ACB), which has a nationwide charter to make loans to agricultural and aquatic cooperatives and rural utilities, as well as to other persons or organizations that have transactions with, or are owned by, such cooperatives. The ACB finances U.S. agricultural exports and imports and provides international banking services for farmer-owned cooperatives. In addition to making loans to cooperatives, the ACB provides loan funds to five ACAs, which serve New York, New Jersey, Connecticut, Rhode Island, Maine, Massachusetts, New Hampshire, Vermont, Alaska, Oregon, Washington, Montana, and Idaho.

In addition to the banks and associations described above, two special-purpose entities of the System are examined and regulated by FCA:

1. The **Federal Farm Credit Banks Funding Corporation,** which markets debt securities that the banks sell to raise loan funds. The Funding Corporation is owned by the System banks.

2. The **Farm Credit System Financial Assistance Corporation,** created in 1988 by Congress to carry out a temporary program of financial assistance to System institutions that were experiencing financial difficulty. The Assistance Corporation funded its activities through the sale of $1.261 billion in 15-year bonds guaranteed by the U.S. Treasury. The last outstanding bonds matured and were repaid on June 10, 2005, and the Assistance Corporation received a final audit in September 2005. The FCA Board determined that the Assistance Corporation had completed its statutory mission and canceled its charter as of December 31, 2006.

2. The Federal Land Banks were the first part of the FCS and they were created in 1916. Other major parts of the FCS were created in 1923 and 1933.

3. The ACA is the parent company with two wholly owned subsidiaries, a PCA and an FLCA. Although legally separated, the ACA, the PCA, and the FLCA operate an integrated lending business, with loans made through the subsidiaries with the appropriate authority. The ACA, the PCA, and the FLCA are jointly and severally liable on the full amount of the indebtedness to the bank under the bank's General Financing Agreement. In addition, the three associations agree to guarantee each other's debts and obligations, pledge their respective assets as security for the guarantee, and share each other's capital. The three institutions have a common board and management and a common set of shareholders. Under the Farm Credit Act, the FLCA is exempt from Federal income taxes.

FCA also examines and regulates the following five service corporations organized under section 4.25 of the Farm Credit Act[4]:

1. **AgVantis, Inc.,** which provides technology-related and other support services to the associations affiliated with U.S. AgBank, Farm Credit Bank (FCB). AgVantis is owned by the bank and 17 of its affiliated associations.

2. **Farm Credit Leasing Services Corporation,** which provides equipment leasing services to eligible borrowers, including agricultural producers, cooperatives, and rural utilities, and is wholly owned by CoBank, ACB.

3. **Farm Credit Financial Partners, Inc.,** which provides support services to CoBank, ACB; CoBank's five affiliated associations; the Farm Credit Leasing Services Corporation; five associations affiliated with U.S. AgBank, FCB; two associations affiliated with AgriBank, FCB; and two System-related entities.

4. **The FCS Building Association,** which acquires, manages, and maintains facilities to house FCA's headquarters and field office staff. The FCS Building Association is owned by the FCS banks. The FCA Board oversees the Building Association's activities on behalf of its owners.

5. **Farm Credit Finance Corporation of Puerto Rico (FCFCPR),** which used tax incentives offered to investors to provide low-interest funding (other than that from the Federal Farm Credit Banks Funding Corporation) to Puerto Rico Farm Credit, ACA. Because of changes in the tax treatment of the corporation, AgFirst Farm Credit Bank, the sole owner of FCFCPR, suspended operations of FCFCPR as of December 31, 2005. The service corporation is currently inactive, although the charter remains outstanding.

In addition, FCA examines and regulates the **Federal Agricultural Mortgage Corporation (Farmer Mac).**[5] Farmer Mac provides a secondary market arrangement for agricultural real estate and rural housing mortgage loans and provides greater liquidity and lending capacity to agricultural lenders. Under the Farmer Mac I program, Farmer Mac guarantees prompt payment of principal and interest on securities representing interests in, or obligations backed by, mortgage loans secured by first liens on agricultural real estate or rural housing; it also purchases or commits to purchase qualified loans or securities backed by qualified loans directly from lenders. Under the Farmer Mac II program, it guarantees securities backed by the "guaranteed portions" of farm ownership and operating loans, rural business and community development loans, and certain other loans guaranteed by the U.S. Department of Agriculture (USDA).

When Congress established the FCS as a GSE, its purpose was to provide a permanent, reliable source of credit and related services to agriculture and aquatic producers, their cooperatives, and related businesses in rural America. Congress intended the farmer-owned cooperative FCS to improve the income and well-being of American farmers and ranchers. It further encouraged farmer- and rancher-borrower participation in the management, control, and ownership of these cooperative institutions to help them remain focused on serving their members' needs.

4. Section 4.25 of the Farm Credit Act provides that one or more FCS banks or associations may organize a service corporation to perform functions and services on their behalf. These federally chartered service corporations are prohibited from extending credit or providing insurance services.

5. Farmer Mac is established in law as an FCS institution. However, Farmer Mac has no liability for the debt of any other System institution, and the other System institutions have no liability for Farmer Mac debt. Farmer Mac is organized as an investor-owned corporation, not a member-owned cooperative. Investors in voting stock may include commercial banks, insurance companies, other financial organizations, and FCS institutions. Nonvoting stock may be owned by any investor. Farmer Mac is regulated and examined by FCA through the Office of Secondary Market Oversight, whose director reports to the FCA Board on matters of policy.

The System meets a broad public need by preserving liquidity and competition in rural credit markets in both good and bad economic times. The accomplishment of this public goal benefits all eligible borrowers, including young, beginning, and small (YBS) farmers, as well as rural home owners.

FCA's regulations, policy statements, examinations, chartering activities, and other regulatory activities (discussed in later chapters of this report) support and facilitate the accomplishment of the System's mission by ensuring that FCS institutions operate in a safe and sound manner without undue risk to taxpayers, investors in System securities, or borrower-stockholders.

The sections in this chapter first assess the System's financial strength and then its service to rural America. The discussion relies on commonly used measures, including trends in volume by a variety of loan types, volume of funding for non-System rural lenders and participations with other lenders, and the System's share in the marketplace. Discussion in the next chapter also covers lending activity and programs that benefit YBS farmers and ranchers and the use of Government guarantee programs in supporting loans to farmers who are unable to meet normal underwriting requirements.

Financial Condition of the FCS[6]

The overall condition and performance of the FCS remained safe and sound in 2006, as demonstrated by its growth, asset quality, capital position, earnings performance, and overall liquidity. Over the 12 months ended December 31, 2006, gross loans and investments increased by 16 percent and 20 percent, respectively (table 1). Asset quality indicators remained strong. Capital grew, but at less than half the rate of assets; as a result, capital ratios fell at each bank and at about three-fourths of the associations. Nevertheless, all banks and associations continued to meet minimum regulatory capital requirements, and capital levels remained strong. Net income for the year was $2.4 billion, up 13.5 percent from 2005. The increase in net income in 2006 stemmed from a substantial increase in the level of earning assets and higher interest rates that increased income from invested equity. The increased net income was somewhat offset by the continuing decline in interest rate spreads and margins. System liquidity remained satisfactory and well above minimum regulatory requirements.

6. The information presented in this section pertains to all FCBs, the ACB, and their affiliated associations. The FCS institutions provided the data used in the overall FCS analysis to FCA or to the Federal Farm Credit Banks Funding Corporation. The analysis in this report is based on publicly available information and, except where noted, is based on the 12-month period ended December 31, 2006.

Table 1

FCS Assets

Dollars in Millions

	As of December 31		Change	
	2005	2006	Dollars	Percent
Cash	500	568	68	13.6
Federal funds sold and repossessed	2,383	1,952	(431)	-18.1
Investments				
Available for sale	23,604	27,736	4,132	17.5
MRIs held to maturity	1,634	2,083	449	27.5
MRIs available for sale	306	778	472	154.2
Total investments	25,544	30,597	5,053	19.8
Gross loans	106,272	123,436	17,164	16.2
ALL	(755)	(734)	21	-2.8
Net loans	105,517	122,702	17,185	16.2
Accrued interest receivable	1,405	1,839	434	30.9
Premises and equipment	498	526	28	5.6
Other assets	1,977	2,368	391	19.8
Restricted assets	2,062	2,312	250	12.1
Total assets	**139,886**	**162,864**	**22,978**	**16.4**

Sources: FCS Annual Information Statements.

MRI=mission-related investment
ALL=allowance for loan losses

Loans, Investments, and Asset Quality

At December 31, 2006, the System's total assets were $162.9 billion, up $23 billion or 16.4 percent from a year earlier. Gross loans increased by 16.2 percent during 2006 for the highest one-year increase since 1980. Gross loans were $123.4 billion, up from $106.3 billion a year earlier (figure 1). Almost 75 percent of the increase in loan volume occurred in the AgriBank and CoBank districts, but the Texas district grew the fastest—26.3 percent. The sharp increase in lending arose primarily from the financing of farm real estate and agribusiness activities, including ethanol plants and crop inventories. Investment activity also increased in 2006, growing $5.1 billion, or 19.8 percent, to reach $30.6 billion at year-end. Most of the investment growth was in mortgage-backed securities, which increased $3.4 billion (table 2).

The quality of FCS assets remains strong (figure 2). The loan delinquency rate[7] decreased marginally over the course of 2006 (from 0.40 percent of accruing loans a year earlier to 0.38 percent for 2006). The allowance for loan losses (ALL) dropped $21 million to $734 million, while nonperforming loans increased by $15 million to $615 million.

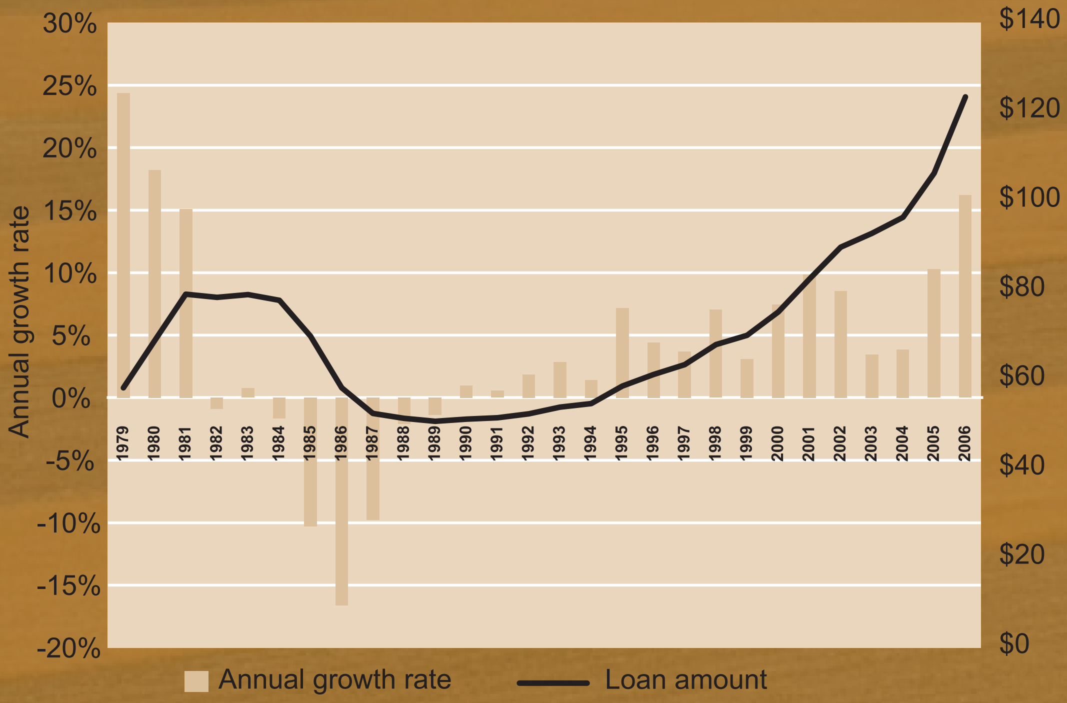
7. The delinquency rate is defined as accruing loans 30 or more days past due as a percentage of accruing loans.

Figure 1

FCS Loans Outstanding, 1979–2006

As of December 31

Dollars in Billions



Sources: FCS Quarterly Information Statements.

Table 2

FCS Investments

Dollars in Millions

	As of December 31				Change		
	2005		2006		Amount		WAY
	$	WAY %	$	WAY %	$	%	bp
Available for sale (fair value)							
Money market instruments	2,129	4.3	2,857	5.3	728	34.2	100
U.S. agency securities	289	3.3	283	4.3	(6)	(2.1)	100
Mortgage-backed securities	18,073	4.4	21,172	5.1	3,099	17.1	71
Other asset-backed securities	3,113	4.5	3,424	5.5	311	10.0	94
Mission-related and other investments	306	6.5	778	5.2	472	154.2	(130)
Total	23,910	4.4	28,514	5.1	4,604	19.3	74
Held to maturity (amortized cost)							
Money market instruments			24	7.5	24		745
Mortgage-backed securities	1,599	5.4	1,921	5.6	322	20.1	27
Other asset-backed securities	35	7.0	138	7.4	103	294.3	37
Total	1,634	5.4	2,083	5.8	449	27.5	37

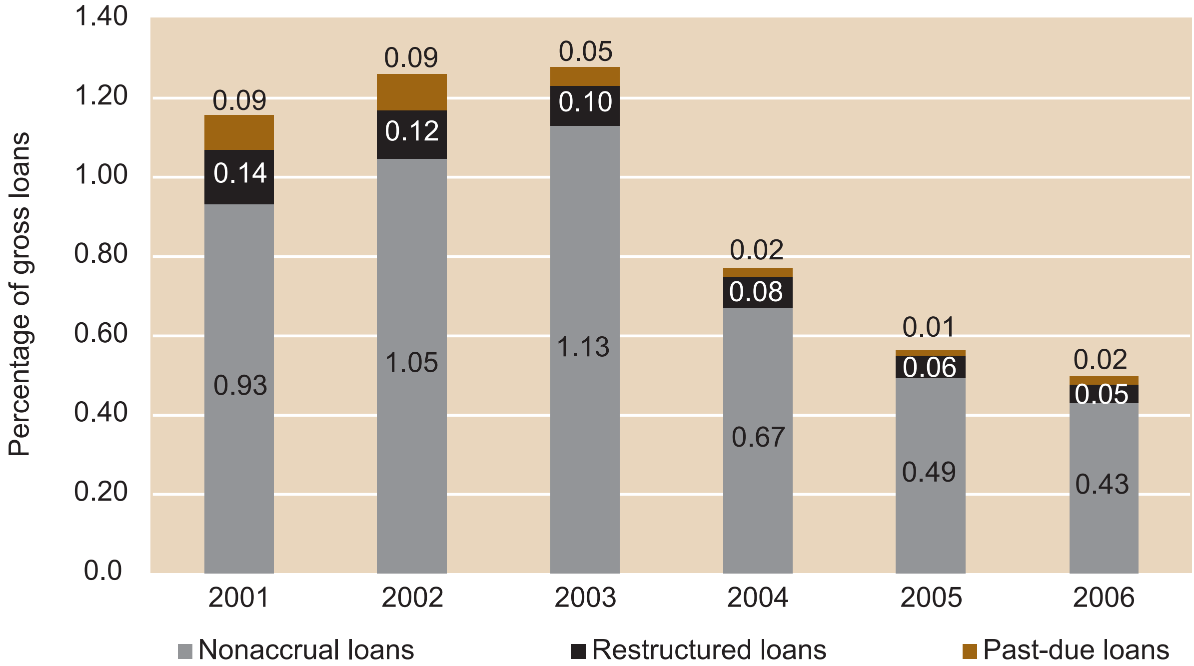
Sources: FCS Annual Information Statements.

WAY = weighted average yield
bp = basis point (1 /100 of 1 percent)

Figure 2

FCS Nonperforming Loans, 2001–2006

As of December 31



Sources: Federal Farm Credit Banks Funding Corporation, Annual Information Statements.

The allowance coverage ratio, or ALL to nonperforming loans, declined slightly to 119 percent. The significant increase in gross loans also caused the ratio of ALL as a percentage of total loans to decline from 0.71 percent to 0.59 percent. Net loan charge-offs during 2006 were $50 million, which represented 0.04 percent of average loans outstanding during the year, unchanged from 2005.

Liquidity

As figure 3 shows, the FCS maintained 141 days of liquidity at December 31, 2006, well above the regulatory minimum of 90 days, but down from 187 days of liquidity at year-end 2005.[8] The decline in liquidity at year-end 2006 was due to an increase in Systemwide debt securities with maturities of fewer than three months and a larger amount of Systemwide debt securities approaching maturity.

8. The regulatory liquidity standard requires each FCS bank to maintain a minimum of 90 days of liquidity on a continuous basis, assuming no access to the capital markets. The number of days of liquidity is calculated by comparing maturing Systemwide debt securities and other bonds for which the bank is primarily liable with the total amount of cash, investments, and other liquid assets maintained by that bank. For purposes of calculating liquidity, liquid assets are subject to discounts that reflect potential exposure to adverse market value changes that might be recognized upon liquidation or sale.

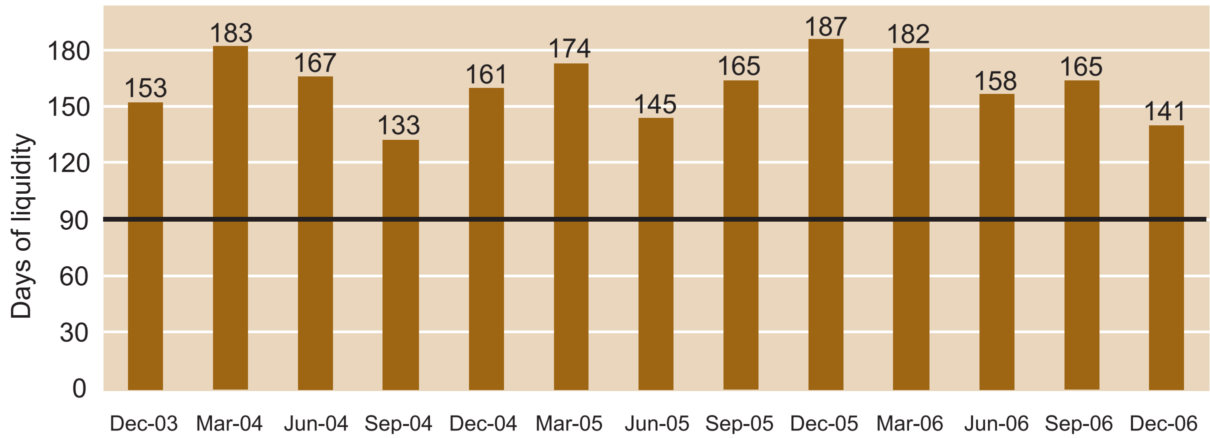
Earnings

The FCS earned $2.4 billion in 2006, a record if one ignores 2004 with its unusual ALL reversal.[9] As noted in figure 4, net income was up $283 million (13.5 percent) from 2005 due in large part to increased earning assets and higher interest rates that increased income on invested equity. Net interest income increased $338 million even though interest margins and spreads narrowed in 2006. Interest rates on earning assets increased by 99 basis points. However, the rates paid on interest-bearing liabilities rose by 124 basis points, which reduced the net interest spread to 1.76 percent from 2.01 percent for 2005. The record income for 2006 produced good returns on the System's capital. The return on average capital was 10.0 percent compared with 9.4 percent for 2005.

Noninterest expenses increased $95 million to $1.5 billion for 2006, primarily due to an increase in salaries and employee benefits and to an increase in other operating expenses. However, the increase in net interest income from the System's growth in loans and investments exceeded the 6.7 percent increase in operating expenses, contributing to operating efficiency. The ratio of operating expense divided by the sum of net interest income and noninterest income declined from 39.2 percent in 2005 to 37.6 percent in 2006.[10]

Figure 3

FCS Liquidity, 2003–2006



Sources: FCS Annual and Quarterly Information Statements.

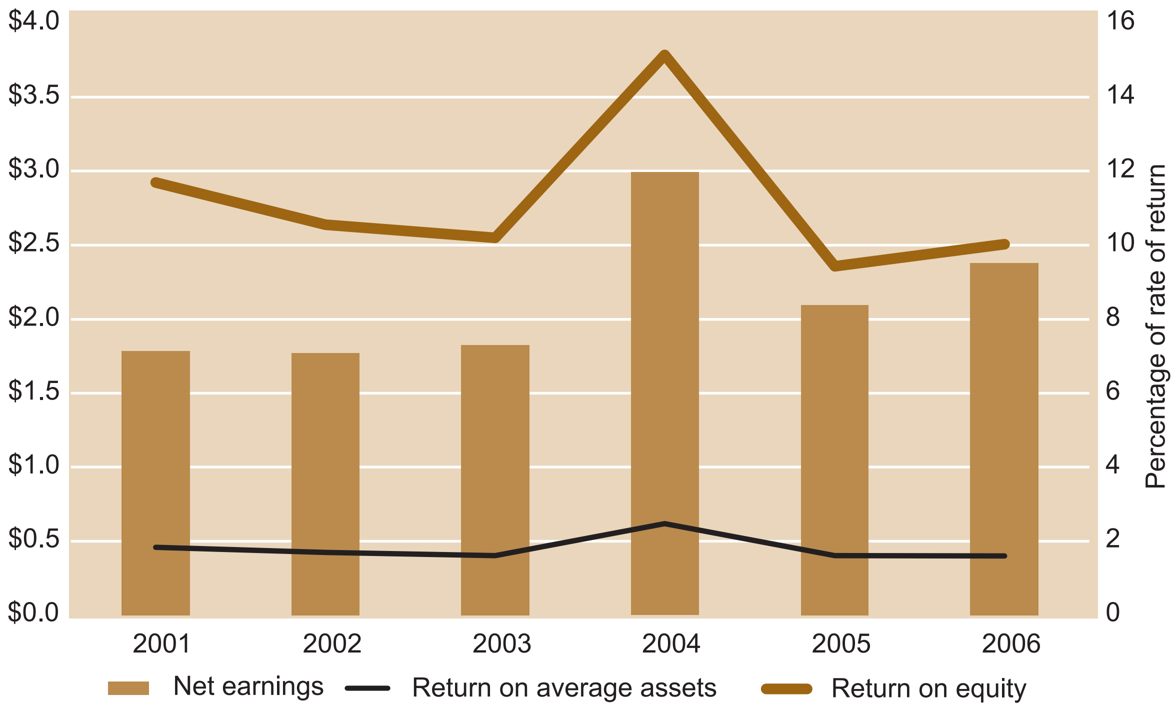
9. In 2004, the System's net income was $2.99 billion. However, the final figure was affected by an extraordinary one-time adjustment when the ALL was reversed by $1.17 billion after it was evaluated and refined with new accounting requirements and methodologies. Without the ALL reversal, the System's net income in 2004 would have been $1.83 billion.

10. This ratio is a primary measure of operational efficiency—how much it costs to produce income. The lower the ratio, the more cost-effective the bank is at generating income. For 2006, the FCS spent $376 in operating expenses to generate $1,000 in gross income. Commercial banks typically report operating efficiency ratios of 50 to 70 percent, but their operating expenses include the costs of deposit collecting.

Figure 4

FCS Net Income, 2001–2006

As of December 31
Dollars in Billions



Sources: Federal Farm Credit Banks Funding Corporation, Annual Information Statements.

Capital

Total FCS capital was $24.4 billion at December 31, 2006, up 7.3 percent from a year earlier. While capital grew by $1.7 billion in 2006, the growth rate was less than half the growth rate of total assets. Consequently, the capital-to-asset ratio fell from 16.3 percent to 15.0 percent and the debt-to-equity ratio increased from 5.1 percent to 5.7 percent. Surplus continued to provide the overwhelming majority of capital, accounting for 82 percent of the total amount (figure 5). Beyond surplus, the only other element showing a large gain in 2006 was restricted capital (Insurance Fund), which increased $250 million, or 12.1 percent. Preferred stock remained essentially unchanged at slightly more than $1 billion.

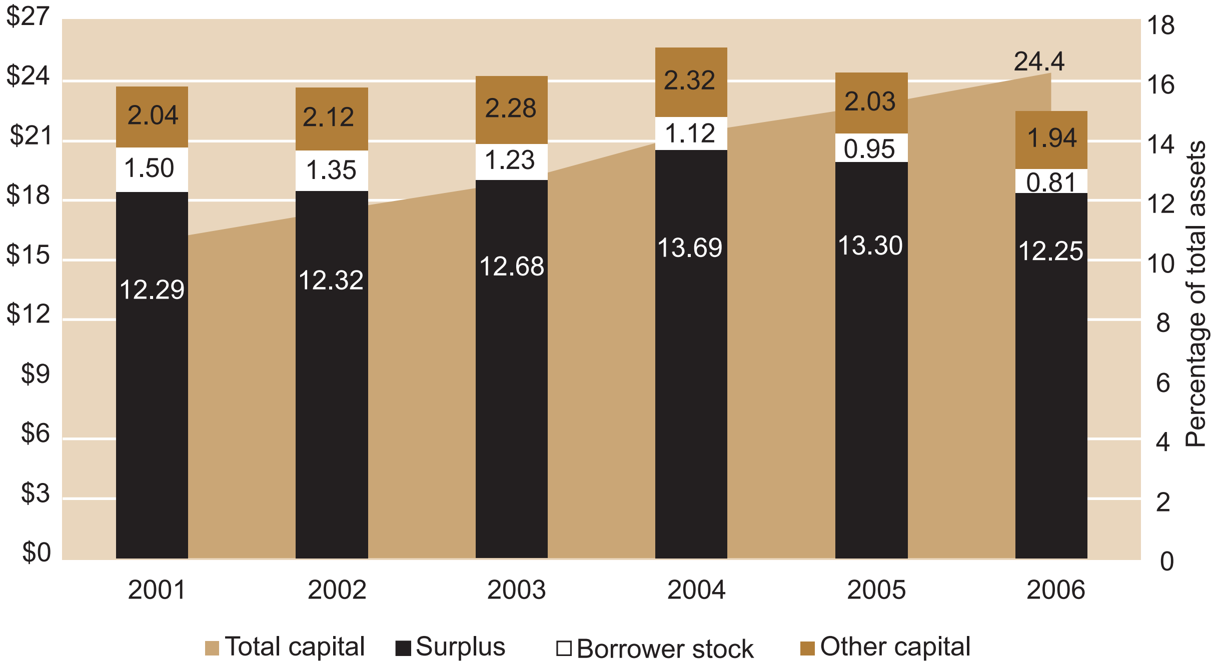
Significant differences in capital accumulation occurred at the banks and associations. Total capital increased twice as much and at a faster rate in the associations than in the banks. In the combined associations, capital increased by $1.1 billion (7.4 percent), whereas in the combined banks, it increased by $530 million (6.9 percent). However, because the lending operations of the four Farm Credit banks consist of wholesale loans to their affiliated associations and loan participations,[11] their risk exposure is lower than the associations' exposure for a given level of assets; thus, the banks do not need to accumulate as much capital as the associations.

11. The fifth System bank—CoBank, ACB—is different from the four FCBs. In addition to making wholesale loans and buying loan participations, CoBank makes retail loans to cooperatives and other eligible entities, which increases its need for capital accretion.

Figure 5

FCS Capital, 2001–2006

As of December 31
Dollars in Billions



Sources: Federal Farm Credit Banks Funding Corporation, Annual Information Statements.

The net collateral ratio fell at each bank except for U.S. AgBank, where it remained essentially unchanged. This ratio at all of the banks was greater than 104 percent at year-end 2006.[12] The other regulatory capital ratios declined at each bank and at about three-fourths of all associations. Despite the declines, all banks and associations continued to exceed all regulatory capital requirements. Moreover, nearly all institutions had satisfactory capital levels relative to the risk on their balance sheets.

Many FCS institutions pay patronage and other dividend distributions. While these distributions reduce the System's capital levels as they occur, they are consistent with cooperative principles and are generally encouraged as long as they do not jeopardize the institutions' safety and soundness. For the past several years, System patronage has been increasing as institutions with existing programs distributed more of their income to member-borrowers and other institutions launched new programs. Currently, 85 percent of FCS associations pay patronage, compared with 20 percent 10 years ago. In 2006, declared patronage was $718 million, down from $874 million in 2005, reflecting the System's need to maintain strong capital levels at a time of high loan growth.

Selected FCS Financial Indicators

The System's financial results for 2006 continue a steady improvement trend that began in the early 1990s, when—with an infusion of almost $1.3 billion of direct financial assistance from Congress—it regained its footing and rebounded from the agricultural crisis of the mid-1980s. In the ensuing years, the FCS improved its operating efficiency and lending practices through a combination of organizational restructurings, reconstituted boards and management, and FCA's close oversight and supervision. The culmination of the System's remarkable turnaround is evidenced by the financial results for 2006.

Because of its success, the System was able to fully repay the final financial assistance bonds by June 2005, as scheduled. After determining that the Farm Credit System Financial Assistance Corporation had fulfilled all of its obligations and other business affairs, FCA canceled its charter on December 31, 2006, ending an important chapter in the System's history. Selected financial indicators of the System's condition for the past five years and selected information for each FCS district for 2006 are contained in tables 3 and 4. This information clearly shows that the System's overall financial condition is not only strong, but also that it continues to improve.

Borrowers Served

The System fulfills its overall mission by lending to agriculture and rural America. Since 1916, when the first part of the FCS was established, the System's authority to serve its customer base has evolved to include the following loan products:

- Long-term agricultural real estate loans
- Short- and intermediate-term agricultural loans
- Loans to producers and harvesters of aquatic products
- Loans to certain farmer-owned agricultural processing facilities and farm-related businesses
- Loans to rural homeowners
- Loans to farmer-owned agricultural cooperatives
- Loans that finance agricultural exports and imports
- Loans to rural utilities

12. FCS banks are required to maintain a minimum net collateral ratio of 103 percent. The net collateral ratio is similar to leverage ratios applied to commercial banks by other financial regulators. In addition, all banks and associations must maintain a regulatory minimum permanent capital ratio of 7.0 percent, a total surplus ratio of 7.0 percent, and a core surplus ratio of 3.5 percent.

Table 3

Farm Credit System Major Financial Indicators, Annual Comparison

As of December 31
Dollars in Thousands

FCS banks[a]	2002	2003	2004	2005	2006
Gross loan volume	80,370,840	82,986,046	85,411,707	94,865,873	115,632,398
Accruing restructured loans[b]	17,264	9,492	7,050	6,131	5,591
Accrual loans 90 or more days past due	54,017	22,456	5,420	1,322	5,516
Nonaccrual loans	353,765	444,663	227,003	152,223	116,301
Nonperforming loans/total loans[c]	0.53%	0.57%	0.28%	0.17%	0.11%
Cash and marketable investments	17,076,661	19,908,823	23,089,548	27,788,225	31,688,647
Capital/assets[d]	6.70%	6.89%	6.79%	6.20%	5.88%
Unallocated retained earnings/assets	3.66%	3.49%	3.54%	3.28%	3.20%
Net income	751,343	613,401	733,012	740,785	867,970
Return on assets[e]	0.78%	0.68%	0.68%	0.61%	0.64%
Return on equity[e]	10.67%	9.85%	9.82%	9.48%	10.52%
Net interest margin	1.15%	0.99%	0.92%	0.84%	0.85%
Operating expense rate[f]	0.36%	0.33%	0.36%	0.33%	0.36%
Associations					
Gross loan volume	66,606,213	70,897,369	75,619,681	83,253,781	93,413,119
Accruing restructured loans[b]	90,726	83,075	68,439	53,885	51,384
Accrual loans 90 or more days past due	27,654	20,742	15,375	13,156	19,504
Nonaccrual loans	589,645	607,351	419,312	371,703	425,545
Nonperforming loans/gross loans[c]	1.06%	1.00%	0.67%	0.53%	0.53%
Capital/assets[g]	15.85%	16.34%	17.72%	17.19%	16.27%
Unallocated retained earnings/assets	13.63%	13.96%	15.28%	14.79%	13.89%
Net income	1,187,596	1,341,261	2,420,251	1,613,346	1,662,505
Return on assets[e]	1.80%	1.83%	3.10%	1.85%	1.75%
Return on equity[e]	11.20%	11.10%	18.22%	10.55%	10.44%
Net interest margin	2.69%	2.72%	2.72%	2.71%	2.93%
Operating expense rate[f]	1.50%	1.56%	1.58%	1.53%	1.58%
Total FCS[h]					
Gross loan volume	89,772,000	92,790,000	96,367,000	106,272,000	123,436,000
Nonperforming loans	1,131,000	1,186,000	743,000	600,000	615,000
Nonaccrual loans	939,000	1,049,000	646,000	524,000	533,000
Nonperforming loans/gross loans[c]	1.26%	1.28%	0.77%	0.56%	0.50%
Bonds and notes	90,980,000	95,310,000	100,330,000	113,576,000	134,466,000
Capital/assets[i]	15.41%	16.19%	17.13%	16.28%	15.00%
Surplus/assets	12.32%	12.68%	13.69%	13.30%	12.25%
Net income	1,773,000	1,825,000	2,993,000	2,096,000	2,379,000
Return on assets[e]	1.67%	1.60%	2.46%	1.58%	1.56%
Return on equity[e]	10.58%	10.11%	14.85%	9.38%	9.99%
Net interest margin	2.78%	2.65%	2.56%	2.58%	2.48%

Sources: Uniform Call Report data as of February 20, 2007, and the Federal Farm Credit Banks Funding Corporation news release of February 14, 2007.

a. This category includes Farm Credit Banks and the Agricultural Credit Bank.
b. This category excludes loans 90 or more days past due.
c. Nonperforming loans are defined as nonaccrual loans, accruing restructured loans, and accrual loans 90 or more days past due.
d. Capital excludes mandatorily redeemable preferred stock.
e. Income ratios are annualized.
f. Operating expenses are divided by average gross loans, annualized.
g. Capital excludes protected borrower capital.
h. The data provided in this category cannot be derived through summation of above categories because of intradistrict and intra-System eliminations used in Reports to Investors.
i. Capital includes restricted capital (amount in Farm Credit Insurance Fund) and excludes mandatorily redeemable preferred stock and protected borrower capital.

Table 4

Farm Credit System Major Financial Indicators, by District[a]

As of December 31, 2006
Dollars in Thousands

FCS banks	Total assets	Loan volume	Gross nonaccrual loans	Allowance for loan losses	Cash and marketable investments[b]	Capital stock[c]	Surplus[d]	Total capital[e]
AgFirst	24,412,164	17,152,337	15,110	463	6,958,764	463,353	715,752	1,181,087
AgriBank	47,007,371	37,090,083	5,024	3,029	9,363,712	932,287	1,340,535	2,252,978
CoBank	41,379,092	33,075,842	82,511	438,231	8,159,764	1,742,438	1,337,016	3,040,058
Texas	12,915,760	10,055,428	3,712	142	2,784,798	361,421	324,270	664,221
U.S. AgBank	19,580,528	14,886,784	1,199	927	4,413,674	547,257	576,599	1,075,505
Total	145,294,915	112,260,474	107,556	442,792	31,680,712	4,046,756	4,294,172	8,213,849
Associations								
AgFirst	16,835,857	15,394,419	62,441	71,449	631,969	172,939	2,330,214	2,502,795
AgriBank	44,051,704	41,006,616	167,082	82,344	471,383	197,730	6,895,404	7,093,134
CoBank	10,117,541	9,472,714	80,973	54,760	83,036	29,143	1,651,670	1,677,420
Texas	11,102,497	10,671,729	32,790	13,826	53,568	60,813	1,577,409	1,638,222
U.S. AgBank	18,544,604	16,867,641	82,259	63,712	736,005	219,289	3,250,967	3,463,323
Total	100,652,203	93,413,119	425,545	286,091	1,975,961	679,914	15,705,664	16,374,894
Total FCS	**162,864,000**	**123,436,000**	**533,000**	**734,000**	**33,117,000**	**1,324,000**	**19,954,000**	**24,430,000**

Sources: Uniform Call Report data as of February 20, 2007, and the Federal Farm Credit Banks Funding Corporation news release of February 14, 2007.

a. Aggregations of district data may not equal totals because of eliminations.
b. This category includes accrued interest receivable on marketable investments.
c. This category includes capital stock and participation certificates and excludes mandatorily redeemable preferred stock and protected borrower capital.
d. This category includes allocated and unallocated surplus.
e. Total capital includes capital stock, participation certificates, perpetual preferred stock, surplus, and accumulated other comprehensive income. Restricted capital excludes mandatorily redeemable preferred stock and protected borrower capital.

Nationwide, the System had $123.4 billion in gross loans outstanding as of December 31, 2006, (see table 5). Agricultural producers represented by far the largest borrower group, with $85.2 billion, or 69.0 percent, of the total dollar amount of loans outstanding.[13] As required by law, all borrowers own stock or participation certificates in System institutions. The FCS had nearly 754,000 loans and approximately 462,000 stockholders in 2006. Approximately 83 percent of the stockholders were farmers with voting stock. The remaining voting stockholders were cooperative associations. (The System also has nonvoting stockholders, including other financing institutions [OFIs] that borrow from the System and rural homeowners.)

The aggregate total of loans outstanding at FCS banks and associations (net of intra-System lending) grew by $17.2 billion, or 16.2 percent, during the year ended December 31, 2006. This increase easily exceeded the 10.3 percent increase in 2005. However, in 2003 and 2004, the annual increases were only 3.4 percent and 3.9 percent, respectively. Since year-end 2002, total System loans outstanding increased by $33.7 billion, or 37.5 percent.

As of December 31, 2006, 45.8 percent of the System's loans outstanding were in long-term real estate loans, 23.3 percent in short- and intermediate-term loans to agricultural producers, and 17.1 percent in agribusiness loans. Agribusiness loans are broken down further into 9.9 percent for cooperatives, 5.5 percent for processing and marketing enterprises, and 1.7 percent for farm-related businesses. Loans to finance rural utilities represented 7.8 percent of the System's loan volume, while rural residential real estate loans made up about 2.8 percent of the System's total loans. International loans (export financing) represented 1.8 percent of the System's loan portfolio, and lease receivables accounted for 1.2 percent of the overall portfolio. Finally, loans outstanding to OFIs represented a small but growing segment of the System's portfolio.

The System's increased loan volume over the past 12 months stemmed primarily from agribusiness loans (up $6.5 billion, or 44.1 percent), long-term real estate loans (up $4.8 billion, or 9.3 percent), and short- and intermediate-term loans (up $3.8 billion, or 15.2 percent). Agribusiness loans also exhibited the largest percentage increase over the previous five years, with a 79.1 percent increase since 2002, or a $9.3 billion increase in nominal terms. With the exception of international loans, which decreased by more than 25 percent over this period, all components of the System's loan portfolio experienced positive growth rates, and most of them were at double-digit levels.[14]

Several factors facilitated the System's strong loan growth in 2006. The funding environment remained favorable, allowing the System to offer competitive interest rates. System institutions also mounted effective marketing campaigns to finance more integrated operations and bioenergy plants—mostly ethanol—through processing and marketing loans. Moreover, a number of System institutions used loan participations and syndications, both inside and outside the System, to make use of their strong capital base and to diversify their portfolios and reduce risk. Of the 95 FCS associations, 38 experienced double-digit loan growth rates, while 8 associations experienced loan volume declines.

13. This amount does not include loans to rural homeowners as defined in section 613.3030 of the FCA regulations, and leases.
14. In recent years, the level of international lending activity has been constrained by the amount of funding for loan guarantees. A majority of the System's international portfolio is guaranteed by the Commodity Credit Corporation through USDA's GSM-102 and GSM-103 export credit guarantee programs.

Table 5

FCS Gross Loans Outstanding, 2002–2006

As of December 31
Dollars in Millions

Loan category	2002	2003	2004	2005	2006	Percent change from 2002
Production agriculture						
Long-term real estate mortgage loans	43,517	46,480	47,695	51,690	56,489	29.8
Short- and intermediate-term loans	20,491	21,058	22,789	24,935	28,731	40.2
Agribusiness loans[a]	11,802	12,094	12,053	14,673	21,141	79.1
Rural utility loans	6,900	6,451	7,200	8,063	9,569	38.7
Rural residential loans	2,327	2,278	2,482	2,950	3,408	46.5
International loans	3,062	2,795	2,624	2,277	2,183	-28.7
Lease receivables	1,384	1,323	1,168	1,290	1,489	7.6
Loans to other financing institutions	289	311	356	394	426	47.4
Total	**89,772**	**92,790**	**96,367**	**106,272**	**123,436**	**37.5**

Source: Federal Farm Credit Banks Funding Corporation 2006 Annual Information Statement.

a. At December 31, 2006, agribusiness loans consisted of loans to cooperatives of $12.2 billion; processing and marketing loans of $6.8 billion; and farm-related business loans of $2.1 billion.

Funding for Other Lenders

Other Financing Institutions

Under the Farm Credit Act, System banks may further serve the credit needs of rural America by providing funding and discounting services to non-System lending institutions known as "other financing institutions." OFIs include commercial banks, thrifts, credit unions, trust companies, agricultural credit corporations, and other specified agricultural lenders. System banks can fund and discount short- and intermediate-term loans for OFIs that are significantly involved in lending to agricultural and aquatic producers and harvesters if these OFIs demonstrate a need for additional funding to meet the credit needs of eligible borrowers. OFIs benefit by using the System as an additional source of liquidity for their own lending activities and by capitalizing on the System's expertise in agricultural lending to make safe, sound, and constructive loans.

As of December 31, 2006, the System served 26 OFIs, the same number as the year before. Outstanding loan volume to OFIs was $426 million at year-end, up 8 percent from 2005 and 47 percent from 2002. However, OFI loan volume continues to be a very small part of the System's loan portfolio (less than 0.5 percent); it was only 1.48 percent of the System's production and intermediate-term loan volume to farm producers in 2006. About 75 percent of the System's OFI loan volume is in the Midwest.

Rising Loan Participations and Syndications with Non-FCS Lenders

Under conditions prescribed by the Farm Credit Act, System banks and associations have authority to participate with commercial banks and other lending institutions in making loans to agriculture and rural America. Financial institutions primarily use loan participations and syndications to reduce credit and interest rate risk and to resolve lending limit issues, but they also use them to manage and optimize capital, earnings, and liquidity. For example, a financial institution with a high concentration of production loans for a single commodity could use participations or syndications to diversify the loan portfolio, or it could use them to sell loans that are beyond its credit limit.

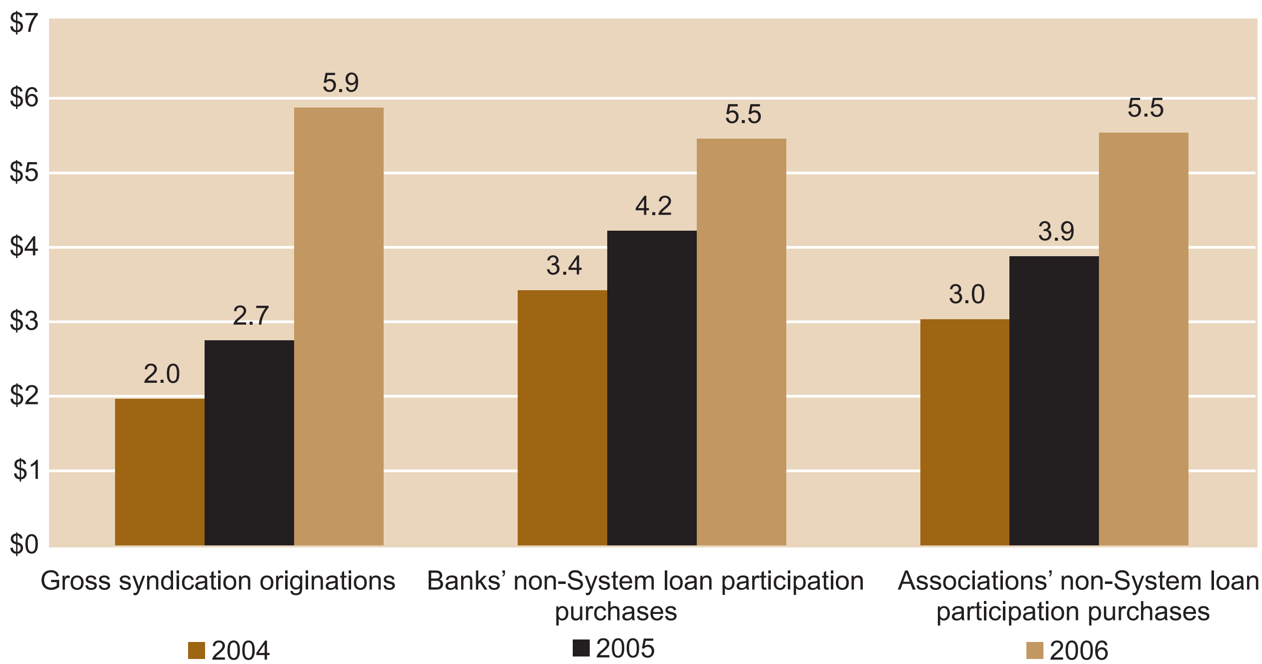
Activity from loan participations and syndications has been growing rapidly over the past three years. Figure 6 provides a breakout of purchased loan participations by the System's banks and associations from non-System institutions.[15] Also shown is loan syndication activity by FCS banks for the past three years, including purchased assignments.

In addition to participating in loans to eligible borrowers, FCS institutions have authority to work with non-System lenders that originate similar-entity loans. A similar-entity borrower is not eligible to borrow directly from an FCS institution, but because the operation is functionally similar to that of an eligible borrower, the System can participate in these loans (the partici-

Figure 6

FCS Participations and Syndications with Non-System Lenders, 2004–2006

As of December 31
Dollars in Billions



Sources: Call Reports received from the FCS institutions, year ended December 31.

15. The System also sells participations to non-System lenders, which amounted to $1.2 billion in 2006.

pation interest must be less than 50 percent). At the end of 2006, similar-entity participations in the System amounted to $5.8 billion.

As of December 31, 2006, FCS banks had purchased $5.5 billion of loan participations from non-System lenders, compared with $4.2 billion at year-end 2005 and $3.4 billion at year-end 2004. These increases represent strong growth rates averaging more than 25 percent per year. At the association level, the results were equally impressive: purchased participations from non-System lenders amounted to $5.5 billion at year-end 2006, up more than 40 percent from a year earlier.[16]

Syndication purchases by the System with non-System lenders totaled $5.9 billion in 2006, more than double the $2.7 billion posted in 2005. As a result, these purchases continued to expand sharply in relation to the System's loan portfolio, rising from 2.6 percent of gross loans at the end of 2005 to 4.8 percent a year later. The sharp increase in syndication purchases reflects general market trends in which commercial credits are becoming more complex and are causing lenders to switch from participations to syndicated loans as a way to manage risk while satisfying the credit needs of their customers. Overall favorable market conditions have also contributed to increased partnering between System and non-System lenders. Such partnering has expanded the availability of credit to rural America.

Market Share of Farm Debt

According to USDA data, the System and commercial banks both achieved small gains in market share of total farm debt for the year ended December 31, 2006. USDA's final estimate for farm business debt was $226.2 billion, with commercial banks holding 42.4 percent and the System 32.6 percent.[17] (Figure 7 shows market share shifts for the major lenders since 1986.)

Farm debt previously peaked at $189 billion at the end of 1984, fell during the farm financial crisis to less than $131 billion by the end of 1989, and rose to more than $193 billion as of December 31, 2002, surpassing the previous record level in nominal terms. The past four years have continued the pattern of setting new nominal highs.

Except for the unusual period of the 1980s and a brief time in the 1990s, the FCS has typically been the dominant lender for farm real estate mortgages, enjoying the largest market share. Commercial banks have always dominated non-real estate lending. The System's share of debt secured by farm real estate increased to 38.2 percent at year-end 2006 from 36.6 percent in 2002, continuing a steady upward trend for the past 10 years. The System's share of non-real estate farm debt was 26.2 percent at year-end 2006, compared with 21.9 percent at year-end 2002 and slightly less than 20 percent in the late 1990s.

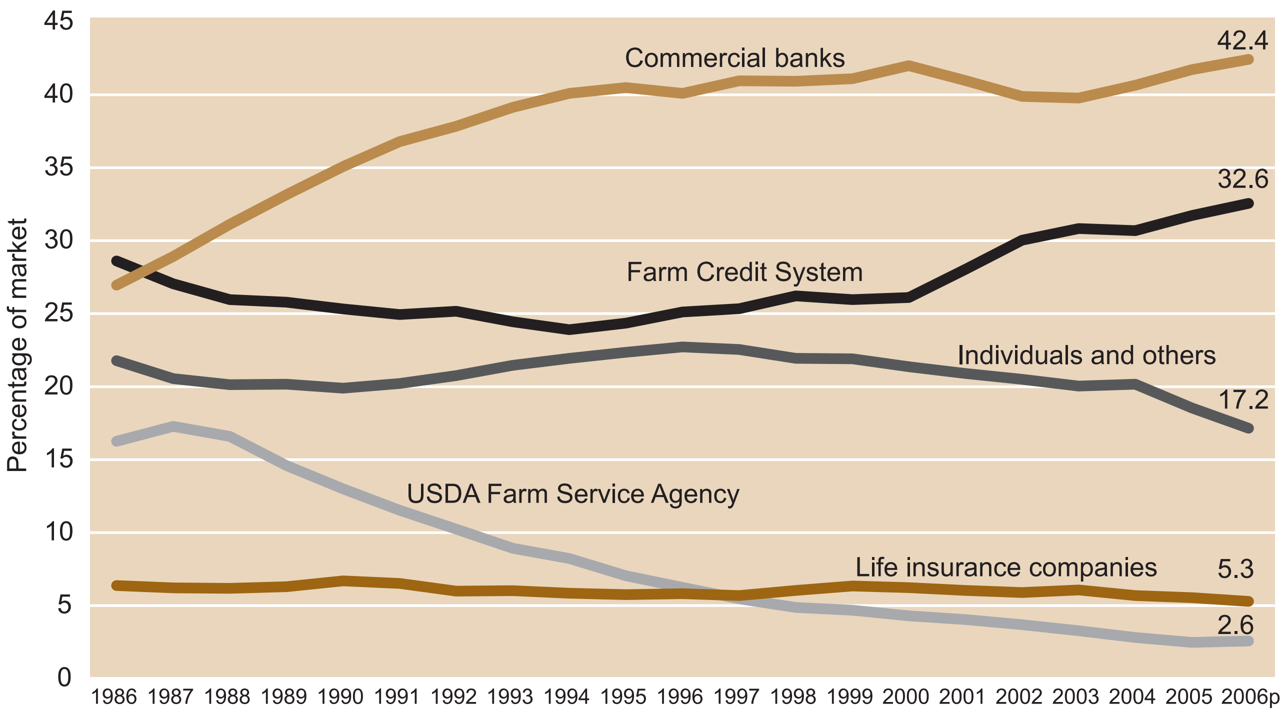
In 2000, commercial banks, with several years of steady gains, edged ahead of the System in the debt market secured by farm real estate, with a 32.7 percent share. However, their share slipped during the next four years before climbing to 35.8 percent at the end of 2006, a few percentage points behind the System. In the non-real estate market, the market share held by commercial banks was almost 50 percent at the end of 2006, essentially unchanged from 2005. However, their share averaged nearly 52 percent over the 1996–2000 period, when the FCS was still regaining its financial footing from the crisis of the mid-1980s.

16. Loan participations with non-FCS lenders include four types of asset purchases reported on Call Report Schedule RC-O: loan participations, similar-entity transactions, lease interest, and other interest in loans. Loan syndications are a line item reported on Schedule RC-1 Memoranda.

17. USDA calculates its own figures for farm debt held by the System. The estimates differ from the numbers reported elsewhere in this report.

Figure 7

Market Shares of U.S. Farm Business Debt, 1986–2006p



Sources: USDA, Economic Research Service, Web site, February 14, 2007.

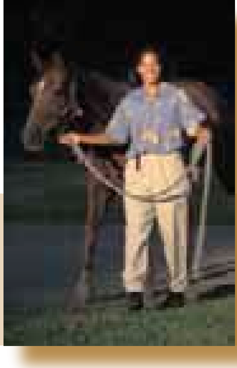
Farmer Mac as a Secondary Market

Farmer Mac was created to provide a secondary marketing arrangement for agricultural real estate and rural housing mortgage loans and greater liquidity and lending capacity to agricultural lenders. In USDA's estimates of farm sector debt by lender, Farmer Mac's purchases of farm real estate loans (about $3.8 billion outstanding as of December 31, 2006) from various lenders are included as a subcategory that USDA labels "Individuals and Others."

Farmer Mac also plays a role in the farm debt market through a product known as the Long-Term Standby Purchase Commitment program, which was introduced in 1999. Under a Standby, a financial institution acquires a Farmer Mac guarantee for an annual fee on a loan pool that the institution retains. While Farmer Mac's Standby product is available to agricultural lenders generally, System institutions accounted for nearly all ($2.0 billion) of the outstanding volume in Standbys as of December 31, 2006.[18]

Since not all farm mortgages are eligible for Farmer Mac funding, Farmer Mac calculates its market share by estimating the portion of the total farm real estate debt market that would qualify as eligible mortgages under Farmer Mac's underwriting criteria. According to these calculations, outstanding program volume ($7.2 billion) is about 15 percent of the eligible farm real estate debt market.

18. The Standby guaranteed amounts by Farmer Mac are reported in USDA's farm business debt estimates as being provided by the originating lender, as is the case with certain program securities (e.g., off-balance-sheet AgVantage securities) that are guaranteed by Farmer Mac but are collateralized by the eligible loans that reside at the primary lender. This is also how approximately $10 billion in loans guaranteed by the Farm Service Agency (FSA) is treated; that is, the share reported for USDA/FSA is just for its direct lending activity.



Serving Young, Beginning, and Small Farmers and Ranchers

Providing financially sound and constructive credit and related services to young, beginning, and small (YBS) farmers and ranchers is a legislated mandate and a high priority for the System. Loans to YBS borrowers help ensure a smooth transition of agribusiness to the next generation and a continued diversified customer base, from very small enterprises to large commercial operations, for the FCS. Through its regulatory agenda, special reports, disclosure requirements, and examination activities, FCA is strongly committed to ensuring that the System fulfills its responsibility to support this important segment of the agricultural industry.

As the percentage of retirement-age farmers continues to rise, the System's potential role in helping young and beginning farmers finance the purchase of agricultural assets sold by those who are exiting the business becomes more important. USDA's 2002 Census of Agriculture found that 26.2 percent of principal operators are 65 years old or older, compared with 21.4 percent in 1987. The census also reported a continuing sharp decline in the percentage of young operators. Principal operators aged 34 or younger dropped from 13.3 percent in 1987 to 5.8 percent in 2002. Other USDA surveys and studies show that potential YBS borrowers have a heavy and increasing reliance on off-farm income, plus a wide range of credit needs beyond their agricultural production activities. Such changing demographics and economic conditions in many areas of rural America pose challenges for System institutions in meeting their YBS program goals.

Each System bank is required to adopt written policies that direct each association board to have a program for furnishing sound and constructive credit and financially related services to YBS borrowers. The Farm Credit Act stipulates that associations must coordinate with other Government and private sources of credit in implementing their YBS programs. In addition, each institution is required to report yearly on its operations and achievements in its YBS program. FCA's oversight and examination activities encourage System institutions to assess their performance and market penetration in the YBS area, which increases their mission awareness and prompts them to earmark resources to serve this important market segment. Finally, FCA continues to review and consider various policy options for supporting the System's YBS programs.

YBS Lending Results

In calendar year 2006, the overall trends for YBS lending for each of the three borrower categories continued to be positive, with loans made during the year and year-end loans outstanding showing solid gains from 2005 levels.[19] Table 6 contains information on loans outstanding in each category at the end of 2006; table 7 provides information on new loans made during the year.

In the next major section of the report, after discussing the 2006 results, FCA provides information on the progress in YBS lending activity since 2001. That was the first year institutions were required to report their results using the current definitions for young, beginning, and small farmers and ranchers.

Young—The System's extension of credit to young farmers, those aged 35 or younger, consisted of 140,209 loans totaling $15.4 billion at the end of 2006. During 2006, 46,459 new loans totaling $5.5 billion were made to young borrowers. These new loans represented 17.0 percent of all new loans the System made for the year, which totaled 272,861, and 10.5 percent of the new loan dollar volume, which totaled $52.2 billion for the entire System. The average new loan size was $117,729. New loans made during the year, rather than loans outstanding at year-end, are a good measure of current service to YBS borrowers. The number of new loans made to young farmers during 2006 was 9.7 percent higher than in 2005 and the volume of new loans was 8.7 percent higher.

19. System data on service to YBS farmers and ranchers cover the calendar year and are reported at year-end. The statistics show loans made during the year (counts and volume) as well as loans outstanding at year-end (counts and volume). The volume measure includes loan commitments to borrowers, which typically exceed actual loan advances.

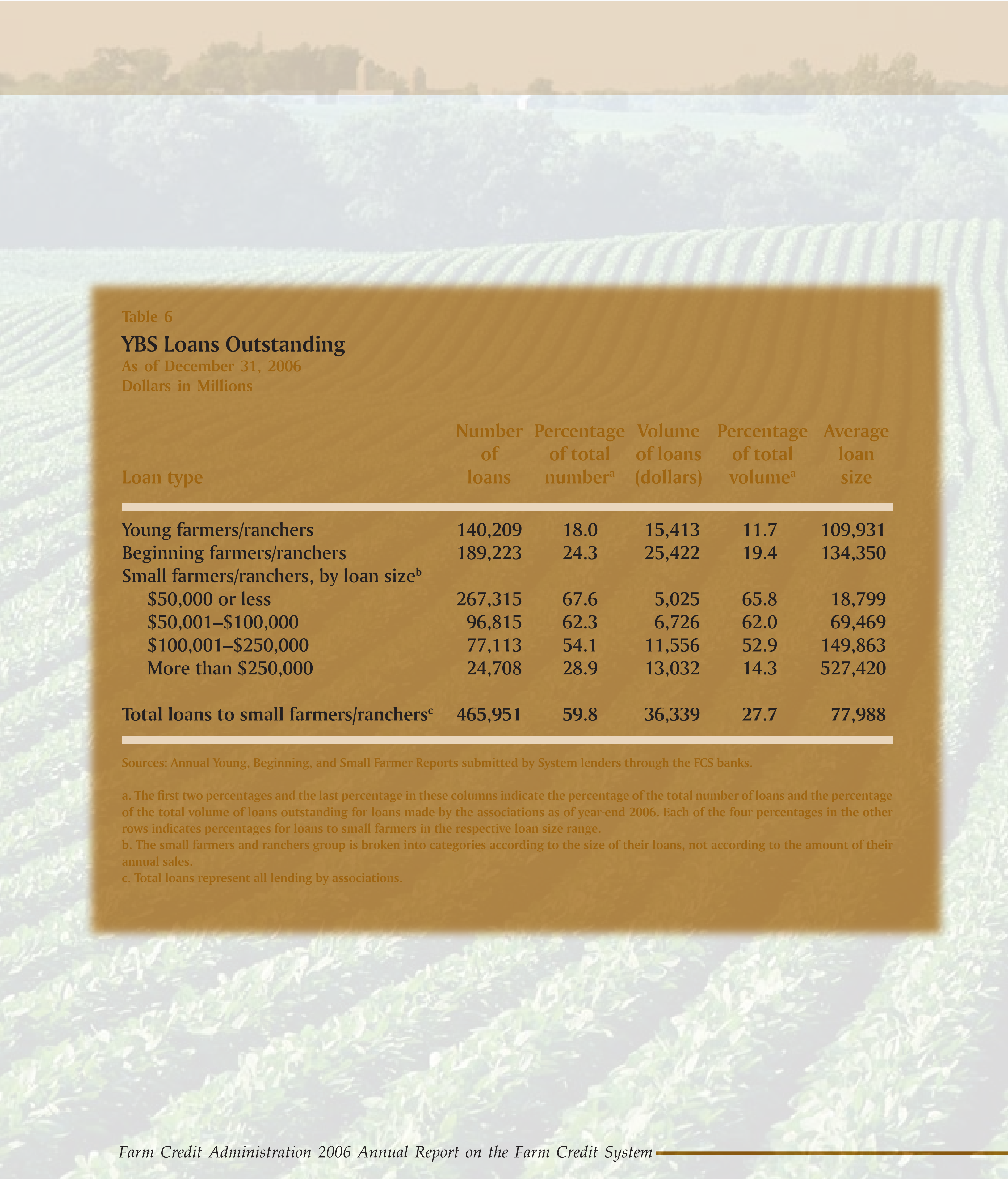


Table 6

YBS Loans Outstanding

As of December 31, 2006
Dollars in Millions

Loan type	Number of loans	Percentage of total number[a]	Volume of loans (dollars)	Percentage of total volume[a]	Average loan size
Young farmers/ranchers	140,209	18.0	15,413	11.7	109,931
Beginning farmers/ranchers	189,223	24.3	25,422	19.4	134,350
Small farmers/ranchers, by loan size[b]					
$50,000 or less	267,315	67.6	5,025	65.8	18,799
$50,001–$100,000	96,815	62.3	6,726	62.0	69,469
$100,001–$250,000	77,113	54.1	11,556	52.9	149,863
More than $250,000	24,708	28.9	13,032	14.3	527,420
Total loans to small farmers/ranchers[c]	**465,951**	**59.8**	**36,339**	**27.7**	**77,988**

Sources: Annual Young, Beginning, and Small Farmer Reports submitted by System lenders through the FCS banks.

a. The first two percentages and the last percentage in these columns indicate the percentage of the total number of loans and the percentage of the total volume of loans outstanding for loans made by the associations as of year-end 2006. Each of the four percentages in the other rows indicates percentages for loans to small farmers in the respective loan size range.
b. The small farmers and ranchers group is broken into categories according to the size of their loans, not according to the amount of their annual sales.
c. Total loans represent all lending by associations.

Table 7

YBS New Loans Made During 2006

As of December 31, 2006
Dollars in Millions

Loan type	Number of loans	Percentage of total number[a]	Volume of loans	Percentage of total volume[a]	Average loan size
Young farmers/ranchers	46,459	17.0	5,470	10.5	117,729
Beginning farmers/ranchers	57,828	21.2	9,263	17.8	160,182
Small farmers/ranchers, by loan size[b]					
$50,000 or less	91,536	69.0	1,549	64.0	16,919
$50,001–$100,000	27,911	55.4	1,770	56.3	63,428
$100,001–$250,000	20,444	45.3	3,104	47.1	151,820
More than $250,000	8,134	18.2	5,152	12.9	633,429
Total loans to small farmers/ranchers[c]	148,025	54.3	11,575	22.2	78,198

Sources: Annual Young, Beginning, and Small Farmer Reports submitted by System lenders through the FCS banks.

a. The first two percentages and the last percentage in these columns indicate the percentage of the total number of loans and the percentage of the total volume of loans outstanding for loans made by the associations as of year-end 2006. Each of the four percentages in the other rows indicates percentages for loans to small farmers in the respective loan size range.
b. The small farmers and ranchers group is broken into categories according to the size of their loans, not according to the amount of their annual sales.
c. Total loans represent all lending by associations.

Beginning—Beginning farmers, defined as those with 10 or fewer years of farming experience, constituted 189,223 of the System loans, totaling $25.4 billion at year-end 2006. During 2006, 57,828 new loans, totaling $9.3 billion, were made to beginning borrowers. New loans to beginning farmers represented 21.2 percent of all new loans and 17.8 percent of new loan dollar volume. The average new loan size was $160,189. The number of new loans made during 2006 was 5.4 percent higher than in 2005, and the volume of new loans was 12.3 percent higher than in the previous year.

Small—FCS institutions had 465,951 outstanding loans, totaling $36.3 billion, to small farmers (those with gross annual sales of less than $250,000) at the end of 2006. During 2006, 148,025 new loans were made to small borrowers for a total of $11.6 billion. New loans to small farmers represented 54.3 percent of all new loans and 22.2 percent of new loan volume. The average new loan size was $78,198. Although the number of new loans made during 2006 was essentially unchanged from 2005, the volume of new loans increased 6 percent.

The YBS information is reported separately for each of the three YBS borrower categories because, depending on a borrower's characteristics, a loan may be counted two or even three times. Therefore, the YBS categories should not be added together because the final figure would be a misleading measurement of the System's YBS lending involvement. Loans outstanding to YBS farmers include real estate loans and short- and intermediate-term loans.

Assessment of YBS Results for Individual Associations

Individual associations vary significantly in their YBS lending results, not only within a given year but also between years. Although a given institution might have a high number or dollar volume of loans in one category and be low in another, every institution reported at least some activity in each category in 2006.

Over time, the rankings of a given association likely will shift as top-ranked associations in one year are often replaced by different institutions in the following year. In 2006, 41 out of 95 associations increased their dollar volume of new lending to young farmers, and 49 associations accomplished this feat for beginning farmers. However, only a third of the associations increased their dollar volume of new lending to small farmers in 2006, with the remaining associations posting declines. Beginning with 1999, specific YBS data by institution, by district, and for the System as a whole are available on FCA's Web site, **www.fca.gov**.

Differences among institutions' YBS results are to be expected, given the significant diversity in farm types and sizes and farmer demographics across the United States. For example, in 2005 the average value of farm production in four States was more than $250,000 per farm, compared with 17 other States with average production values of less than $100,000 per farm. Census of Agriculture data also show that the average age of farmers, and especially the percentage of operators in the "young" group, vary considerably from State to State. Such differences make comparisons among individual associations difficult and explain why YBS regulations do not specify fixed goals but require individual institutions to establish YBS targets appropriate for their lending territories. Other factors—such as the competitiveness of the local lending market and the availability of State and USDA/Farm Service Agency (FSA) guarantees—play a role in individual association results.

The structure of agriculture in an association's territory can affect its YBS lending results. For example, the 2002 Census of Agriculture classified about 93 percent of all U.S. farms as small, using the same definition for a small farm as that used for YBS reporting. The census found that less than half of all small farms had interest paid as a farm business expense, which meant that more than half of all small farms had no farm debt on the date of the census and likely would not be FCS borrowers. In fact, according to the census, nearly 39 percent of all farms had sales of $2,500 or less.

As noted earlier, the System reported that small farmers held almost 60 percent of the total number of loans in association portfolios at the end of 2006. Moreover, 54 percent of System loans made in 2006 were to small farmers. Since small farms are less likely to carry debt than large farms, these statistics reveal a strong commitment by the FCS to serve the credit needs of small producers.

YBS Borrowing Trends, 2001–2006

FCA now has six years of System YBS results under the definitions and reporting requirements that became mandatory in 2001. In addition, all institutions have had examinations of their YBS reporting. In some cases, these examinations have resulted in corrections of previously reported YBS data. The information in figures 8A, 8B, and 8C shows fairly strong upward trends in dollars of loans outstanding and dollars of loans made for each of the three categories from 2001 to 2006. (Similar trends exist for the number of loans in each category.)

Although YBS loan volumes over the past six years point to a strong upward trend, YBS results as a percentage of total loans outstanding present a different picture. Slight dips have occurred in the percentages of total volumes outstanding for young and small farmers over the past three years, while the percentage for beginning farmers has leveled off following a five-year rise. However, given the downward trend in the percentages of young and small farm operators noted in recent Census of Agriculture and other USDA reports, the YBS dollar results are noteworthy. What's more, the downward trend in the percentage of YBS loans in the System's total loan portfolio is a byproduct of the System's strong lending activity in 2006, when loans outstanding surged more than 16 percent.

Comparisons in YBS lending cannot be made between FCS institutions and other lenders because other Federal regulators do not require reporting on young and beginning farmer loans. While large banks are required to report on small farm loans, small farm lending is defined in terms of loan size (a loan of less than $500,000 is considered a small farm loan) rather than in terms of the borrower's annual sales. In addition, because of differences in data definitions and data collection methods, annual YBS data are not comparable with Census of Agriculture data, which are collected only once every five years.

YBS Programs

Because of its GSE status, the FCS is in a unique position to develop YBS programs, to coordinate those programs with other Government programs, which reduces risks, and to make a continuing commitment to lend to YBS borrowers. In establishing their YBS programs, institutions may use a variety of tools to fulfill their commitment to YBS lending. Associations may offer less stringent underwriting standards or reduced interest rates to make it easier for potential YBS borrowers to qualify for loans. The differential underwriting standards often include higher loan-to-market value ratios or lower debt-coverage requirements for YBS borrowers. Some institutions establish special risk pools in which capital is segregated to support YBS lending. One institution is developing a starter farmer program under investment authorities approved by the Agency (see page 41). Almost all programs involve coordinating with Federal or State sources to obtain guarantees on loans to qualifying YBS borrowers.

During 2006, 52 percent of the associations offered differential underwriting standards, or exceptions, for YBS borrowers, down from 60 percent in 2001. Also, 43 percent had programs that offered lower interest rates or charged lower loan fees for YBS borrowers. In most cases, institutions used more than one credit enhancement program.

Figures 8A, 8B, and 8C

Loans Made to, and Loans Outstanding for, YBS Farmers and Ranchers, 2001–2006

As of December 31

Figure 8A

Young Farmers and Ranchers

Dollars in Billions

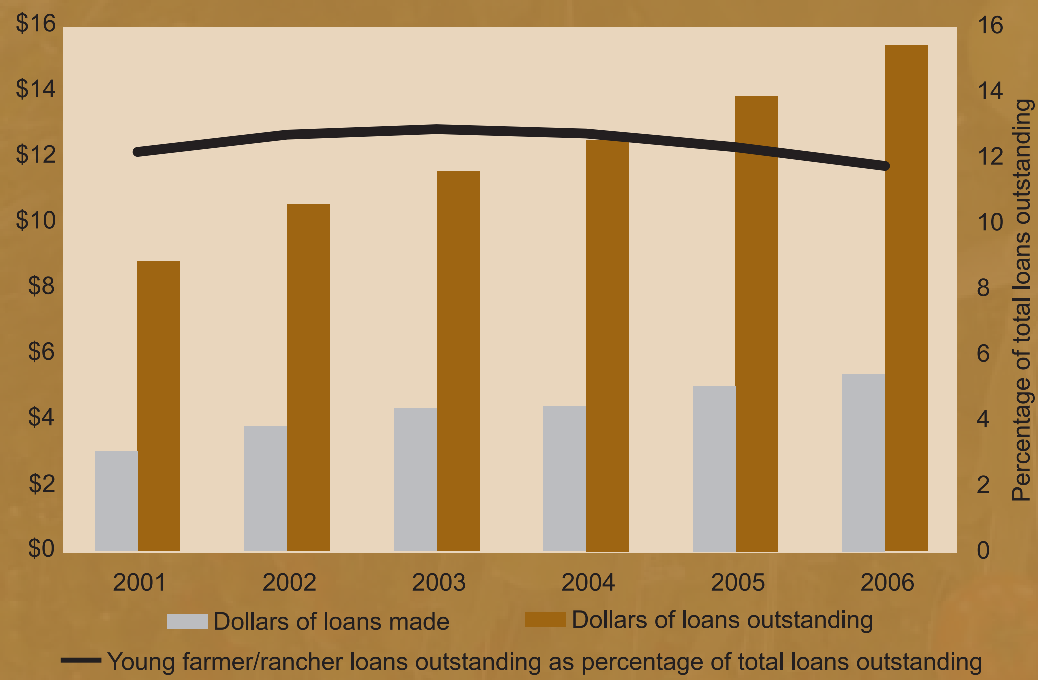


Figure 8B

Beginning Farmers and Ranchers

Dollars in Billions

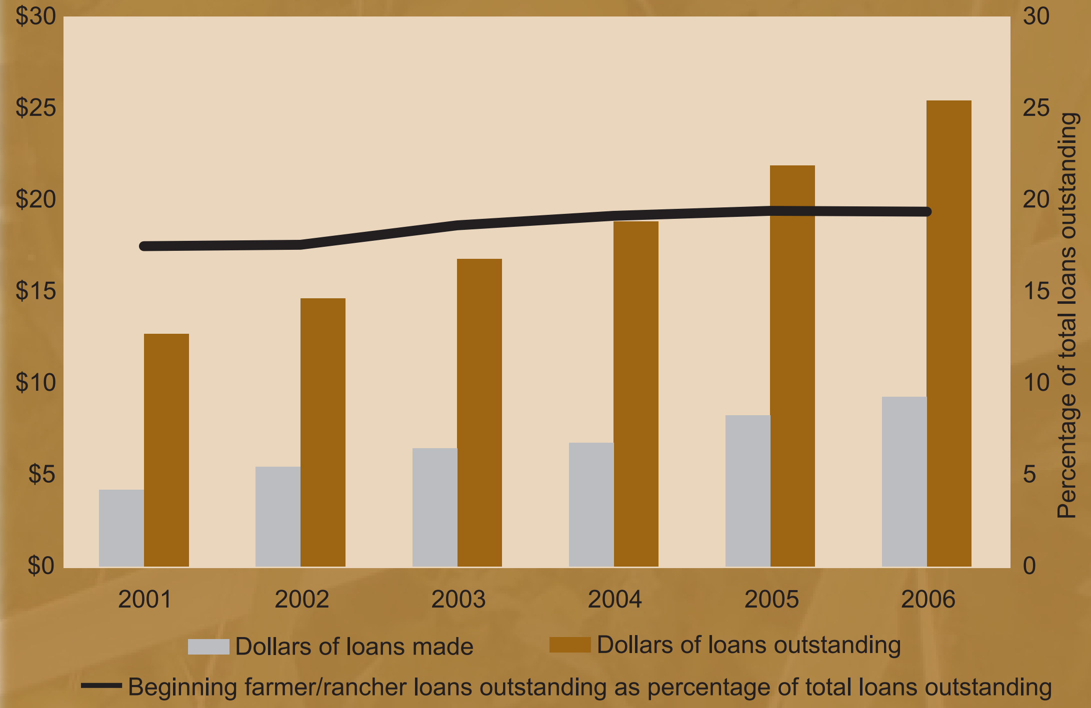
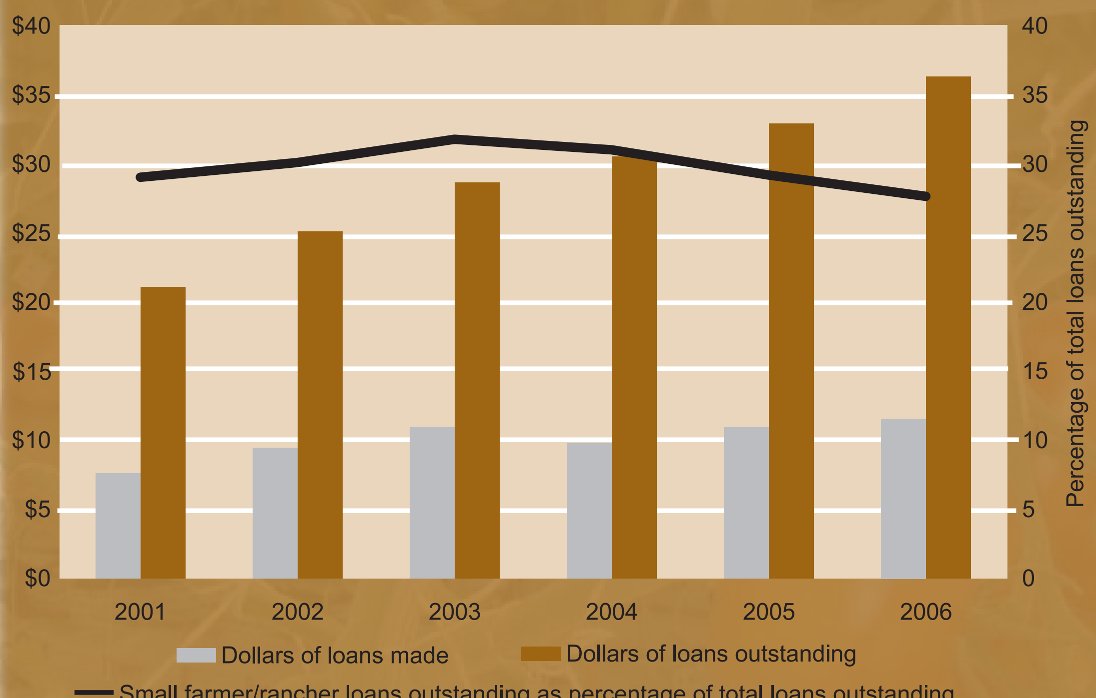


Figure 8C

Small Farmers and Ranchers

Dollars in Billions



Sources: Annual YBS reports submitted by System lenders through the FCS banks.

Some YBS borrowers are assisted by the various State and Federal programs that provide interest rate reductions or guarantees to help commercial lenders and FCS institutions reduce credit risks for borrowers. Without such concessions and guarantees, credit would not be extended to some YBS borrowers because of excessive repayment or collateral risks. FSA is the primary provider of Government-guaranteed loans for farmers, although a small portion of guaranteed loans is made through the Small Business Administration (SBA) and various State programs. System lending institutions actively use FSA's guaranteed lending program for both conventional and YBS lending. Agency surveys indicate that about one-fourth of the System's overall volume of FSA-guaranteed loans outstanding was to young farmers; another one-third was to beginning farmers; and about one-third was to small farmers (numbers are not additive). However, the volume of YBS loans with FSA guarantees represents a small percentage (roughly 3 to 5 percent) of the overall YBS program figures. At year-end 2006, the guaranteed loan volume figures for Y, B, and S loans were $764 million, $962 million, and $1.08 billion, respectively.

An increasing number of associations offer a growing array of training programs and other services that benefit YBS farmers and ranchers. The most common training program focuses on leadership; some 65 percent offered this training as of year-end 2006. Approximately 64 percent offered training in business and financial management skills. Most associations also offer other financial services programs, including estate planning, recordkeeping, tax planning and preparation, and farm business consulting. Sometimes associations discount or waive the cost of these programs for YBS borrowers.

Other outreach activities are offered in conjunction with such organizations as State or national young farmer groups, colleges of agriculture, State or national cooperative association leadership programs, and local chapters of 4-H and of the National FFA Organization. Many associations also provide financial support for scholarships and for FFA, 4-H, and other agricultural organizations.

Each FCS association responds to an annual FCA questionnaire on the content of its YBS program. The survey generally covers program goals, board reporting, YBS credit provisions, use of Government guarantee programs, and use of training or other related services. As of year-end 2006, 32 institutions achieved their specific YBS goals for the percentage of loans outstanding in each YBS category, compared with 44 institutions in 2005. Although the goals generally are set according to results from studies on eligible borrower demographics in the institution's territory, the success rate often depends on new market developments, management's commitment to the program, and the degree to which the goals are realistic. FCA's oversight activities are designed to help institutions stay focused on this important mission area.

Regulatory Policy and Approvals

FCS Corporate Activity

In 2006, corporate activity between associations increased from the previous year. The parent-subsidiary structure, with an ACA as parent and its wholly owned PCA and FLCA as subsidiaries, remained the dominant association structure in the System and accounted for 91 percent of all associations as of December 31, 2006.[20] Under this structure, the ACA and its subsidiaries operate with a common board of directors and joint employees and are obligated on each other's debts and liabilities.

The structure allows the ACA to build and use capital more efficiently and enables members to be stockholders of one entity—the ACA—and to be borrowers of the ACA or of one or both subsidiaries. This structure gives the ACA and its subsidiaries greater flexibility in serving their customers and allows credit and related services to be delivered to borrowers more efficiently. All 86 ACAs operate with this structure. Nine FLCAs, which are authorized to provide long-term credit only, continue as independent associations.

This section describes the changes that occurred in the FCS structure during 2006.

Summary of Activity

1. The number of corporate applications submitted for FCA Board approval increased from the previous year. In 2006, FCA analyzed and approved 11 applications, compared with one application processed in 2005. One application processed in 2006 was a proposed merger of two ACAs, each operating with subsidiaries. The FCA Board approved the merger subject to approval by the voting stockholders of each ACA. The voting stockholders of one of the associations voted against the merger and so it did not take effect.

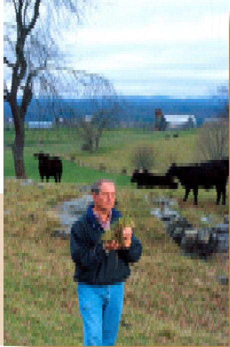
2. On April 1, 2006, an FLCA affiliated with the Farm Credit Bank of Texas (FCBT) changed its name and headquarters location. A second FLCA, also affiliated with the FCBT, changed its name on August 1, 2006. On September 1, 2006, two ACAs—one affiliated with AgriBank, FCB, and the other with AgFirst Farm Credit Bank—changed their names and the names of their respective PCA and FLCA subsidiaries. On December 1, 2006, an ACA and its PCA and FLCA subsidiaries, which were affiliated with AgFirst Farm Credit Bank, moved their headquarters to another city in the same county.

3. On June 30, 2006, the FCA Board approved an amendment to the articles of incorporation of a section 4.25 service corporation, which is owned by a bank and several associations, to increase the amount of stock authorized for issuance.

4. On July 1, 2006, an FLCA affiliated with the FCBT converted its charter with FCA approval to an ACA. To establish the ACA, FCA chartered a PCA with which the FLCA consolidated. The ACA now operates with PCA and FLCA subsidiaries.

   The ACA parent-subsidiary structure allows an association to provide a broader range of specialized services to its member-borrowers. This structure also allows earnings made by FLCA subsidiaries of an ACA to remain tax exempt while allowing one-stop borrowing

20. FCA views the ACA and its wholly owned operating subsidiaries as a single entity for most regulatory and examination purposes on the basis of their common ownership and control and cross-guarantee agreements between the entities, with each entity responsible for the debts of the others and their capital and assets combined to absorb any losses.



for both long- and short-term loans. On October 1, 2006, another FLCA affiliated with the FCBT converted its charter with FCA approval to an ACA (again, FCA chartered a PCA with which the FLCA consolidated to form the new ACA). Like its sister institutions, the ACA operates with PCA and FLCA subsidiaries.

5. On October 1, 2006, two ACAs affiliated with the FCBT merged into a single ACA with subsidiaries.

6. Effective December 31, 2006, FCA canceled the charter of the Farm Credit System Financial Assistance Corporation (FAC) upon the request of the FAC board of directors, which certified that the board had discharged all of its responsibilities under sections 6.9 and 6.26 of the Farm Credit Act. At the direction of Congress, FCA chartered FAC on January 11, 1988, to carry out a program to provide capital to FCS institutions that were experiencing financial difficulties. FAC provided capital to certain FCS banks as directed by the Farm Credit System Assistance Board, a separately chartered Federal instrumentality.[21] FAC provided the financial assistance by purchasing preferred stock in FCS banks receiving the aid. FAC funded its activities by issuing $1.261 billion (principal only) of FAC bonds to outside investors. Payment of principal and interest on FAC bonds was guaranteed by the U.S. Treasury. On June 10, 2005, the last remaining bonds matured and were repaid, and all interest advanced by the U.S. Treasury was also repaid. Notice of the FAC charter cancellation was published in the Federal Register at 72 FR 2880, January 23, 2007.

7. The total number of associations decreased from 96 as of December 31, 2005, to 95 as of December 31, 2006. The number of banks remains at five. Figure 9 shows the chartered territory of each FCS bank. Details about specific corporate applications are available on FCA's Web site, **www.fca.gov.**

Regulations and Policies

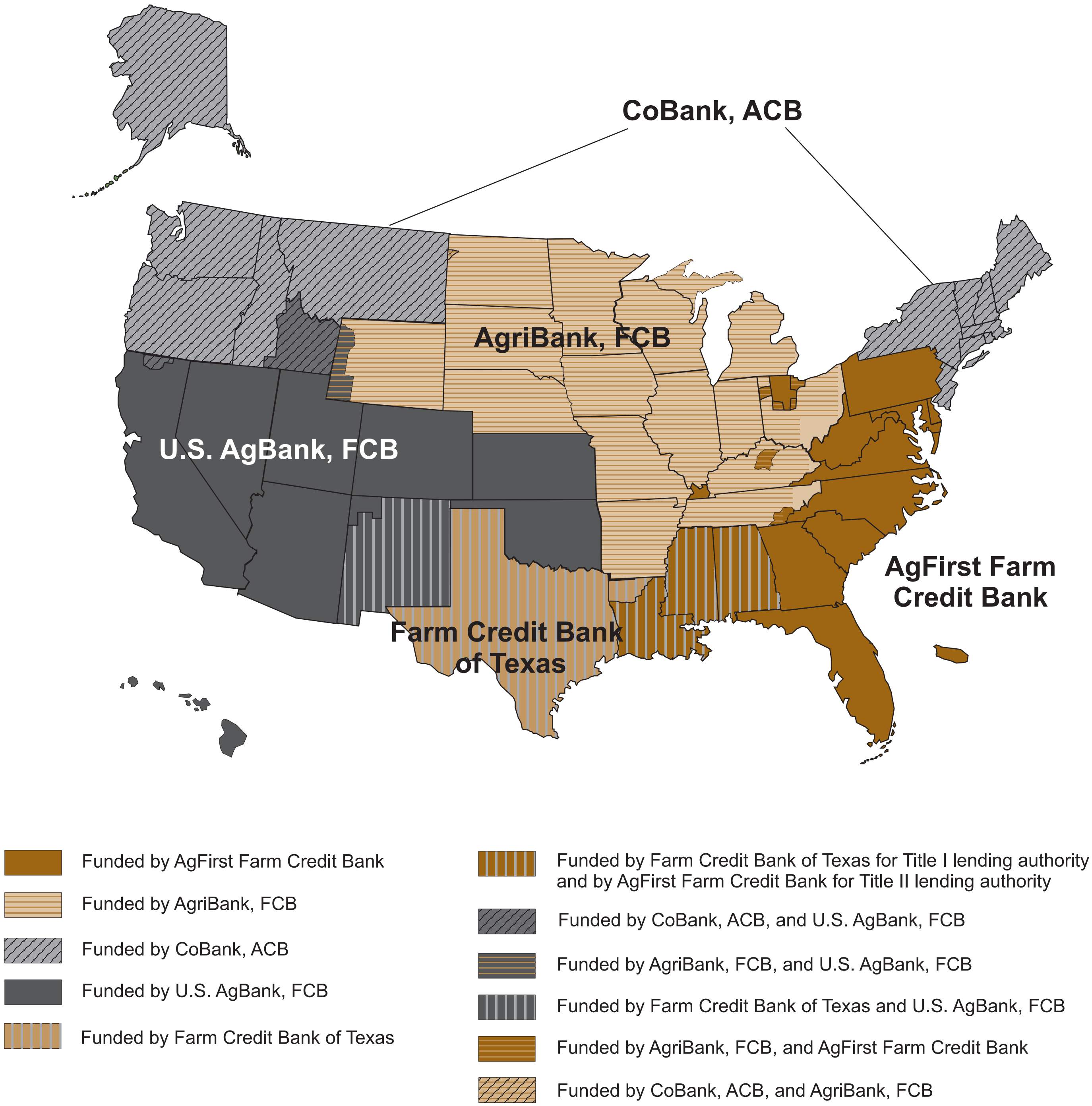
FCA routinely issues regulations, policy statements, and other documents to ensure that the System complies with the law, operates in a safe and sound manner, and efficiently carries out its statutory mission. Changes to the FCA Board policy statement on regulatory development highlight the structure of System institutions: FCS institutions are structured as cooperatives, which makes the System's role as an agricultural lender unique.

The regulatory philosophy of the Agency articulates its commitment to establish a flexible regulatory environment that enables the System to offer high-quality, reasonably priced credit and related services to farmers and ranchers, their cooperatives, rural residents, and other entities on which farming operations depend. This commitment translates into development of balanced, well-reasoned, and flexible regulations in which the Agency makes every effort to ensure that the benefits outweigh the costs. FCA's objectives are (1) to enhance the System's relevance in the marketplace and in rural America while remaining consistent with the law and safety and soundness principles, and (2) to promote participation by member-borrowers in the management, control, and ownership of their GSE institutions.

21. In accordance with section 6.12 of the Act, FCA canceled the charter of the Farm Credit System Assistance Board on December 31, 1992.

Figure 9

Chartered Territories of FCS Banks



Note: CoBank funds five associations in the indicated areas and serves cooperatives nationwide; U.S. AgBank, FCB, funds 29 associations; Farm Credit Bank of Texas funds 20 associations; AgriBank, FCB, funds 18 associations; and AgFirst Farm Credit Bank funds 23 associations. The FCS contains a total of 100 banks and associations.

The following paragraphs describe some of FCA's regulatory efforts in 2006 along with several projects that will remain active in 2007.

Terminations

The FCA Board adopted a final rule in August 2006 to amend and update the regulations that govern the termination of System status. The final rule addressed numerous issues, including costs, timing, communication, voter quorums, tax implications, directors' rights, the equitable treatment of dissenting stockholders, and the basis for FCA disapproval of termination.

Disclosure and Reporting Requirements

The FCA Board adopted a final rule in November 2006 to amend the regulatory disclosure and reporting requirements for FCS institutions. The new rule will improve transparency and therefore enhance shareholders' and investors' understanding of and confidence in the System's operations.

Farmer Mac Risk-Based Capital Stress Test (RBC Model) Revisions

The FCA Board approved a final rule in November 2006 that will affect Farmer Mac's RBC Model submission as of the end of the first quarter of calendar year 2007. The rule makes changes to the model used to calculate Farmer Mac's minimum regulatory capital requirement. The revised RBC Model ensures a more accurate reflection of the risk embedded in the terms and structure of certain program business underwritten by Farmer Mac.

Governance, Conflict of Interest, Compensation Disclosure, and Audit Committee Standards

FCA issued a rule amending its regulations on the governance of FCS institutions to enhance the oversight of management and operations. The rule also augments the disclosure requirements for System institution employees and directors who receive compensation from other entities. In addition, it requires all FCS lending institutions to establish audit committee standards and compensation committees.

Investments in Farmers' Notes

The objective of this reproposed rule was to make credit more available to non-System lenders that make agricultural loans and to enterprises that sell agricultural supplies, equipment, and other capital goods on credit to farmers and ranchers. However, FCA withdrew the proposal because it received limited support from the System and was opposed by many commercial banks, one of the key groups the rule was aimed at benefiting.

Regulatory Burden Review

FCA made several regulatory changes to remove or revise outdated, unnecessary, or burdensome regulations identified in its earlier solicitation for regulatory burden comments.

Lending Programs for Other Credit Needs of Farmers

FCA issued an Examination Bulletin to provide guidance for evaluating programs that System institutions use in meeting other (i.e., nonagricultural) credit needs of farmers, ranchers, and producers or harvesters of aquatic products. The Examination Bulletin clarifies the types of "other-credit-needs financing" that are available to eligible borrowers.

Livestock Risk Protection and Other Insurance Products Offered by the Federal Crop Insurance Corporation

FCA issued an Informational Memorandum to inform System banks and associations that the Agency considers all insurance products that are approved and administered by the Federal Crop Insurance Corporation and the Risk Management Agency to be approved by FCA in the multiple-peril crop insurance-related service listed in 12 Code of Federal Regulations part 618, subpart A.

Qualified Residential Loans

FCA issued an Examination Bulletin to provide clarification and guidance regarding the types of loans that can be considered "qualified residential loans" and regarding proper risk-weighting treatment for regulatory capital purposes.

Zero Percent Capital Risk-Weighting of Guaranteed Portions of Loans Purchased in the Secondary Market

System institutions that purchase instruments guaranteed by U.S. Government agencies may assign those assets to the zero percent risk category as long as the guarantee is "unconditional." FCA issued an Informational Memorandum in October to clarify the attributes of an "unconditional" loan guarantee by a Government agency that would qualify assets for the zero risk-weighting under FCA capital regulations.

Security for Long-Term Loans

FCA issued an Informational Memorandum to clarify the regulations on security requirements for long-term loans. The Informational Memorandum clarifies the following:

- The types of property that satisfy the "agricultural or rural property" collateral requirements

- The amount of additional nonrural, nonagricultural property an institution can take as collateral

Similar-Entity Transactions

FCA issued clarifications on reporting loans that enter the System as transactions to borrowers who are "similar entities" under one title of the statute but are eligible borrowers under other titles.

Electronic Filing of Regulatory Reports

FCA issued an Informational Memorandum to reemphasize the guidance it provided to System institutions in 2002 on the electronic filing of regulatory reports. This communication encourages all FCS institutions to submit various financial reports and other examination reporting information electronically.

Capital Adequacy—Basel Accord

The Agency continues to monitor the development of Basel II and Basel IA proposals on capital adequacy by the other Federal banking agencies. FCA plans to develop and issue an Advance Notice of Proposed Rulemaking to solicit public input on capital adequacy requirements for the System.

Joint and Several Liability, Priority of Claims

FCA is in the process of proposing a rule in response to a regulatory petition from the System's banks asking FCA to modify the priority of claims under their joint and several obligations for debt issuances.

Investments in Rural America

FCA continues to evaluate ways in which System partnerships and investments are increasing the availability of funds through pilot programs that were initiated in 2005. The pilot programs are designed to help stimulate economic growth and development in rural America. System institutions must obtain Agency permission before making investments under these programs. (See pages 40–41 for more information on the approved pilot programs.)

Processing and Marketing

FCA published a proposed rule for public comment in October 2006 to change the ownership requirement that processing and marketing entities must meet to be eligible for System financing. The FCA Board is evaluating public comments on the rule and will make a final determination in 2007.

Loan Syndications and Assignment Markets Study

FCA continues to study loan syndication and assignment markets to determine whether the Agency's applicable regulations should be modified to reflect significant changes in the markets.

Scope of Lending, Moderately Priced Housing, and Related Issues

FCA is reviewing the eligibility and scope of lending regulations to determine if the current requirements are appropriate. FCA will clarify the definition of moderately priced housing to ensure that it is interpreted and applied consistently throughout the System. The Agency also plans to develop a proposed rule for the FCA Board's consideration in 2007 to address the eligibility and scope-of-lending standards.

Funding Activity

The FCS funds its loans with a combination of consolidated Systemwide debt and capital. Debt securities are sold on the System's behalf by the Federal Farm Credit Banks Funding Corporation, the fiscal agent for the five System banks.[22] Through this conduit, funds flow from worldwide capital market investors to agriculture and to rural communities, thereby providing these communities with efficient and expansive access to global resources. The Funding Corporation issues Systemwide debt securities as discount notes, master notes, bonds, and designated bonds. As required by the Farm Credit Act, the FCS must obtain FCA approval for all funding requests.

To participate in the issuance of an FCS debt security, a System bank must maintain, free from any lien or other pledge, specified eligible assets (available collateral) that are at least equal in value to the total amount of its outstanding debt securities. Securities subject to the available collateral requirements include Systemwide debt securities for which the bank is primarily liable, investment bonds, and other debt securities, which the bank may have issued individually. As a safe and sound practice, FCA regulations require the five System banks to maintain a net collateral ratio (primarily assets divided by liabilities) of not less than 103 percent. Therefore, all of the banks manage their operations to achieve net collateral ratios that are higher than the required minimum.

22. The primary function of the Funding Corporation, whose headquarters are in Jersey City, New Jersey, is to issue, market, and handle debt securities on behalf of the System's five banks. In addition, the Funding Corporation assists the banks with a variety of asset/liability management and specialized funding activities. The Funding Corporation is responsible for financial disclosure and the release of public information concerning the financial condition and performance of the System as a whole.

As of December 31, 2006, System banks collectively had collateral of $144.5 billion, compared with $136.1 billion of Systemwide debt securities and other obligations. The overall net collateral ratio equaled 105.6 percent, with 104.8 percent the lowest ratio for any single bank.

After the System refinanced substantial portions of its callable debt at significantly lower interest rates in late 2001 and 2002, the volume of new issuances diminished, although it recently has been trending upward. For the 12 months ended December 31, 2006, the System issued $387 billion in insured debt securities, compared with $288 billion for the prior 12 months and $310 billion and $356 billion in 2003 and 2004, respectively.[23] An increased use of discount notes, growth in total assets, and the volume of maturing debt accounted for most of the increase in 2006.

The FCS continued to extend its debt maturities in the inverted yield curve environment that predominated in 2006. The System's weighted-average remaining maturity for all outstanding insured debt increased to 2.9 years as of December 31, 2006, compared with 2.7 years as of December 31, 2005, and 2.5 years as of December 31, 2004. The weighted-average interest rates for the insured debt increased from 4.15 percent as of December 31, 2005, to 4.95 percent as of December 31, 2006.

At year-end 2006, outstanding Systemwide insured debt was $133.6 billion, up from $112.7 billion a year earlier, representing an 18.5 percent increase. The $20.9 billion increase in outstanding debt funded the $17.1 billion, or 16.2 percent, increase in gross loans outstanding, with the balance going primarily to fund investments for liquidity and other purposes.[24]

Mission-Related Investments

FCA is committed to helping ensure a dependable and affordable flow of funds to agriculture and to rural areas so that farmers, ranchers, and rural communities can flourish. Agriculture and rural America face new and unique challenges that require innovative solutions. Since its inception in 1916, the FCS has been a key partner with agriculture and with rural areas, as they are very much interdependent. Investments in rural communities can help create infrastructure improvements that promote the communities' economic vitality and development for current and future generations of American farmers. These farming families will increasingly benefit from these off-farm income opportunities. Investments in rural communities also play an important role in attracting and retaining YBS farmers and other rural entrepreneurs who provide essential services for agricultural production.

FCA's current regulations allow Farm Credit institutions to make certain mission-related investments. Examples include investments in farmers' notes; certain debt obligations issued or guaranteed by Federal agencies or State or local municipalities for rural utilities and other economic development; and agricultural mortgage-backed securities (AMBS), which Farmer Mac issues or guarantees. As of December 31, 2006, the mission-related investment securities held under these regulatory authorities totaled $1.9 billion, including $1.4 billion in AMBS. In addition, in 2005 FCA approved Farm Credit institution holdings of investments in successor-in-interest contracts created as a result of the Tobacco Transition Payment Program.[25] As of December 31, 2006, investments in successor-in-interest contracts totaled $804.1 million.

23. Payment of principal and interest on Systemwide debt securities is insured by FCSIC's Farm Credit Insurance Fund to the extent provided in the Farm Credit Act. Some FCS debt ($836 million outstanding as of December 31, 2006) was issued by individual banks of the FCS. These individual banks are solely liable for the principal payments on this uninsured debt.

24. System banks, as part of an ongoing effort to ensure their collective ability to meet their obligations under their mutual agreements concerning joint and several liability on Systemwide debt, adopted a Common Liquidity Standard that requires each bank to maintain a minimum of 90 days of liquidity to guard against a possible interruption in its access to the capital markets.

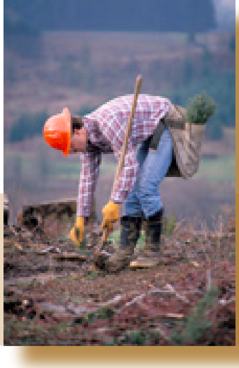
25. On October 22, 2004, Congress enacted the Fair and Equitable Tobacco Reform Act of 2004 as part of the American Jobs Creation Act of 2004. The Tobacco Act repeals the Federal tobacco price support and quota programs, provides payments to tobacco quota owners and producers for the elimination of the quota, and includes a provision that allows the quota holders to assign to a financial institution the right to receive contract payments under a contract with the Secretary of Agriculture. FCA determined that FCS institutions meet the Tobacco Act's financial institution criteria and are therefore eligible to participate in the Tobacco Transition Payment Program.

The Agency realizes, however, that these investment vehicles may no longer be sufficient to meet the growing and changing demands of agriculture and of rural communities for dependable, affordable, and flexible financing in the 21st century. In particular, FCA recognizes that rural areas have an essential and growing need for additional sources of equity capital to support economic growth and infrastructure improvements. In response, FCA issued guidance that gave System institutions a provisional opportunity to make additional mission-related investments through pilot programs supporting investments in rural America (see FCA Informational Memorandum dated January 11, 2005, on Investments in Rural America—Pilot Investment Programs, which is available on the FCA Web site at **www.fca.gov**).

The pilot programs are intended to strengthen the System's mission to provide for an adequate and flexible flow of funds, under specified conditions, to agriculture and to rural communities across the country. Further, the pilot investment programs are intended to provide FCS institutions greater flexibility to partner with Government agencies and other agricultural and rural lenders in fulfilling their mission objectives. Through these pilot investment programs, FCA is looking to gain a better understanding of the diverse financing needs of agriculture and rural communities and of how FCS institution investments can help increase the availability and efficiency of funds to these markets.

FCA has placed a significant number of controls on these pilot investment programs to ensure their legal sufficiency, safety and soundness, and consistency with the FCS mission. These controls include participation criteria to ensure that only well-managed and strongly capitalized institutions may make investments in rural America through pilot programs. The controls also specify the investment purposes that the programs should fulfill; impose program and risk limits; require prudent investment management standards; and limit the pilot period to one to three years. These programs are also subject to special examination and reporting. During 2006, FCA approved several pilot investment programs, listed below, which authorized individual institutions or the affiliated associations of a funding bank to purchase and hold investments in rural America.

Rural Housing Mortgage Securities—In March 2006, FCA approved two requests from FCBs to purchase and hold rural housing mortgage securities (RHMS) under a three-year pilot program. This request was similar to a request approved in May 2005. RHMS must be fully guaranteed by a Government agency or another GSE. The rural housing loans backing the RHMS must be conforming first-lien residential mortgage loans originated by non-System lenders in "rural areas" (as defined by the Farm Security and Rural Investment Act of 2002). These pilot programs are intended to provide additional liquidity for rural housing loans by providing economic incentives to lenders to create RHMS



for sale in the secondary market. In turn, these programs will create more cost-effective credit for rural homeowners. As of December 31, 2006, the investment securities of the FCBs participating in this program included $1.26 billion in RHMS classified as held to maturity.

Agriculture and Rural Community Bonds and Securities—During 2006, the FCA Board authorized eight pilot programs focusing on investments that provide funding for economic development, infrastructure, essential community facilities, and revitalization and stabilization projects that are necessary to maintain a vibrant American agriculture and strong rural communities. The pilot programs authorized in 2006 were similar to the four pilot programs approved during 2005. These programs authorized the remaining System banks and associations to participate in a designated pilot program under specific conditions. A key objective of these pilot programs is to stimulate FCS partnerships and alliances with other agricultural and rural lenders that will increase the availability of cost-effective funds to agriculture and to rural communities. All pilot programs include requirements to meet specific legal and safety and soundness criteria. As of December 31, 2006, the investments in rural America authorized through bond pilot programs totaled $76.8 million.

Equity Investments—FCA also approved several mission-related equity investments in 2006, including an investment in a starter farmer program for beginning farmers and producers as well as investments in regional venture capital funds focusing on rural areas. Also, several FCS institutions had the opportunity to invest in rural business investment companies (RBICs). The Farm Security and Rural Investment Act of 2002 established the Rural Business Investment Program to promote economic development and create wealth and job opportunities in rural areas by creating and licensing RBICs.[26] As of December 31, 2006, the aggregate amount of mission-related equity investments outstanding totaled $757,000.

26. The Farm Security and Rural Investment Act of 2002 authorizes any FCS institution to establish and invest in RBICs, provided that such investments are not greater than 5 percent of the capital and surplus of the FCS institution. Further, if FCS institutions (alone or collectively) hold more than 15 percent of the shares of an RBIC, the RBIC may not provide equity investments or financial assistance to entities that are not otherwise eligible to receive financing from the FCS under the Farm Credit Act.

Maintaining a Dependable Source of Credit for Farmers and Ranchers

As federally chartered agricultural lending cooperatives, the institutions of the FCS are limited-purpose lenders exposed to risk in making loans to benefit their borrower-stockholders and meet their public mission. As a GSE, the FCS benefits from preferred access to the capital markets, but the Federal Government does not subsidize or back it directly.

For FCS institutions to maintain their presence in the marketplace as a dependable source of credit and financially related services for rural America, they must operate profitably and appropriately manage and control risk. That is why FCA deploys examination and supervisory resources based on systemic risk in the FCS and on specific risk in each institution. This "risk-based" examination and supervisory program requires examiners to determine how existing or emerging issues facing an institution or the agriculture industry may affect the nature and extent of risk in that institution. The risk-based approach helps to ensure that FCA provides the most effective and efficient regulatory oversight to the System.

To evaluate whether an institution is meeting its public mission, examiners determine whether it is operating in compliance with applicable laws and regulations and whether it is responsive to the credit needs of all types of agricultural producers and cooperatives that are eligible for credit. As part of their mission, FCS associations are obligated to establish programs that respond to the needs of YBS farmers and ranchers for credit and related services.

Conducting a Risk-Based Examination and Oversight Program

FCA's risk-based examination and oversight program is designed to maximize its effectiveness and efficiency while strategically addressing FCS risk. During the establishment and implementation of oversight and examination plans for each FCS institution, FCA allocates examination resources to matters of highest priority and potential risk within individual institutions and the System as a whole. This differential approach considers the ability of FCS institutions to identify and manage both institution-specific and systemic risks. When institutions are either unable or unwilling to address unsafe and unsound practices or to comply with applicable laws and regulations, FCA's examination efforts are supported by appropriate supervisory action.

Through its oversight practices, the Agency ensures that FCS institutions have the programs, policies, procedures, and controls to effectively identify and manage risks and that FCA policies and regulations are effective, clear, and minimally intrusive. For example, FCA regulations require FCS institutions to have effective loan underwriting and loan administration processes. Agency examiners test those FCS processes, and Agency analysts compare banking industry trends with System results to determine relative performance. FCA also has specific regulations requiring FCS institutions to maintain strong asset-liability management capabilities. Over the last 15 years, FCA has developed a comprehensive regulatory and supervisory framework for ensuring System safety and soundness. FCS institutions, on their own and in response to FCA efforts, have developed appropriate risk management systems.

Meeting Statutory Examination Requirements

The Farm Credit Act requires FCA to examine each FCS institution at least once every 18 months. In addition to meeting this minimum requirement, the Agency has embraced an ongoing examination approach in which it conducts ongoing monitoring and interim examination activities as risk and circumstances warrant in each institution. FCA then integrates identified systemic risks into its national oversight strategies to mitigate such risks Systemwide. This approach provides differential risk-driven examination activities for all institutions. As of December 31, 2006, FCA was conducting oversight and examination activities for 95 FCS direct-lender associations; four FCBs; one ACB; five service corporations and two special-purpose entities; Farmer Mac; and the National Cooperative Bank, which is not an FCS institution.[27] FCA's examination approach emphasizes the importance of proactive, constructive communication with regulated institutions through a combination of communication methods.

SBA and USDA continued to use FCA's examiner expertise in 2006. SBA contracted with FCA to conduct examinations of financial companies licensed by SBA to make guaranteed loans to small businesses. USDA contracted with FCA to conduct examinations of financial companies authorized by USDA to make guaranteed loans under USDA's Business and Industry Guaranteed Loan program. FCA examiners also completed reviews of the Business and Industry Guaranteed Loan program operations at selected USDA State offices. The Agency issued 13 Reports of Examination as part of these contracted activities during 2006. While the safety and soundness of the FCS remains FCA's principal focus and responsibility, it finds that assisting SBA and USDA broadens examiners' skills while increasing their job satisfaction and retention. Moreover, reimbursable fees earned from SBA and USDA reduce assessments on FCS institutions.

Identifying and Responding to Potential Threats to Safety and Soundness

Because of the evolving dynamics and risks in the agricultural and financial industries, FCA must ensure that FCS institutions have the culture, policies, procedures, and management controls to effectively identify and manage risks. To be fully effective in meeting this challenge, the Agency has processes for evaluating and responding to systemic risks that can affect an institution, a group of institutions, the System as a whole, agriculture, and the financial industry.

On the basis of risk assessment and analysis activities to date, FCA highlights the following four areas within its examination program for FCS institutions:

1. Internal control environment and accuracy and completeness of disclosures

2. Governance, with special attention to cooperative principles, capital management, and compensation practices

3. Risk management systems, especially processes related to counterparty risk and collateral risk

4. Mission accomplishment, including investments in rural America, lending to YBS farmers and ranchers, and diversity

Measuring the System's Safety and Soundness

The Financial Institution Rating System (FIRS) is a key risk rating methodology used by FCA to indicate the safety and soundness threats in each institution. Similar to the systems used by other Federal financial regulators, it is a "CAMELS"-based system, with component ratings for capital adequacy, asset quality, management performance, earnings, liquidity, and sensitivity to interest rate risk all factoring into an overall composite rating. The FIRS provides a general framework for evaluating and assimilating all significant financial, asset quality, and management factors. It assigns component and composite ratings to each institution on a scale of 1 to 5. A composite rating of 1 indicates an institution is sound in every respect. A rating of 3 means an institution displays a combination of financial, management, or compliance weaknesses ranging from moderately severe to unsatisfactory. A 5 rating represents an extremely high, immediate, or near-term probability of failure.[28]

27. The National Consumer Cooperative Bank Act of 1978, as amended, provides for FCA to examine and report on the condition of the National Cooperative Bank. Since the passage of this law, FCA has conducted safety and soundness examinations of the National Cooperative Bank and issued reports to the bank's board.
28. See the Glossary for a complete description of the FIRS ratings.

Through its ongoing monitoring and oversight programs, FCA examiners continually evaluate institutional risk and regularly review and update FIRS ratings to reflect current risks and conditions. The Agency maintains both quantitative and qualitative benchmarks as general examiner guidelines to facilitate consistent application of the FIRS process. FCA discloses the FIRS composite and component ratings to the institution's board to provide perspective on relative safety and soundness. Examination reports and other communication also provide the institution board with an assessment of management's performance, the quality of assets, and the financial condition and performance of the institution.

FIRS ratings continued to reflect strong FCS financial condition and performance during 2006. As shown in figure 10, FIRS ratings have trended upward for several years. At December 31, 2006, 82 FCS institutions were rated 1, 17 were rated 2, and 1 was rated 3. Notably, there were no 4- or 5-rated institutions (data reflect only banks and associations). Such ratings reflect a financially safe and sound FCS. The overall financial strength maintained by the System reduces the risk to investors in FCS debt, to FCSIC, and to FCS institution stockholders.

In addition to using the FIRS process, FCA examiners began using a new set of risk assessment criteria in 2006. The risk areas are credit, interest rate, liquidity, operational, compliance, strategic, and reputation. This tool is used, along with FIRS ratings and other information, to assist the Office of Examination in allocating resources in the most risk-based manner.

Providing Differential Supervision and Enforcement

FCA uses a risk-based supervisory and enforcement program to differentially respond to the risks and particular oversight needs of FCS institutions. Risks are inherent in lending, and managing risks associated with a single sector of the economy, such as agriculture, presents an additional challenge for FCS lenders. If FCA discovers unwarranted risks, it takes differential and corresponding supervisory action to ensure that the identified risks are appropriately mitigated. Corrective actions include reducing risk exposures, increasing capital (i.e., risk-bearing ability), and strengthening risk management.

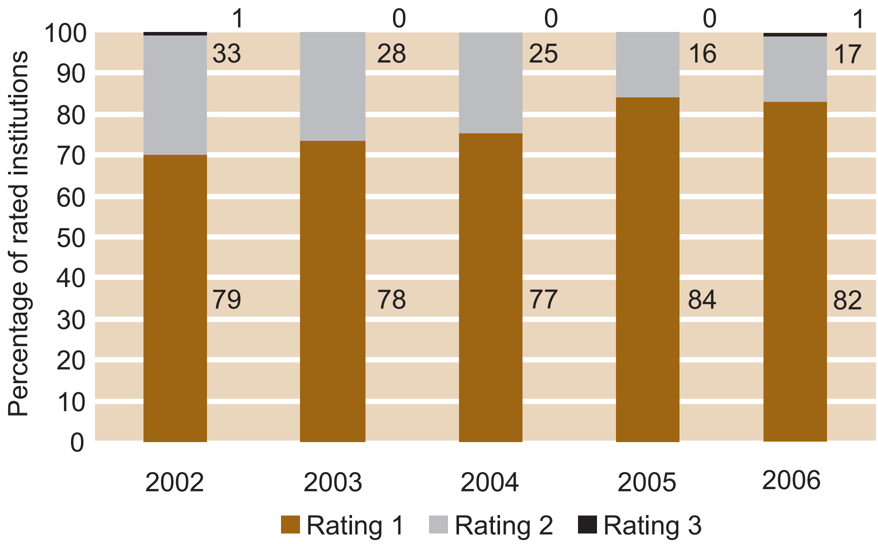
The Agency uses a three-tiered supervision program: normal supervision, special supervision, and enforcement actions. Institutions under normal supervision are generally performing in a safe and sound manner and operating in compliance with applicable laws and regulations. These institutions are able to correct identified weaknesses in the normal course of business. For those institutions displaying more serious or protracted weaknesses, FCA shifts from normal to special supervision, and its examination oversight increases accordingly. Under special supervision, institutions are given clear and firm regulatory guidance to address identified weaknesses, and the institution is allowed time to correct the problems. If less formal supervisory approaches have not been or are not likely to be successful, FCA will use its formal enforcement authorities to ensure that the operations of FCS institutions are safe and sound and are in compliance with laws and regulations. Enforcement action may be required for a number of reasons, including (1) a situation that threatens an institution's financial stability; (2) uncorrected safety and soundness problems or violations of laws or regulations, and (3) the inability or unwillingness of the institution's board and management to correct identified problems.

FCA's enforcement authorities include the power to enter into formal agreements; to issue orders to cease and desist; to levy civil money penalties; and to suspend or remove officers, directors, and other persons. If an enforcement action is taken, the FCS institution must operate under the Agency's enforcement program and report back to FCA. FCA's examiners oversee the institution's performance to ensure compliance with the enforcement action. It has not been necessary for FCA to use its formal enforcement authorities during the past eight years.

Figure 10

Financial Institution Rating System (FIRS) Composite Ratings for the FCS, 2002–2006

As of December 31



Sources: Farm Credit Administration Reports of Examination.

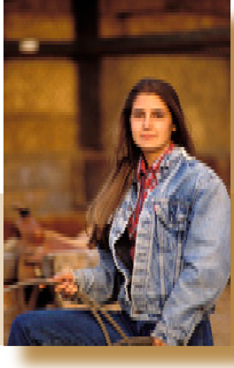
Note: FIRS ratings are based on capital, asset quality, management performance (including the board of directors), earnings, liquidity, and sensitivity to interest rate risk. Ratings range from 1 (a sound institution) to 5 (an institution that is likely to fail).

Working with Financially Stressed Borrowers

Agriculture involves significant inherent risks and volatility because of many factors, including adverse weather, changes in Government programs, international trade issues, fluctuations in commodity prices, and crop and livestock diseases. Such conditions can make it difficult for borrowers to repay loans. Unlike other lenders, the System (under provisions of the Farm Credit Act) provides borrowers certain rights when they apply for loans and when they have difficulty repaying loans. For example, the Act requires FCS institutions to consider restructuring an agricultural loan before initiating foreclosure. It also provides borrowers an opportunity to seek review of certain credit and restructuring decisions. If a loan is foreclosed on, the Farm Credit Act also provides borrowers the opportunity to buy back their property at the fair market value.

FCA enforces, and examines for compliance with, the borrower rights provisions of the Farm Credit Act. It also receives and reviews complaints from borrowers regarding their borrower rights. Through these efforts, FCA ensures compliance with the law and helps FCS institutions continue to provide sound and constructive credit and related services to eligible farmers and ranchers.

Condition of Farmer Mac



Farmer Mac is a stockholder-owned, federally chartered instrumentality of the United States. It was created in 1988 to establish a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac conducts its business primarily through three core programs: Farmer Mac I, Farmer Mac II, and the AgVantage program. Under Farmer Mac I, Farmer Mac purchases, or commits to purchase, qualified loans or obligations backed by qualified loans that are not guaranteed by any instrumentality or agency of the United States. Under Farmer Mac II, Farmer Mac purchases the guaranteed portions of farm ownership and farm operating loans, rural business and community development loans, and certain other loans guaranteed by USDA. Under the AgVantage program, Farmer Mac buys or guarantees securities issued by agricultural mortgage lenders.

Farmer Mac is regulated by FCA through the Office of Secondary Market Oversight (OSMO), which was established in 1992 by Public Law 102-237. This office provides for the examination and general supervision of Farmer Mac's safe and sound performance of its powers, functions, and duties. The statute requires that OSMO constitute a separate office that reports directly to the FCA Board and that its activities, to the extent practicable, be carried out by individuals not responsible for supervising the banks and associations of the FCS.

Through this office, the Agency performs annual examinations based on capital adequacy, asset quality, management performance, earnings, liquidity, and sensitivity to interest rate risk; supervises Farmer Mac's operations; and evaluates its safety and soundness and mission achievement. The work of OSMO includes the ongoing review of Farmer Mac's compliance with the risk-based capital regulations and the ongoing supervision of its operations and condition throughout the year. Table 8 summarizes Farmer Mac's balance sheets at the end of the year for 2001 to 2006. FCA notes that certain prior-year amounts will differ from previously published FCA Annual Reports, owing to Farmer Mac's financial restatement for several reporting periods in late 2006. The restatement was required as a result of Farmer Mac's determination that it was not appropriately applying hedge accounting in accordance with Statement of Financial Accounting Standard 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). Farmer Mac completed the financial restatements during the fourth quarter of 2006 and eliminated the use of hedge accounting.

Capital

By statutory design, secondary market GSEs like Farmer Mac operate with lower statutory capital margins than do primary market lenders. Accordingly, monitoring the capital levels of Farmer Mac is a central component of FCA's oversight programs.

On December 31, 2006, Farmer Mac's net worth (i.e., equity capital determined using generally accepted accounting principles [GAAP]) was $248.5 million, compared with $246.0 million a year earlier. Net worth was 5.0 percent of on-balance-sheet assets as of December 31, 2006. When Farmer Mac's off-balance-sheet program assets (i.e., guarantee obligations) are added to total on-balance-sheet assets, capital coverage is 2.5 percent. In August 2004, Farmer Mac established a new common stock dividend policy and a stock repurchase program, both of which continued through 2006. While these policies affect outstanding common equity and number of shares, Farmer Mac is expected to continue to meet statutory and regulatory capital requirements.

Farmer Mac's core capital (the sum of the par value of outstanding common stock, the par value of outstanding preferred stock, paid-in capital, and retained earnings) remained above the statutory minimum requirement, and its regulatory capital (core capital plus allowance for losses) exceeded the required amount of regulatory capital as determined by the Risk-Based Capital Stress Test (RBC Model). Farmer Mac's core capital continued its upward trend and, as

Table 8

Farmer Mac Condensed Balance Sheets, 2001–2006

As of December 31
Dollars in Millions

	2001 Restated	2002 Restated	2003 Restated	2004 Restated	2005 Restated	2006	Growth rate 2005–2006
Total assets	3,413.6	4,222.0	4,299.7	3,847.4	4,341.4	4,953.7	14.1%
Total liabilities	3,284.6	4,039.3	4,089.2	3,612.2	4,095.4	4,705.2	14.9%
Net worth or equity capital	129.0	182.7	210.5	235.2	246.0	248.5	1.0%

Sources: Farmer Mac's Securities and Exchange Commission Form 10-Ks.

of December 31, 2006, totaled $243.5 million, exceeding the statutory minimum capital requirement[29] of $174.5 million by $69.0 million. Farmer Mac's regulatory capital totaled $248.1 million as of December 31, 2006, exceeding the regulatory risk-based capital requirement of $42.9 million by $205.2 million. Regulatory capital was 3.9 percent of total Farmer Mac I program volume (on and off the balance sheet). Table 9 offers a historical perspective on capital and capital requirements for 2004 to 2006.

In 2006, FCA published a final rule revising the risk-based capital regulations that originally became effective in 2002. The revisions updated the RBC Model in response to changing financial markets, new business practices, and the evolution of the loan portfolio at Farmer Mac, as well as continued development of best industry practices among leading financial institutions. During 2007, FCA plans to issue a new proposed rule revising the risk-based capital regulations to address off-balance-sheet AgVantage securities and other items.

In addition to supporting program assets, Farmer Mac's capital supports nonprogram investment needs. Nonprogram investments provide liquidity in the event of a short-term disruption in the capital markets that prevents Farmer Mac from issuing new debt. Nonprogram investments are investment securities, cash, and cash equivalents. FCA regulations governing Farmer Mac's nonprogram investments and liquidity became effective in the third quarter of 2005. Farmer Mac has been in compliance with those regulations since their publication. Farmer Mac's policy is to maintain nonprogram investments at levels that provide liquidity for a minimum of 60 days of maturing obligations, with a target of 90 days. Farmer Mac was in compliance with its liquidity policy throughout the year.

Program Activity

Farmer Mac's total program activity increased significantly over the past year to $7.2 billion on December 31, 2006, from $5.3 billion a year earlier (see figure 11). Farmer Mac attributes the increase in program activity to successful implementation of its marketing strategies based on large, higher-quality asset transactions with commensurately lower compensation for the assumption of credit risk and administrative costs.

29. The statute requires minimum capital coverage of 2.75 percent for on-balance-sheet assets and of 0.75 percent for off-balance-sheet obligations.

Table 9

Farmer Mac Capital Positions, 2004–2006

As of December 31
Dollars in Millions

	2004 Restated	2005 Restated	2006
GAAP equity	235.2	246.0	248.5
Core capital	204.0	230.8	243.5
Regulatory capital	NA	239.4	248.1
Statutory requirement	128.9	142.5	174.5
Regulatory requirement	NA	29.5	42.9
Excess over statutory or regulatory requirement[a]	75.0	88.3	69.0
Capital margin excess > minimum	58.2%	62.0%	39.6%

Sources: Farmer Mac's Securities and Exchange Commission Form 10-Ks.

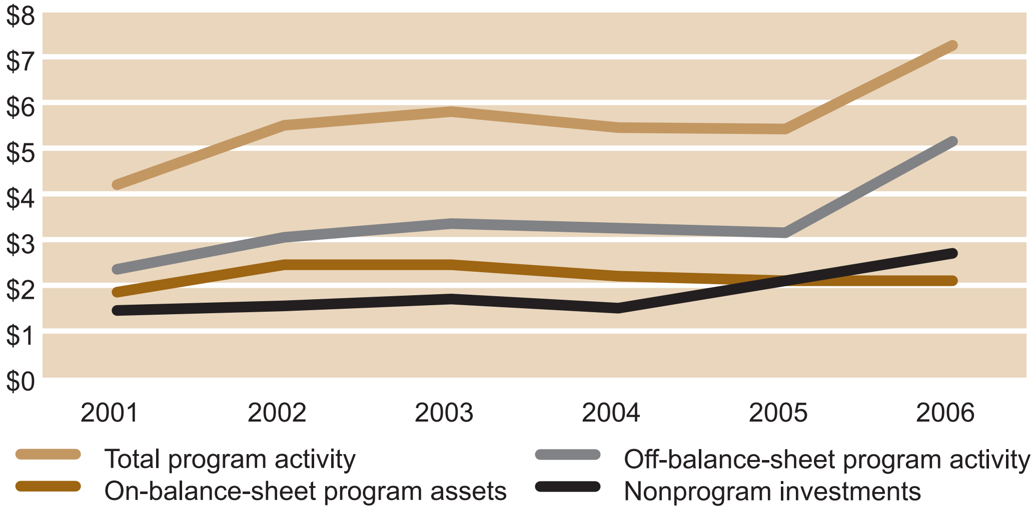
NA=not available (because line items have not been restated for prior periods)
>=greater than

a. Farmer Mac is required to hold capital at the higher of the statutory minimum capital requirement or the amount required by FCA regulations as determined by the Risk-Based Capital Stress Test.

Figure 11

Farmer Mac Program Activity and Nonprogram Investment Trends, 2001–2006

As of December 31
Dollars in Billions



Sources: Farmer Mac's Annual Reports on Securities and Exchange Commission Form 10-Ks.

A large portion of Farmer Mac's recent program growth was driven by off-balance-sheet AgVantage program activity with the Metropolitan Life Insurance Company. Off-balance-sheet AgVantage transactions are Farmer Mac guaranteed general obligations of the issuer collateralized by eligible agricultural mortgage loans. Farmer Mac's Long-Term Standby Purchase Commitment product is another primary source of growth in program activity. Under Farmer Mac Standbys, a financial institution pays an annual fee in return for Farmer Mac's commitment to purchase loans in a specific pool under specified conditions at the option of the institution. The Standby product grew significantly between its introduction in 1999 and 2006. Lenders may elect to exchange Standby commitments for Farmer Mac guaranteed securities. Such exchanges occurred for the first time in 2006 and totaled more than $1 billion. After these exchanges, Standbys were down 15 percent in 2006 to $2 billion.

Off-balance-sheet program activity consists of Standbys, certain AgVantage securities, and AMBS sold to investors. At the end of December 2006, 71.2 percent of program activity consisted of off-balance-sheet obligations[30] (see figure 12).

Asset Quality

On December 31, 2006, the portion of the Farmer Mac I program portfolio that was nonperforming was $39.2 million, or 0.82 percent, of the principal balance of all loans purchased, guaranteed, or committed to be purchased since enactment of the Farm Credit System Reform Act of 1996 (1996 Act).[31] This compares with $48.8 million, or 1.11 percent, on December 31, 2005. Nonperforming assets are (1) those that are 90 or more days past due, in foreclosure, or in bankruptcy, or (2) real estate property acquired by Farmer Mac through foreclosure. Real estate owned as of December 31, 2006, was $2.1 million, down from $3.5 million a year earlier. The total dollar amount and percentage of nonperforming assets continued to decline in 2006. As of year-end 2006, Farmer Mac estimated that $1.5 billion (31 percent) of loans and loans underlying Standbys and guaranteed securities were in their peak default years. As that percentage is slightly higher than it was in 2004 and 2005, Farmer Mac noted that delinquencies could increase, followed potentially by higher charge-offs.

On December 31, 2006, Farmer Mac's allowance for losses totaled $4.6 million, compared with $8.7 million on December 31, 2005. Farmer Mac attributes the decrease in the allowance for losses primarily to reversals in the provision for loan losses recognized during the year. Figure 13 shows the level of Farmer Mac's allowance and nonperforming assets relative to outstanding post-1996 Act program volume.

Earnings

Net income computed according to GAAP that was available to common stockholders for the year ended December 31, 2006, was $29.8 million, down $17.3 million (36.7 percent) from restated 2005 net income available to common stockholders. This significant decrease in earnings is attributable to a reduced net interest income, a reduced level of net reversals to the allowance for loan losses, and reduced mark-to-market net gains on derivatives and trading assets. Core earnings[32] for 2006 were $25.9 million, a decrease of 9.7 percent from 2005. Net interest income, which excludes guarantee fee income, was $38.3 million in 2006, down 24.4 percent from 2005 restated net interest income. Guarantee fee income, at $21.8 million, was 11.6 percent

30. This amount will not tie precisely to AMBS, Standbys, and AgVantage program activity in figure 11 because of a small portion of on-balance-sheet AgVantage activity.

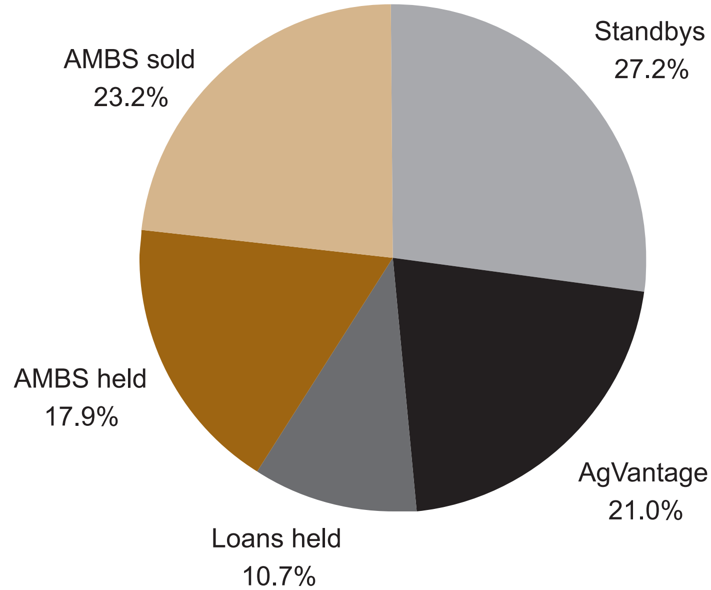
31. Farmer Mac assumes 100 percent of the credit risk on post-1996 Act loans, whereas pre-1996 Act loans are supported by mandatory 10 percent subordinated interests, which mitigate Farmer Mac's exposure. For that reason, pre-1996 Act loans are excluded from analysis for comparison purposes. These amounts also exclude loans underlying AgVantage guaranteed securities, whose risk is significantly mitigated by the general obligation of the issuer.

32. Core earnings is a non-GAAP measure of financial results that excludes the effects of certain unrealized gains and losses and nonrecurring items. Farmer Mac began reporting core earnings to present an alternative measure of earnings performance. The components included in core earnings calculations are at the reporting entity's discretion.

Figure 12

Farmer Mac Total Program Activity

As of December 31



Source: Farmer Mac's Annual Report on Securities and Exchange Commission Form 10-K.

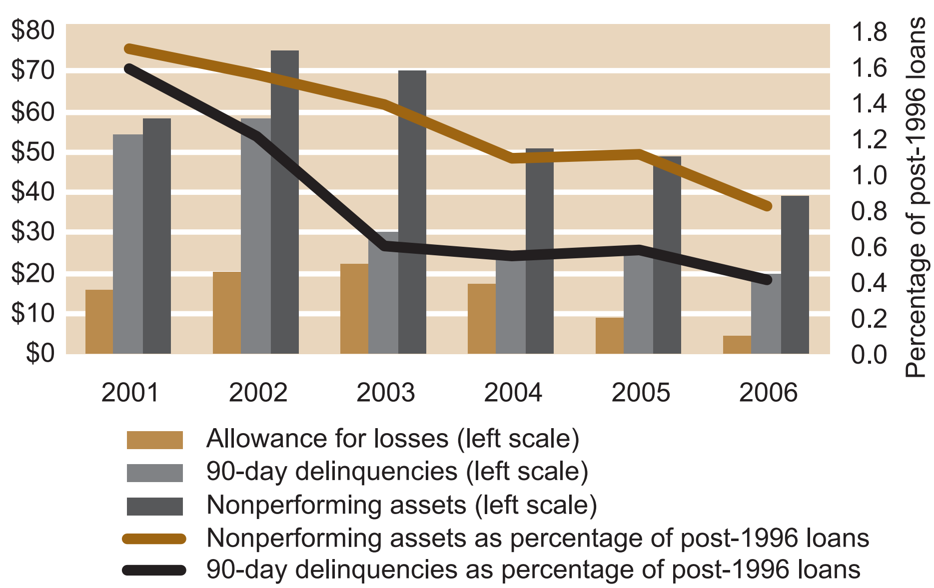
AMBS=agricultural mortgage-backed securities

Figure 13

Allowance, Nonperforming Assets, and Delinquency Trends, 2001–2006

As of December 31

Dollars in Billions



Sources: Farmer Mac's Annual Reports on Securities and Exchange Commission Form 10-Ks.

higher in 2006 than in 2005. The increase reflects the significant growth in the average balance of outstanding guaranteed securities. However, fee income growth did not keep pace with guaranteed securities because of new marketing strategies referenced in the "Program Activity" section above. Nonprogram investments accounted for an estimated 51 percent of interest income for 2006, up from 37 percent for 2005. The increase resulted from (1) a large increase in the average balance of nonprogram investments and (2) a rise in the average rates earned on the investments. Table 10 shows a six-year trend in key income components. However, Farmer Mac experienced a reduction in its net interest yield because its cost of funds increased more than the increased yields it realized on interest-bearing assets.

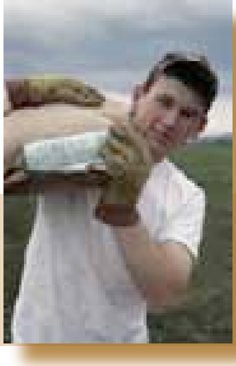
Table 10

Farmer Mac Condensed Statements of Operations, 2001–2006

As of December 31
Dollars in Millions

	2001 Restated	2002 Restated	2003 Restated	2004 Restated	2005 Restated	2006	Growth rate 2005–2006
Total revenues	18.7	-16.9	76.3	77.3	83.9	67.8	-19.2%
Total expenses	16.6	6.1	37.3	38.3	36.8	38.0	3.2%
Net income available to shareholders	2.1	-23.0	39.0	39.0	47.0	29.8	-36.7%
Core earnings	17.1	22.9	23.0	27.4	28.7	25.9	-9.7%

Sources: Farmer Mac's Annual Reports on Securities and Exchange Commission Form 10-Ks.



Challenges Facing Agriculture and the FCS

The FCS enjoyed solid earnings and capital growth in 2006. However, several challenges, both domestic and foreign, could affect the System's long-term ability to profitably finance the agricultural industry. The System's capacity to bear risk, absorb losses, and sustain operations is at an all-time high as a result of its high capital levels. But a number of risks and uncertainties that are largely beyond the control of the System could introduce both positive and negative outcomes for FCS institutions.

With the sudden boom in ethanol production and the accompanying surge in commodity prices, especially for corn, the overall picture for farm income and wealth is improving. Many analysts are very optimistic about the future of the agricultural industry, believing that the drive for greater independence from foreign fuel sources will result in an era of unprecedented prosperity for rural America. At the same time, agriculture is moving into uncharted waters, where the commodity markets and land values will be subject to a new source of volatility—the price of crude oil. Riding oil's coattails produces an interesting paradox for many grain producers: they want oil prices to stay high because higher prices will stimulate ethanol production and boost the price of corn and the value of land. If the price of oil falls below $50 per barrel, however, and the ethanol boom deflates, the ride could become unpleasant for some highly leveraged borrowers, who may have difficulty making their loan payments.

The uppermost question for policymakers and farmers concerns the ethanol industry's overall profitability. Will the renewable fuels phenomenon be a long-term, self-sustaining development or a brief, speculative adventure? Future oil prices and the pace of new ethanol construction probably hold the answer for the short term, but for the long term, the answer rests with future energy policies, the development of renewable fuels, the 2007 farm bill, future trade agreements, and a whole host of other variables. In the following paragraphs, FCA identifies some of the immediate and longer-term challenges facing the System. FCA will continue to use a strong surveillance system in its regulatory and examination activities to monitor and address these challenges.

Overall Prospects in the General Economy

The following points indicate that the economy should perform well in 2007:

1. So far, the economy seems to have weathered the housing-induced slowdown with limited side effects. More jobs and higher wages will boost consumer spending this year; factory output and business capital spending are expected to strengthen from the temporary adjustments made in the second half of 2006; and the export sector is expanding. Offsetting this optimism is a growing concern about subprime mortgage default rates and the extent to which they may drag down economic growth. On balance, real gross domestic product (GDP) may range between 2.5 and 3.0 percent in 2007 and 2008, somewhat below the long-term sustainable growth rate of the economy. However, the employment picture looks good for the rest of this year.

2. Inflation concerns seem to be abating despite the energy spikes in 2006 and 2007 and the recent pressure on food prices. Core inflation, which excludes food and energy, is well anchored at slightly above 2 percent, reflecting consumer optimism on inflationary expectations and competitive labor and product markets. But the risks are on the upside because of the geopolitical situation in the Middle East and tight labor markets in the United States.

3. Despite several interest rate hikes by the Federal Reserve, long-term rates remain relatively low, resulting in a flat yield curve. If the Fed is able to hold the line on rates this year, the System's member-borrowers will likely continue to receive favorable loan rates.

4. Not only does the positive outlook for the economy point to continued strong demand for farm and food products in 2007, but also it indicates that off-farm income opportunities will be good. The latter point is important because about 80 percent of farm households receive more than half of their income from off-farm employment, outside business interests, and other investments.

Renewable Fuels Offer Promise

The surge in ethanol demand has caused corn prices to increase sharply since last fall, and futures market prices remain strong by historical standards. Projected net returns for corn producers now point to more than $300 per acre in many regions, almost triple the usual figure. Consequently, corn acreage may increase 10–12 million acres in 2007, mostly at the expense of soybean and cotton acreage, which will lead to higher prices in other crops. Livestock producers will be facing much higher feed costs and will need to adjust production and inventory levels to rebalance supplies with market demand over the next few years. The elevated crop prices have led to significantly higher farmland values, with some states reporting double-digit gains for the past year. Consequently, cash rents are also increasing sharply in many regions.

The current euphoria over ethanol masks a lot of the risk it poses for agriculture. Although farm commodity markets generally experience some price volatility every year, the degree of volatility may increase as new developments occur in the oil and ethanol markets. The new energy focus means that global supply and demand issues for both oil and grains could cause wide swings in farm prices and incomes over the next few years. This risky environment will be a challenge for both producers and the FCS to effectively manage and profit from. The Agency will be closely watching System institutions for loan underwriting practices that do not fully consider the risks associated with the ethanol boom.

The System's total exposure to ethanol plants at year-end 2006 was about $2.6 billion, which was 10.5 percent of capital and 2.1 percent of gross loans. This total does not include loan commitments. For example, a significant number of loans are in the pipeline for plants under construction. While this loan exposure is noteworthy, the amount of systemic risk from the ethanol boom is far more significant for the System's traditional business lines of financing farm real estate and production credit because these loans make up almost 70 percent of the total portfolio.

The following list summarizes a few of the specific risks associated with ethanol that may challenge the FCS in 2007 and beyond:

1. If oil prices remain near $60 per barrel, most ethanol plants can operate profitably even if corn prices rise to $5 per bushel. However, the energy picture can change quickly and a significant weather event, such as drought, can drive corn and other crop prices to new heights.

2. Because ethanol prices are closely related to crude oil prices, the price of crude oil is a significant risk factor for ethanol plant owners and many farmers who rely on the plants to absorb their production. A number of ethanol plants could have problems servicing their debt if oil prices dropped or if the 51-cent-per-gallon blender subsidy were eliminated.

3. Carryover supplies of corn are very low, which increases the sensitivity of corn prices to anything that significantly affects supply and demand. For example, if world corn production increased sharply in response to high prices or if ethanol imports supplanted some of our domestic production, some analysts believe U.S. farmers could again be awash in corn, with prices retreating to substantially lower levels. This outcome would not bode well for land values but would be welcomed by livestock and dairy producers.

4. The current surge in farmland values poses significant collateral risk for the System. If other products eventually replaced corn as the primary feedstock for ethanol production, the price of corn and the value of land would likely fall, thereby increasing the probability of loan losses. Interest in cellulosic sources of ethanol is growing because they are in abundant supply and are potentially cheaper than corn to convert into ethanol, if the right production technology and transport systems can be developed.

5. Many other countries are also exploring alternative sources of ethanol that could result in a growing supply of low-cost ethanol for their economies and exports to the United States. Foreign competition is a risk to our corn-based industry, especially if the current import tariff on ethanol is allowed to expire at the end of 2008.

6. The potential demand for ethanol in U.S. coastal markets is huge, but supplies to these markets are limited by infrastructure and transportation issues. One risk is that the developing ethanol industry in the Midwest may expand too fast, creating temporary production gluts and low net returns. Another longer-term demand risk is related to the future of Government ethanol policy. Unless additional incentives or mandates for ethanol use are put in place, growth in ethanol demand may stall as production nears a level that meets the 10 percent ethanol gas blend (E-10), the maximum recommended for existing auto engines.

Farm Income Picture Centers on Policy Issues

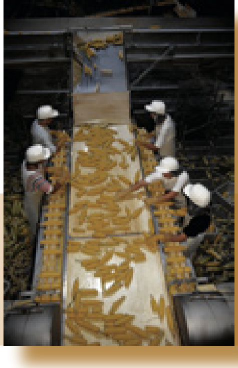
For the past several years, farm income has been strong, with net cash income hitting an all-time high of $85.5 billion in 2004, followed by $82.8 billion in 2005. Although the 2006 figure, $66.7 billion, was down significantly from the previous records, it was higher than the 10-year average of $64.6 billion. The projected figure for net cash income in 2007 is $67.2 billion, a slight increase from 2006.

With all the optimism over the corn-ethanol economy, some people may wonder why USDA's farm income estimates for the next couple of years aren't higher. One reason is that direct Government payments in 2007 will be about $12.4 billion—down about $4 billion, or 25 percent, from a year ago and down 50 percent from their peak in 2005 (countercyclical and loan deficiency payments will be almost nil in 2007). Thus, farmers will be receiving more of their cash income from the market and less from the Government in 2007. Another offsetting factor for net farm income prospects is the sharp rise in production expenses for both crops and livestock, which are expected to increase more than $12 billion in 2007.

Farm income can vary widely, not only from year to year, but also from one sector or region to another within a given year. As noted, energy developments will likely increase price and income volatility in 2007, causing the crop sector to receive significantly better net returns than the livestock industry. However, a key concern for lenders is that volatility—or the uncertainty of income—affects the ability of all producers to schedule and make their loan payments.

Two important events that will add to the uncertainty of farm income over the next couple of years are the 2007 farm bill and any new trade agreements that may arise from the World Trade Organization (WTO).[33] A lot of uncertainty surrounds these issues because, with the farm bill, the key safety net parameters could be reduced by Congress and, with the WTO, trade negotiations are at an impasse with few signs that the participants will reach an agreement any time soon. The successful resolution of both issues will help remove some of the uncertainty in the farm income picture.

33. The WTO is a voluntary association of 149 countries that meets periodically (in what are known as "rounds" of negotiations) to set rules in international trade to which all of its members agree to adhere. The Doha Round of trade negotiations, launched in 2001 in Doha, Qatar, is the most recent series of meetings. Although trade rounds may take several years to complete, negotiations in the Doha Round are stretching out over an unusually long time.



The 2007 Farm Bill—The challenge that Congress faces with any new farm bill is how to balance the conflicting demands of various domestic interest groups with the expectations of the world community to reduce agricultural subsidies for American farmers. Under almost any scenario, Congress will be looking to scale back expenditures in the new farm bill to mitigate the budget deficit problem. The high market prices that producers are currently receiving should contribute to that objective over the next couple of years.

The chief risk for the FCS is that Congress will look at the strong markets for the program crops and decide it can lower the Federal safety net for those producers, thereby increasing their vulnerability to volatile market conditions. The System will need to monitor the 2007 legislation closely because the euphoria over potential grain prices will no doubt cause some farmers to expand too fast, pay too much for land, and borrow too much money. This problem will be magnified if the corn-based ethanol boom dissipates.

World Trade and the Doha Round—Farm exports have been a bright spot for the economy, establishing record sales almost every year. The projected figure for the 2007 fiscal year is a record $78 billion, compared with $68.7 billion for fiscal year 2006. The increase reflects a combination of substantially higher farm commodity prices, increases in bulk volume, and the continued expansion of value-added product sales. Although the future for farm exports appears bright because of projected GDP growth in developing countries, the inability of trade negotiators to bring the Doha Round to a successful conclusion is worrisome because continued growth in export markets is essential for agricultural prosperity. Domestic market growth cannot maintain that prosperity alone, even with the boom in ethanol production.

A growing risk associated with the euphoria over alternative fuels is that farmers (and Congress) may begin to downplay the value of trade and the WTO process. Some people believe, for example, that biofuels are the panacea that will (1) allow Congress to reduce or eliminate subsidies in traditional farm programs and (2) strengthen domestic markets to the point where producers won't have to worry about or support the greater market access objectives in the WTO negotiations. Such a view is shortsighted.

A new trade agreement would provide several important benefits to American agriculture even though some producers of fruits and vegetables might lose markets to foreign competitors. However, many farm producers would gain greater access to foreign markets and be able to compete more openly and fairly in these markets to boost their sales. Also, a new agreement would eliminate a large piece of uncertainty in the farm picture and allow farmers to make informed production and investment decisions for their operations and more accurately gauge their debt service capacity. This latter point is particularly important to lenders, and the lack of a new trade agreement has to be a growing concern for them.

System's Strong Loan Growth Creates Operational Challenges

Financial institutions like to grow in order to make greater returns on equity, provide service to communities, and provide a firm foundation for local economies. However, financial regulators start to worry when growth rates accelerate to double-digit levels and remain high for a protracted period. The concern is that rapid growth may contribute to increased risk during a potentially less favorable lending environment, especially if the growth is occurring in new business lines.

The System's strong growth in 2006 came from many sources, including its primary business lines of originating farm real estate loans and short- and intermediate-term loans for production credit. However, the fastest-growing segments of the loan portfolio were agribusiness loans and loans to rural communication utilities. Continued shifts in this direction may introduce new challenges for some System institutions, especially if they are acquiring these interests through loan participations and syndications.

Loan participations in new business lines contribute to the diversity of an institution's loan portfolio and help mitigate risk if the practice is managed properly. However, institutions may be adding risk to their balance sheets if the new business lines go beyond their level of expertise, lending controls, and underwriting standards. Another risk is that, in some instances, institutions may be tempted to rely too much on the expertise of the lead lender and assume the credit risk is being properly controlled and managed by that lender. History shows that the failure to exercise appropriate due diligence and independent credit judgment on new business lines often results in financial losses.

As long as FCS institutions operate within their policy guidelines on participations, do their due diligence, and focus on enterprises they understand, they should be able to manage their growth in a safe and sound manner. But until growth rates abate, FCA will continue to focus resources on monitoring and evaluating the underlying sources of loan growth, the overall quality of the System's assets, and management's ability to manage the associated risks of significant asset growth.

Other Challenges Facing the FCS

Although the FCS is in excellent financial health and can withstand a number of shocks before its viability is endangered, strong forces are at play that will continue to challenge the System's ability to grow and prosper in the coming years. Some of the challenges deal with the biological nature of the agricultural industry. Others arise from agriculture's structural shifts and the effect they are having on the System's business practices. The following points provide some insight into these challenges.

1. Agriculture is inherently risky because it is subject to biological production processes that are affected by weather events, disease issues, and food safety concerns. Drought or floods or bugs seem to hit somewhere almost every year. Although concerns about major animal diseases subsided in 2006, they were offset by *E. coli* outbreaks in spinach and more evidence of soybean rust in the Midwest. Bioterrorism is always a threat to the safety of our food and water supply. Because most of these risks are beyond the control of producers, they must take appropriate measures to sustain their operations when hardships occur. The System has a good understanding of these risks, but the challenge of managing them is never easy.

2. Dynamic forces are changing the structure of agriculture at a rapid pace, creating tremendous diversity in size, income and wealth, and operator characteristics. A key concern for any service provider, including the FCS, is making sure it can serve all segments of the industry while remaining competitive in this rapidly changing environment. Although the Farm Credit Act and FCA regulations have been amended several times since 1971, the magnitude of structural change in rural America continues to challenge the System's creativity in meeting the financial needs of its rural customer base. The growing significance of off-farm income to the welfare of farm families is a sharp reminder that the System's traditional business model of serving full-time farmers may require new approaches for it to continue to fulfill the credit needs of its rural customers. In addition, the mandate to serve the needs of YBS farmers and ranchers will continue to be a challenge for the System because this group is increasingly dependent on the off-farm economy to sustain its financial health and ability to live in rural areas.

Appendix

Farm Credit Administration Offices

The 256 full- and part-time employees of FCA work together to ensure that the FCS remains a dependable source of credit for agriculture and rural America. The following paragraphs explain the functions of each of the Agency's offices, and figure 14 shows the organizational structure.

The **FCA Board** approves the policies, regulations, charters, and enforcement activities that ensure a strong FCS. The Board also provides for the examination and supervision of the FCS and Farmer Mac and oversees the activities of the FCS Building Association, which acquires, manages, and maintains FCA headquarters and field office facilities.

The **Secretary to the Board** ensures that the FCA Board complies with statutory, regulatory, and internal operation procedures and requirements. The Secretary to the FCA Board also serves as Secretary to FCSIC and as Parliamentarian and Sunshine Act Official for the FCA Board.

The **Office of the Chief Executive Officer** enforces the rules, regulations, and orders of the FCA Board. The CEO directs the implementation of policies and regulations adopted by the FCA Board. The office plans, organizes, directs, coordinates, and controls Agency operations and leads the Agency's efforts to achieve and manage a diverse workforce.

The **Office of Congressional and Public Affairs (OCPA)** serves as the Agency's principal point of contact for Congress, the media, other Government agencies, FCS institutions, System borrowers, and the public. OCPA develops and monitors legislation pertinent to FCA and the FCS, serves as the Agency's congressional liaison, and prepares testimony for the Chairman and other staff members. The office provides information to external audiences through news releases, information brochures and fact sheets, the annual FCA Performance and Accountability Report, and other publications. OCPA manages media relations regarding Agency activities and the content of the FCA Web site. The office also coordinates special meetings, briefings for international visitors, and field hearings.

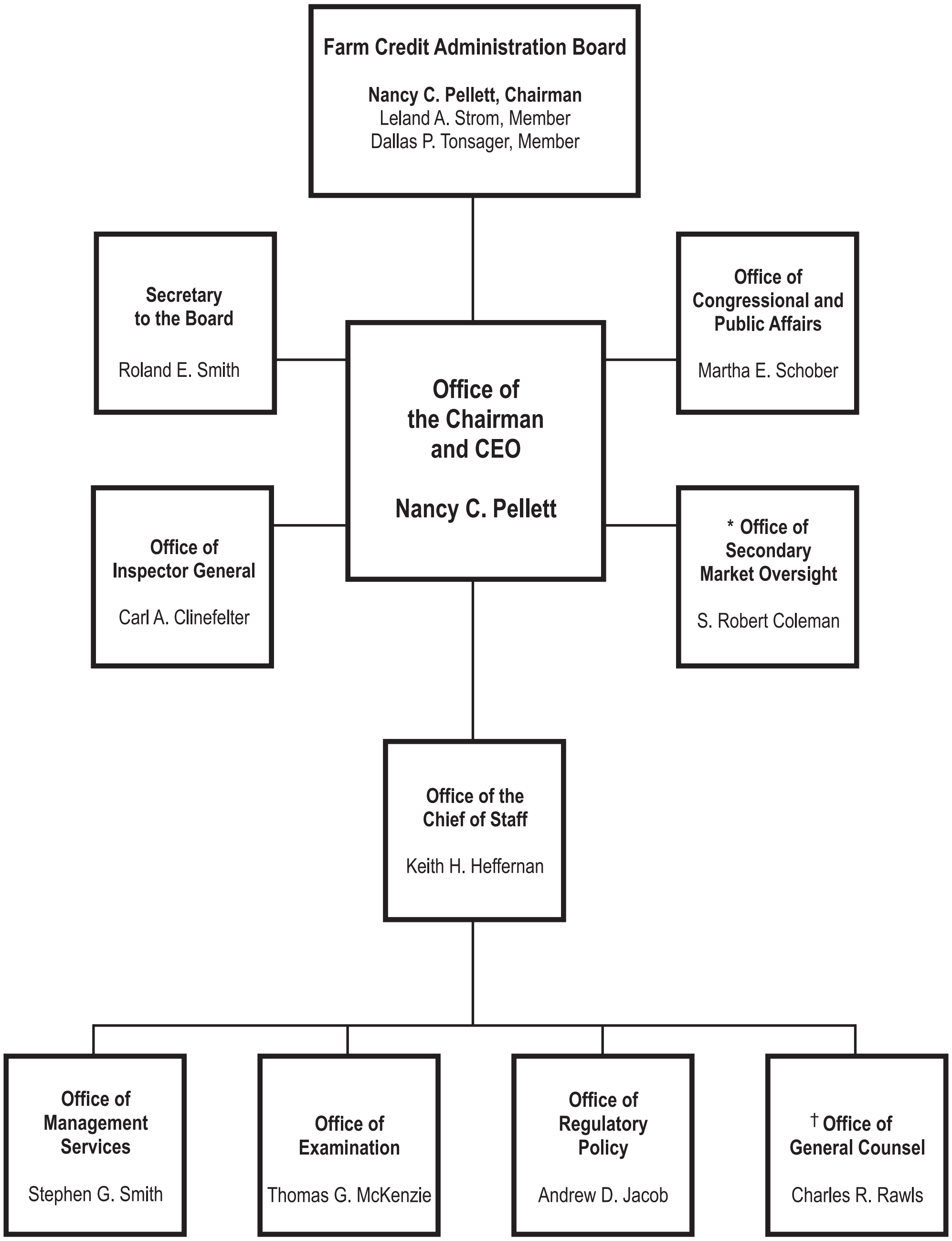
The **Office of Examination** is responsible for programs of examination and supervision of each FCS institution, in accordance with the Farm Credit Act and applicable regulations. The office develops oversight plans; conducts examinations; monitors the System's condition, risks, and emerging risks; and develops supervisory strategies to ensure that the System operates in a safe and sound manner and fulfills its public policy purpose. The FCA Board further defines the Office of Examination's role in Policy Statement 53, available at **www.fca.gov.**

The **Office of General Counsel** provides the FCA Board and staff with legal counsel as well as guidance on general corporate, personnel, ethics, and administrative matters. The office supports the Agency's development and promulgation of regulations, civil litigation, enforcement of applicable laws and regulations, and implementation of conservatorships and receiverships. The office serves as the liaison to the Federal Register, creates and maintains the Agency's public rulemaking files, and handles the Agency's submission of the Unified Agenda of Federal Regulatory and Deregulatory Actions. The office also handles Freedom of Information Act requests and matters pertaining to the Privacy Act.

The **Office of Inspector General** provides independent and objective oversight of Agency programs and operations through audits, inspections, investigations, and the review of proposed legislation and regulations. The office promotes economy and efficiency within FCA and seeks to prevent and detect fraud, waste, and abuse in the Agency's programs and operations.

Figure 14

FCA Organizational Structure



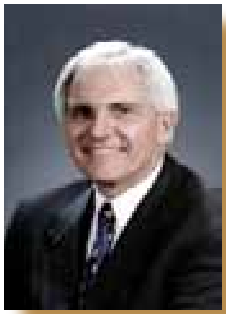
*Reports to the Board for policy and to the CEO for administration.
†Maintains a confidential advisory relationship with each of the Board members.

The **Office of Management Services** manages and delivers FCA's information technology, financial, human capital, and administrative services. The office coordinates planning efforts, including information resources management, security, human capital, and financial plans for the Agency. By centrally planning, managing, and delivering resource services, the Office of Management Services enables the Agency's program offices to fully focus their time and attention on their respective mission-related responsibilities.

The **Office of Regulatory Policy** manages all policy and regulation development activities, manages regulatory and statutory prior approval activities, and conducts policy-related research into risks and emerging issues affecting the FCS. The office is responsible for developing regulations and policy positions that implement applicable statutes, promote the safety and soundness of the FCS, and support the System's mission as a dependable source of credit and related services for agriculture and rural America. Policy and regulation development activities include the analysis of policy and strategic risks to the System, considering economic trends and other risk factors. The office also evaluates all regulatory and statutory prior approval requests from System institutions, including mergers, chartering, and other corporate approvals, as well as funding approval requests on behalf of the FCA Board.

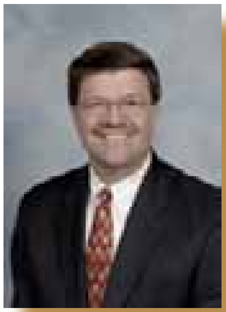
The **Office of Secondary Market Oversight** provides for the examination, regulation, and supervision of the activities of Farmer Mac to ensure its safety and soundness and the accomplishment of its public policy purpose as authorized by Congress. It also ensures that Farmer Mac complies with applicable laws and regulations, and it manages FCA's enforcement activities with respect to Farmer Mac.

Agency Officials



Carl A. Clinefelter is Inspector General. His office provides independent and objective oversight of Agency programs and operations and reports to the Chairman of FCA. This oversight is accomplished through audits, inspections, investigations, and the review of proposed legislation and regulations.

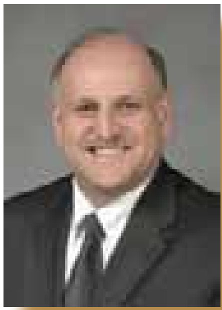
Before assuming this position in July 2005, he served as Acting Director of the Office of Communications and Public Affairs and Acting Director of the Office of Congressional and Legislative Affairs. Mr. Clinefelter also served as Director of the Office of the Ombudsman at FCA and as Director of the Office of Secondary Market Oversight. Before assuming that position in December 1998, Mr. Clinefelter was an Assistant Director of the Office of Policy and Analysis, a regional supervisory officer in the Office of Supervision, and an Associate Regional Director in the Office of Examination and Supervision. Before joining FCA in 1980, he was employed by the Federal Intermediate Credit Bank of New Orleans as assistant vice president.



S. Robert Coleman is Director of the Office of Secondary Market Oversight. His office is responsible for the examination, supervision, and regulation of the Federal Agricultural Mortgage Corporation (Farmer Mac). Before assuming this position in September 2005, Mr. Coleman served as Director of the Agency's Regulation and Policy Division.

Mr. Coleman joined FCA in 1986 as an associate examiner in the Office of Examination and became a commissioned examiner in 1990. He held various positions in that office and provided technical and analytical support to the FCA field offices and to the Policy Development and Planning Division. In 1994, Mr. Coleman transferred to the Office of Policy Analysis, where he served as a policy analyst specializing in regulation development, and then as a senior policy analyst. He was named Director of the Regulation and Policy Division in June 2003.

Keith H. Heffernan is Chief of Staff. He is responsible for planning, organizing, and directing the broad range of day-to-day activities for the Agency. Before joining FCA in July 2004, he served as Chief of Staff for the Under Secretary for Rural Development at USDA. His previous experience includes serving as assistant director of the Center for Agricultural and Rural Development at Iowa State University. From 1983 to 1989, he served the State of Iowa as deputy director of the Iowa Development Commission, as administrative assistant to Governor Terry Brandstad, and as director of the Department of Commerce. He also served as executive director of the Iowa Corn Growers Association from 1977 to 1983.



William J. Hoffman is Executive Assistant to Nancy C. Pellett, Chairman and CEO of FCA. His duties include advising the Chairman on policy, administrative, and management issues affecting FCA, the Farm Credit System, and the Farm Credit System Insurance Corporation. Before this position, he served as Associate Director of the Office of Secondary Market Oversight. Mr. Hoffman began his career as a credit representative in the Louisville Farm Credit District. He joined FCA in 1976 as a credit and operations officer and went on to serve in various management positions, including Associate Deputy Governor for the former Office of

Examination and Supervision. In 1986 he joined the St. Louis Farm Credit Bank as vice president of risk assets and later served as the CEO of PennWest Farm Credit, ACA. Before rejoining FCA in 2004, he was involved in agricultural finance in the private sector and in several international projects.

Andrew D. Jacob, CFA, is Director of the Office of Regulatory Policy. His office is responsible for supporting the FCA Board's regulatory and policy-making agenda, acting on statutory or regulatory approval requests from System institutions, administering a data collection program, and assessing systemic risk exposures.

Before being named to this position in July 2005, he served as Director of the Office of Secondary Market Oversight, a position he assumed in 2004. Mr. Jacob joined the Agency in 1986 as a credit examiner in the Sacramento field office. In 1988, he transferred to FCA's headquarters in McLean, Virginia, where he served as a commissioned FCA examiner, as an information systems examiner, and as a capital markets specialist in the Office of Examination. In 1997, he transferred to the Office of Policy and Analysis, where he served as a senior policy analyst and a senior financial analyst before becoming the Assistant Director of the office in 1999. Mr. Jacob holds the Chartered Financial Analyst® designation, which the CFA Institute awarded him in 2000.

Thomas G. McKenzie is Chief Examiner and Director of the Office of Examination. His office is responsible for all examination and supervision projects for the banks, associations, and related entities that make up the Farm Credit System. Before his current position, he served as Director of the Office of Secondary Market Oversight and as Director of the Office of Policy and Analysis; he has also held regional and division director positions in the Office of Examination and the former Office of Supervision. As a regional director he oversaw field office operations in Albany, Atlanta, Dallas, Denver, and Sacramento. Before joining FCA in 1979, he was a regional manager for a Federal Land Bank; a manager and CEO of a Federal Land Bank Association; and a financial analyst for a Bank for Cooperatives, where he began his career in agricultural credit in 1971.

Charles R. Rawls is General Counsel. His office provides the FCA Board and staff with legal counsel, as well as guidance on general corporate, personnel, ethics, and administrative matters. Before joining FCA in March 2003, he was general counsel and vice president for legal, tax, and accounting at the National Council of Farmer Cooperatives. During the consideration of the 2002 farm bill, he served as General Counsel of the Senate Committee on Agriculture, Nutrition, and Forestry. From 1998 to 2001, he was General Counsel for USDA, and from 1993 to 1998, Chief of Staff to the Deputy Secretary of Agriculture. From 1988 to 1993, he was Legislative Director and then Administrative Assistant to Congressman Martin Lancaster. From 1985 to 1988, he was Associate General Counsel of the House Committee on Agriculture, and from 1983 to 1985, Counsel to the House Agriculture Subcommittee on Forests, Family Farms, and Energy.

Martha E. Schober is Director of the Office of Congressional and Public Affairs. She directs the Agency's congressional relations activities and informs and advises the FCA Board and senior management of developments and issues affecting FCA and the Farm Credit System. Ms. Schober also manages the internal and external communication programs for FCA, which provide a wide range of information about the Agency to Farm Credit System institutions, FCA employees, Federal agencies, the media, System borrowers, and the public.

Before joining FCA, Ms. Schober served as a congressional liaison in the Office of Congressional Relations at USDA. She also served as a confidential assistant to the administrator at USDA's Risk Management Agency. Before entering Government service, Ms. Schober was the director of congressional relations at the American Cotton Shippers Association.

Roland E. Smith is Secretary to the FCA Board, having assumed that position in January 2006. He coordinates the call for agenda items and materials for the FCA Board and serves as the Board Parliamentarian during Board meetings. In addition, he serves as the Audit Followup Official, ensuring that the Agency responds appropriately to resolve issues identified by internal and external audits of its operations and programs. Mr. Smith also coordinates quarterly reporting on FCA's strategic plan goals and performance measures.

Mr. Smith began his career with the FCS in 1974 when he became a loan officer for a System association in Greenville, North Carolina. He later served as a loan officer and credit reviewer for the Farm Credit Banks of Columbia, South Carolina. In 1979, Mr. Smith joined FCA as an examiner in the St. Louis field office and was promoted to Associate Regional Director in 1984. He later managed FCA's Oklahoma City field office and then the Denver field office. In 1996, Mr. Smith was named Chief Examiner and Director of the Office of Examination. He served as the Agency's Executive Director of Planning and Projects from August 2004 until January 2006.

Stephen G. Smith is Chief Financial Officer and Director of the Office of Management Services. His office is responsible for overseeing the information and technology, administrative and personnel, and financial divisions of FCA. Before accepting this position, he served as the Agency's Inspector General. He joined FCA in 1981 as a technical specialist, became an examiner in 1984, and later served as staff assistant for the Chief Examiner. In 1989, he was named Associate Regional Director for the Agency's New York field office and then served as Senior Staff Director for the Chief Examiner before being named Director of the Technical and Operations Division. In 1993, he assumed new responsibilities as Director of the Information Resources Division. He was named Chief Information Officer in 1996 and directed all technology and information operations for FCA. Before joining the Agency, he worked at the North Central Jersey Farm Credit Associations.

Glossary

A

Agricultural Credit Association (ACA)—An ACA results from the merger of a Federal Land Bank Association or an FLCA and a PCA and has the combined authority of the two institutions. An ACA borrows funds from an FCB or ACB to provide short-, intermediate-, and long-term credit to farmers, ranchers, and producers and harvesters of aquatic products. It also makes loans to these borrowers for certain processing and marketing activities, to rural residents for housing, and to certain farm-related businesses.

Agricultural Credit Bank (ACB)—An ACB results from the merger of an FCB and a Bank for Cooperatives and has the combined authorities of those two institutions. An ACB is also authorized to finance U.S. agricultural exports and provide international banking services for farmer-owned cooperatives. CoBank is the only ACB in the FCS.

B

Bank for Cooperatives (BC)—A BC provided lending and other financial services to farmer-owned cooperatives, rural utilities (electric and telephone), and rural sewer and water systems. It was also authorized to finance U.S. agricultural exports and provide international banking services for farmer-owned cooperatives. The last remaining BC in the FCS, the St. Paul Bank for Cooperatives, merged with CoBank on July 1, 1999.

F

Farm Credit Act—The Farm Credit Act of 1971, as amended, (12 U.S.C. §§ 2001–2279cc) is the statute under which the FCS operates. The Farm Credit Act recodified all previous acts governing the FCS.

Farm Credit Bank (FCB)—FCBs provide services and funds to local associations that, in turn, lend those funds to farmers, ranchers, producers and harvesters of aquatic products, rural residents for housing, and some agriculture-related businesses. On July 6, 1988, the Federal Land Bank and the Federal Intermediate Credit Bank in 11 of the 12 then-existing Farm Credit districts merged to become FCBs. The mergers were required by the Agricultural Credit Act of 1987. As of September 30, 2004, there were four FCBs: AgFirst Farm Credit Bank; AgriBank, FCB; Farm Credit Bank of Texas; and U.S. AgBank, FCB.

Farm Credit Leasing Services Corporation—The Leasing Corporation is a service entity owned by CoBank, ACB. It provides equipment leasing and related services to eligible borrowers, including agricultural producers, cooperatives, and rural utilities.

Farm Credit System Insurance Corporation (FCSIC)—FCSIC was established by the Agricultural Credit Act of 1987 as an independent U.S. Government-controlled corporation. Its purpose is to ensure the timely payment of principal and interest on insured notes, bonds, and other obligations issued on behalf of FCS banks and to act as conservator or receiver of FCS institutions. The FCA Board serves ex officio as the Board of Directors for FCSIC. The chairman of the FCSIC board of directors must be someone other than the current Chairman of the FCA Board.

Federal Agricultural Mortgage Corporation (Farmer Mac)—Farmer Mac was created with the enactment of the Agricultural Credit Act of 1987 to provide a secondary market for agricultural real estate and rural housing mortgage loans.

Federal Farm Credit Banks Funding Corporation—The Funding Corporation, based in Jersey City, New Jersey, manages the sale of Systemwide debt securities to finance the loans made by FCS institutions. It uses a network of bond dealers to market its securities.

Federal Intermediate Credit Bank (FICB)—The Agricultural Credits Act of 1923 provided for the creation of 12 FICBs to discount farmers' short- and intermediate-term notes made by commercial banks, livestock loan companies, and thrift institutions. The Farm Credit Act of 1933 authorized farmers to organize PCAs, which could discount notes with FICBs. As a result, PCAs became the primary entities for delivery of short- and intermediate-term credit to farmers and ranchers. The FICBs and the Federal Land Banks in all Farm Credit districts merged to become FCBs or the ACB. Thus, no FICBs remain within the FCS.

Federal Land Bank—The Federal Farm Loan Act of 1916 provided for the establishment of 12 Federal Land Banks to provide long-term mortgage credit to farmers and ranchers, and later to rural home buyers. All Federal Land Banks and FICBs have merged to become FCBs or part of the ACB. Thus, no Federal Land Banks remain.

Federal Land Bank Association—These associations were lending agents for FCBs. Federal Land Bank Associations made and serviced long-term mortgage loans to farmers, ranchers, and rural residents for housing. They did not own loan assets but made loans only on behalf of the FCB with which they were affiliated. As of October 1, 2000, there were no remaining Federal Land Bank Associations serving as lending agents for FCBs.

Federal Land Credit Association (FLCA)—An FLCA is a Federal Land Bank Association that owns its loan assets. An FLCA borrows funds from an FCB to make and service long-term loans to farmers, ranchers, and producers and harvesters of aquatic products. It also makes and services housing loans for rural residents.

Financial Institution Rating System (FIRS)—The FIRS is similar to the Uniform Financial Institutions Rating System used by other Federal banking regulators. However, it has been modified by FCA to reflect the nondepository nature of FCS institutions. The FIRS provides a general framework for assimilating and evaluating all significant financial, asset quality, and management factors to assign a composite rating to each System institution. The ratings are described below.

Rating 1—Institutions in this group are basically sound in every respect; any negative findings or comments are of a minor nature and are anticipated to be resolved in the normal course of business. Such institutions are well managed, resistant to external economic and financial disturbances, and more capable of withstanding the uncertainties of business conditions than institutions with lower ratings. Each institution in this category exhibits the best performance and risk management practices for its size, complexity, and risk profile. As a result, these institutions give no cause for regulatory concern.

Rating 2—Institutions in this group are also fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. The nature and severity of deficiencies are not considered material, therefore, such institutions are stable and able to withstand business fluctuations. Overall risk management practices are satisfactory for the size, complexity, and risk profile of each institution in this group. While areas of weakness could develop into conditions of greater concern, regulatory response is limited to the extent that minor adjustments are resolved in the normal course of business and operations continue in a satisfactory manner.

Rating 3—Institutions in this category exhibit a combination of financial, management, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to asset quality or financial condition, such institutions may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Institutions that are in significant noncompliance with laws and regulations may also be accorded this rating. Risk management practices are less than satisfactory for the size, complexity, and risk profile of each institution in this group. Institutions in this category generally give cause for regulatory concern and require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, still make failure only a remote possibility if corrective actions are implemented.

Rating 4—Institutions in this group have an immoderate number of serious financial or operating weaknesses. Serious problems or unsafe and unsound conditions exist that are not being satisfactorily addressed or resolved. Unless effective actions are taken to correct these conditions, they are likely to develop into a situation that will impair future viability or constitute a threat to the interests of investors, borrowers, and stockholders. Risk management practices are generally unacceptable for the size, complexity, and risk profile of each institution in this group. A potential for failure is present but is not yet imminent or pronounced. Institutions in this category require close regulatory attention, financial surveillance, and a definitive plan for corrective action.

Rating 5—This category is reserved for institutions with an extremely high, immediate or near-term probability of failure. The number and severity of weaknesses or unsafe and unsound conditions are so critical as to require urgent external financial assistance. Risk management practices are inadequate for the size, complexity, and risk profile of each institution in this group. In the absence of decisive corrective measures, these institutions will likely require liquidation or some form of emergency assistance, merger, or acquisition.

G

Government-sponsored enterprise (GSE)—A GSE is a federally chartered corporation that is privately owned, designed to provide a source of credit nationwide, and limited to servicing one economic sector. Each GSE has a public or social purpose: to improve the availability of credit to agriculture, education, or housing. GSEs are usually created because the private markets did not satisfy a purpose that Congress deems worthy—either to fill a credit gap or to enhance competitive behavior in the loan market. Each is given certain features or benefits (called GSE attributes) to allow it to overcome the barriers that prevented purely private markets from developing. In some cases, the GSE receives public assistance only to get started; in other cases, the assistance is ongoing. The FCS is the oldest financial GSE.

P

Participation—A loan participation is usually a large loan in which two or more lenders share in providing loan funds to a borrower to manage credit risk or overcome a legal lending limit for a single credit. One of the participating lenders originates, services, and documents the loan. Generally, the borrower deals with the institution originating the loan and is not aware of the other participating institutions.

Production Credit Association (PCA)—PCAs are FCS entities that deliver only short- and intermediate-term loans to farmers and ranchers. A PCA borrows money from its FCB to lend to farmers. PCAs also own their loan assets. As of January 1, 2003, all PCAs were eliminated as independent, stand-alone, direct-lender associations. All PCAs are now subsidiaries of ACAs.

S

Syndication—A loan syndication (or "syndicated bank facility") is a large loan in which a group of banks work together to provide funds for a borrower. Usually one bank takes the lead, acting as an agent for all syndicate members and serving as the focal point between them and the borrower. All syndicate members are known at the outset to the borrower and they each have a contractual interest in the loan.

Acronyms and Abbreviations

ACA—Agricultural Credit Association
ACB—Agricultural Credit Bank
ALL—allowance for loan losses
AMBS—agricultural mortgage-backed securities
CAMELS—capital adequacy, asset quality, management performance, earnings, liquidity, and sensitivity to interest rate risk
CEO—chief executive officer
FAC—Financial Assistance Corporation
Farm Credit Act, the Act—Farm Credit Act of 1971, as amended
Farmer Mac—Federal Agricultural Mortgage Corporation
FCA—Farm Credit Administration
FCB—Farm Credit Bank
FCBT—Farm Credit Bank of Texas
FCFCPR—Farm Credit Finance Corporation of Puerto Rico
FCS—Farm Credit System
FCSIC—Farm Credit System Insurance Corporation
FIRS—Financial Institution Rating System
FLCA—Federal Land Credit Association
FFA—National FFA Organization (formerly Future Farmers of America)
FSA—Farm Service Agency
GAAP—generally accepted accounting principles
GDP—gross domestic product
GSE—Government-sponsored enterprise
1996 Act—Farm Credit System Reform Act of 1996
OCPA—Office of Congressional and Public Affairs
OFIs—other financing institutions
PCA—Production Credit Association
RBC—Risk-Based Capital (Model)
RBIC—rural business investment company
RHMS—rural housing mortgage securities
SBA—Small Business Administration
USDA—U.S. Department of Agriculture
WTO—World Trade Organization
YBS—young, beginning, and small (farmers and ranchers)

Additional Information

The Farm Credit Administration 2006 Annual Report is available on FCA's Web site at **www.fca.gov.** For questions about this publication, contact

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The Federal Farm Credit Banks Funding Corporation prepares the financial press releases, the System's Annual and Quarterly Information Statements, and the System's combined financial statements contained therein, with the support of the System banks. These documents are available on the Funding Corporation's Web site at **www.farmcredit-ffcb.com.** Copies can also be obtained from

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The Farm Credit System Insurance Corporation's annual report is available on its Web site at **www.fcsic.gov.** Copies of this report can also be obtained from

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