FARM CREDIT ADMINISTRATION





2008 Annual Report on the Farm Credit System

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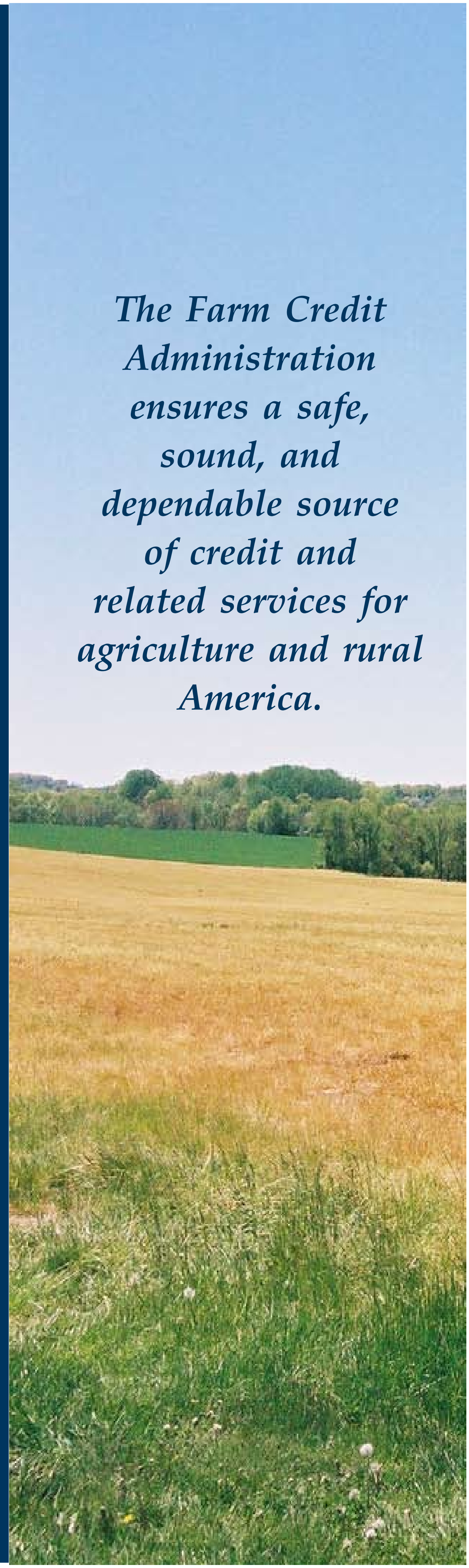


The Farm Credit Administration ensures a safe, sound, and dependable source of credit and related services for agriculture and rural America.

STATEMENT OF THE CHAIRMAN AND CEO

May 2009

Dear Reader,

On behalf of the Board and the dedicated employees of the Farm Credit Administration, I present the 2008 Annual Report on the Farm Credit System (FCS or System).

I am pleased to report that the overall condition and performance of the System remained safe and sound during 2008. The FCS experienced another year of solid earnings and asset growth. Also, the System has good credit quality, adequate capital, and sufficient liquidity. However, stresses from the general economy, the financial and credit crisis, and shocks in commodity prices increase risks to the System and affect the outlook for 2009.

It is in times such as these that the System, as a Government-sponsored enterprise (GSE) devoted to agriculture and rural America, must continue to stand tall in the marketplace and be there for America's farmers, ranchers, agricultural cooperatives, and rural communities. In fact, the System did much during the year to help producers and rural America. When commodity prices soared in early 2008, System institutions stepped forward to meet the critical financing needs of the grain elevator industry. The System also helped borrowers affected by floods, worked with livestock producers as they made difficult choices, and made critical infrastructure projects possible through innovative bond financing.

Following is a sampling of the measures FCA took in 2008 to ensure that the System remains safe and sound and continues to meet the purpose for which it was created:

- FCA completed a final rule that revised the eligibility and scope-of-lending regulations for processing and marketing operations to make them more responsive to the changing ownership structures of these operations.
- The FCA Board approved a final rule that revised FCA regulations governing the Risk-Based Capital Stress Test for the Federal Agricultural Mortgage Corporation (Farmer Mac).
- FCA increased the System's discount note ceiling to $60 billion from $40 billion to give it more flexibility to raise funds if financial markets are not open to term debt.
- The FCA Board adopted a Market Emergency Standby Resolution that would go into effect only in the event of a serious market disruption. It would temporarily allow Farm Credit banks to fund their assets with short-term liabilities even if doing so would cause the liquidity reserve of one or more System banks to drop below the 90-day minimum requirement.
- Throughout the year, FCA provided guidance to System institutions by issuing Informational Memorandums addressing such issues as collateral evaluation requirements, and asset growth, market volatility, and best practices for fast-growing institutions.

The System is required to provide credit to young, beginning, and small (YBS) farmers and ranchers. In 2008, lending by the System to YBS producers continued to show solid gains. Nevertheless, YBS results as a percentage of total loans have either dipped a few points or remained relatively flat over the past several years. However, since the percentage of young and small farmers is decreasing in general, the System's YBS dollar results are noteworthy because institutions have managed to expand YBS loan volume. FCS institutions may use a variety of tools to fulfill their commitment to YBS lending. Many associations revised their YBS policies and procedures in the past year, or reported plans to do so in 2009, in response to guidance issued in an August 2007 FCA Bookletter. This indicates that FCA's oversight activities are accomplishing the goal of helping institution management and boards stay focused on this important mission area.

The System is a GSE with solid financial performance. It has been able to maintain its financial strength and to serve its mission despite the economic and financial market turmoil. However, the System is finding it increasingly difficult to access the financial markets, its primary source of liquidity. Specifically, the crisis in the financial markets has caused the spread between Treasuries and the System's longer-term debt issuances to increase. While the System has been able to endure the financial market uncertainties, continuing weaknesses in the financial markets and potential Government actions will likely make 2009 another difficult year for System debt issuance. In addition, the lending environment for the FCS going forward will be more challenging than the System has faced for many years.

As the regulator of the FCS, FCA will focus on continuing to ensure that the System remains safe and sound by providing appropriate guidance and maintaining strong examination and supervisory programs. With the dynamics and risks in the agricultural and financial industries, FCA must ensure that FCS institutions have the culture, governance, policies, procedures, and management controls to effectively identify and manage risks.

As agriculture and rural America contend with the challenges of these difficult and uncertain times, we are mindful that the System was designed to be a dependable lender to agriculture and rural communities in both good times and bad. FCA remains committed to ensuring that the System can fulfill its mandate to both current and future generations of farmers and ranchers and the rural areas in which they live.

Sincerely,

Leland A. Strom

About the photo: The picture in the background was taken on the Strom Family Farm in Lily Lake, Illinois, around 1938. The two farmers are cutting oats. The man on the cutter is Elof Strom, father of Leland Strom; the man on the tractor pulling the cutter is Otto, Elof's brother. Today, the third-generation farm produces corn and soybeans. It has been dedicated to permanent agricultural use through a farmland preservation program.

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, agricultural and rural utility cooperatives, and other eligible borrowers.

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). 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:

1. It ensures that FCS institutions, including Farmer Mac, comply with applicable law and regulations. FCA's examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risk, as well as on the ability of its board of directors and management to direct its operations. The Agency also evaluates each institution's compliance with laws and regulations to serve all eligible borrowers, including young, beginning, and small farmers and ranchers. If a System institution violates a law or regulation or operates in an unsafe or unsound manner, FCA uses its supervisory and enforcement authorities to ensure appropriate corrective action.

2. It develops policies and regulations that govern how System institutions conduct their business and interact with customers. FCA's policy and regulation development focuses on protecting System safety and soundness; implementing the Farm Credit Act; providing minimum requirements for lending, related services, investments, capital, and mission; and ensuring adequate financial disclosure and governance. The policy development program includes approval of corporate charter changes, System debt issuance, and other financial and operational matters.

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.

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

THE BOARD

FCA policy, its regulatory agenda, and supervisory activities 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. Board members serve a six-year term and may not be reappointed after serving a full term or more than three years of a previous member's term but may remain on the Board until a successor is nominated by the President and confirmed by the Senate. The President designates one member as Chairman of the Board, who serves in that capacity until the end of his or her own term. The Chairman also serves as FCA's Chief Executive Officer (CEO).

FCA Board members also serve as members of the Farm Credit System Insurance Corporation board of directors.

Leland A. "Lee" Strom
Chairman and CEO

Leland A. Strom is Chairman of the Board and CEO of FCA. Mr. Strom was appointed to the FCA Board by President George W. Bush on December 12, 2006, and was designated Chairman and CEO on May 22, 2008. His term expires on October 13, 2012.

Mr. Strom also serves as a member 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. Before being named FCA Chairman and CEO, he had served as chairman of the board of directors of FCSIC since December 2006.

For more than 30 years he has been active in the agriculture industry. He served for more than 25 years on the board of 1st Farm Credit Services, an FCS institution in Illinois, holding various positions, including chairman. During the agriculture crisis of the 1980s, he was selected to sit on the Restructuring Task Force of the Sixth Farm Credit District.

From 2000 to 2006, he was on the Federal Reserve Bank of Chicago Advisory Council on Agriculture, Labor, and Small Business. Part of this time he also served on the Country Mutual Fund Trust Board, an investment fund of the Illinois Farm Bureau and its Country Financial organization.

Other boards Mr. Strom has served on include Northern F.S., Inc., a farm service and supply cooperative serving farmers in Northern Illinois; AgriBank, FCB; and the Farm Credit Council, the national trade organization representing FCS in Government affairs.

Mr. Strom has served in several capacities with the Illinois Farm Bureau. He also served on his county Farm Bureau board. He was a member of the State Young Farmer Committee from 1981 to 1985. 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 suburban Chicago, 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.

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. His community involvement includes having served as vice president of his local K–12 school district, chairman of his church council, 4-H parent leader, and coach of boys' and girls' sports teams. Mr. Strom owns a third-generation family farm in Illinois that produces corn and soybeans. He and his wife, Twyla, have two sons, a daughter, and a daughter-in-law.

Nancy C. Pellett
Board Member

Nancy C. Pellett was appointed to the FCA Board by President George W. Bush on November 26, 2002. She was designated Chairman on May 22, 2004, and served in that capacity until her term expired on May 21, 2008. She continues to serve as a member of the Board until a successor is nominated by the President and confirmed by the Senate.

Ms. Pellett also serves as chairman 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 on the FCA Board, 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 has 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 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.

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. Until recently he served 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 Farm Credit System is a network of borrower-owned cooperative financial institutions and service organizations. Together, these institutions are often viewed as the largest agricultural lender in the United States, serving all 50 States and the Commonwealth of Puerto Rico. Created by Congress in 1916 to provide American agriculture with a dependable source of credit, the FCS is the oldest financial Government-sponsored enterprise (GSE).[1]

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 for its business activities by selling securities in the national and international money markets, subject to approval by FCA. The U.S. Government does not guarantee the securities issued by the System.

As of December 31, 2008, the System was composed of 95 banks and associations. Five Farm Credit banks provided loan funds to 82 Agricultural Credit Association (ACA) parent organizations[2] and 8 stand-alone Federal Land Credit Associations (FLCAs). An ACA can make short-, intermediate-, and long-term loans. An FLCA can make only long-term loans and, under the Farm Credit Act, the FLCA is exempt from State and Federal income taxes.

Each ACA contains two subsidiaries, a Production Credit Association, which can make only short- and intermediate-term loans, and an FLCA. The parent-subsidy structure, with an ACA as parent and its wholly owned PCA and FLCA as subsidiaries, accounted for 91 percent of all associations as of December 31, 2008. The ACA and its two subsidiaries operate with a common board of directors and staff, and each of the three entities is responsible for the debts of the others. As a result, for most regulatory and examination purposes, FCA views the ACA and its subsidiaries as a single entity.

This parent-subsidiary structure enables the ACA to preserve the tax-exempt status of the FLCA. The ACA structure offers several other benefits. It 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 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. Further, the structure allows an association to provide a broader range of specialized services to its member-borrowers. It enables one-stop borrowing—borrowers can obtain long-, intermediate-, and short-term loans from the same institution.

One of the five Farm Credit 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, these 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 affiliated ACAs, which serve New York, New Jersey, Connecticut, Rhode Island, Maine, Massachusetts, New Hampshire, Vermont, Alaska, Oregon, Washington, Montana, and Idaho.

FCA also examines and regulates the Federal Farm Credit Banks Funding Corporation (Funding Corporation), an institution established under the Farm Credit Act. The Funding Corporation issues and markets debt securities on behalf of the banks to raise loan funds.

In addition, FCA examines and regulates the following five service corporations organized under section 4.25 of the Farm Credit Act:[3]

1. The Federal Land Banks were created in 1916, when the System was originally established. Other major parts of the FCS were created in 1923 and 1933.
2. Although legally separated, the ACA, the PCA, and the FLCA operate an integrated lending business, with loans made through the subsidiaries possessing 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.
3. 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.

1. AgVantis, Inc., which provides technology-related and other support services to the associations affiliated with U.S. AgBank, FCB (Farm Credit Bank). AgVantis is owned by the bank and 18 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. (FPI), which provides support services to CoBank, ACB; CoBank's five affiliated associations; two associations affiliated with U.S. AgBank, FCB; one association affiliated with AgriBank, FCB; and two System-related entities. FPI is owned by CoBank, ACB, and the eight associations to which FPI provides services.

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 previously offered tax incentives to investors to provide low-interest funding (other than that from the 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 remains inactive, although the charter is still outstanding.

FCA also examines and regulates the Federal Agricultural Mortgage Corporation (Farmer Mac).[4] Farmer Mac provides a secondary market arrangement for agricultural real estate loans, Government-guaranteed portions of certain loans, and rural housing mortgage loans. These secondary market activities provide 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, Farmer Mac guarantees securities backed by the Government-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). Farmer Mac II does not duplicate the Federal Government's guarantee; it simply ensures timely compensation for losses on guaranteed investments. Farmer Mac received new authorities from Congress in 2008 to purchase and guarantee securities backed by rural utility loans.

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 also encouraged the participation of farmer- and rancher-borrowers in the management, control, and ownership of these cooperative institutions to help the institutions remain focused on serving their members' needs.

The System helps to meet 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 homeowners.

FCA's regulations, policy statements, examinations, chartering activities, and other regulatory activities (discussed in later chapters of this report) support and facilitate the

4. 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.

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 activities 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[5]

As selected financial indicators show (tables 1 and 2), the overall condition and performance of the Farm Credit System remained safe and sound during 2008. Earnings, asset quality, and capital levels indicate that the System is in strong financial condition. However, in the second half of 2008 and into 2009, the global recession was beginning to reduce the demand for farm products, causing commodity prices to decline and thus raising the risk environment of the System.

Although all banks and associations continued to maintain capital ratios well in excess of minimum regulatory requirements, the turmoil in the U.S. and global markets during the latter half of 2008 has limited the System's ability to raise third-party capital and its flexibility to access the capital markets for the issuance of term debt. The System relies on access to the capital markets to raise the funds it needs for making loans to farmers and other eligible borrowers.

The System has benefited, and is expected to continue to benefit, from the financial strength and overall profitability of the farm sector, which had record earnings in 2008. Nonetheless, earnings are expected to decline in 2009 because of tighter margins for most producers, negative profitability for many livestock producers, and overcapacity in the ethanol industry. Farm land values have also begun to weaken in some areas with the changing outlook for commodity prices. In addition, rising unemployment is reducing repayment capacity for many part-time farmers.

These factors are expected to lead to some decline in System financial indicators going forward. For a discussion of how these stresses and others are likely to affect the agricultural economy and the System in 2009 and beyond, see "Challenges Facing Agriculture and the FCS" on pages 52 to 58.

5. The information presented in this section pertains to all Farm Credit Banks, the Agricultural Credit Bank, and the affiliated associations of the System banks. 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, 2008, and is presented on a combined basis reflecting eliminations of transactions between System entities.

Table 1

Farm Credit System Major Financial Indicators, Annual Comparison

As of December 31

Dollars in Thousands

FCS banks[a]	2004	2005	2006	2007[b]	2008
Gross loan volume	85,411,707	94,865,873	112,260,474	131,191,826	149,491,137
Accruing restructured loans[c]	7,050	6,131	5,378	4,301	5,125
Accrual loans 90 or more days past due	5,420	1,322	5,439	12,917	21,594
Nonaccrual loans	227,003	152,223	107,556	46,069	582,160
Nonperforming loans/total loans[d]	0.28%	0.17%	0.11%	0.05%	0.41%
Cash and marketable investments	23,089,548	27,788,225	31,680,712	34,408,807	41,358,881
Capital/assets[e]	6.79%	6.20%	5.65%	5.43%	4.89%
Unallocated retained earnings/assets	3.54%	3.28%	2.95%	2.69%	2.50%
Net income	733,012	740,785	845,191	981,688	1,231,430
Return on assets	0.68%	0.61%	0.60%	0.60%	0.65%
Return on equity	9.82%	9.48%	10.24%	10.59%	12.44%
Net interest margin	0.92%	0.84%	0.80%	0.83%	0.97%
Operating expense rate[f]	0.36%	0.33%	0.33%	0.30%	0.31%
Associations					
Gross loan volume	75,619,681	83,253,781	93,413,704	105,620,488	114,026,858
Accruing restructured loans[c]	68,439	53,885	51,384	47,212	30,381
Accrual loans 90 or more days past due	15,375	13,156	19,504	43,840	70,622
Nonaccrual loans	419,312	371,703	425,545	465,414	1,699,245
Nonperforming loans/gross loans[d]	0.67%	0.53%	0.53%	0.53%	1.58%
Capital/assets[g]	17.72%	17.19%	16.27%	15.57%	15.47%
Unallocated retained earnings/assets	15.28%	14.79%	13.89%	13.58%	13.52%
Net income	2,420,251	1,613,346	1,662,255	1,934,968	1,811,667
Return on assets	3.10%	1.85%	1.75%	1.74%	1.57%
Return on equity	18.22%	10.55%	10.44%	10.82%	9.86%
Net interest margin	2.72%	2.71%	2.64%	2.57%	2.49%
Operating expense rate[f]	1.58%	1.53%	1.58%	1.49%	1.45%
Total FCS[h]					
Gross loan volume	96,367,000	106,272,000	123,436,000	142,906,000	161,423,000
Nonperforming loans	743,000	600,000	615,000	621,000	2,416,000
Nonaccrual loans	646,000	524,000	533,000	512,000	2,282,000
Nonperforming loans/gross loans[d]	0.77%	0.56%	0.50%	0.43%	1.50%
Bonds and notes	100,330,000	113,576,000	134,466,000	155,295,000	179,769,000
Capital/assets[i]	17.13%	16.28%	15.00%	14.17%	12.65%
Surplus/assets	13.69%	13.30%	12.25%	11.52%	10.80%
Net income	2,993,000	2,096,000	2,379,000	2,703,000	2,916,000
Return on assets	2.46%	1.58%	1.56%	1.53%	1.41%
Return on equity	14.85%	9.38%	9.99%	10.38%	10.70%
Net interest margin	2.56%	2.58%	2.48%	2.43%	2.41%

Sources: Farm Credit System Call Reports as of December 31 and the Farm Credit System Annual Information Statements provided by the Federal Farm Credit Banks Funding Corporation.

a. Includes Farm Credit Banks and the Agricultural Credit Bank.
b. Some of the data for 2007 have been corrected from the amounts reported in the 2007 FCA Annual Report on the Farm Credit System.
c. Excludes loans 90 days or more past due.
d. Nonperforming loans are defined as nonaccrual loans, accruing restructured loans, and accrual loans 90 days or more past due.
e. Capital excludes mandatorily redeemable preferred stock.
f. Operating expenses are divided by average gross loans, annualized.
g. Capital excludes protected borrower capital.
h. 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 2

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

As of December 31, 2008

Dollars in Thousands

FCS Banks	Total assets	Gross loan volume	Nonaccrual loans	Allowance for loan losses	Cash and marketable investments[b]	Capital stock[c]	Surplus[d]	Total capital[e]
AgFirst	29,911,050	21,239,330	176,410	44,565	8,288,340	834,929	763,354	1,241,091
AgriBank	63,285,845	52,753,649	60,811	13,883	9,510,636	1,624,615	1,537,851	2,767,212
CoBank	61,162,057	44,549,872	217,797	329,198	14,801,371	2,101,192	1,638,596	3,594,849
Texas	14,760,501	11,403,113	109,661	12,549	3,230,043	427,212	343,113	744,542
U.S. AgBank	25,413,761	19,545,173	17,481	3,202	5,528,491	797,710	586,127	1,170,717
Total	194,533,214	149,491,137	582,160	403,397	41,358,881	5,785,658	4,869,041	9,518,411
Associations								
AgFirst	18,372,616	16,848,927	374,172	124,523	624,322	180,112	2,586,817	2,740,868
AgriBank	54,324,405	49,345,292	768,172	194,290	2,087,199	213,347	8,248,763	8,462,250
CoBank	13,060,950	12,401,042	119,051	88,353	83,092	25,581	1,942,670	1,911,895
Texas	13,969,126	13,349,561	212,820	39,102	186,411	64,620	1,860,307	1,933,547
U.S. AgBank	23,666,200	22,082,036	225,030	83,451	616,258	285,682	3,742,305	4,036,303
Total	123,393,297	114,026,858	1,699,245	529,719	3,597,282	769,342	18,380,862	19,084,863
Total FCS	**214,353,000**	**161,423,000**	**2,282,000**	**936,000**	**43,807,000**	**1,423,000**	**23,148,000**	**27,124,000**

Sources: Farm Credit System Call Reports as of December 31, 2008, and the Farm Credit System Annual Information Statement provided by the Federal Farm Credit Banks Funding Corporation.

a. Aggregations of district data may not equal totals because of eliminations.
b. Includes accrued interest receivable on marketable investments.
c. Includes capital stock and participation certificates, excludes mandatorily redeemable preferred stock and protected borrower capital.
d. Includes allocated and unallocated surplus.
e. Includes capital stock, participation certificates, perpetual preferred stock, surplus, accumulated other comprehensive income, and restricted capital (amount in the Farm Credit Insurance Fund, for Farm Credit System total only). Excludes mandatorily redeemable preferred stock and protected borrower capital.

Earnings

The FCS earned $2.9 billion in 2008 compared with $2.7 billion in 2007. This 7.9 percent increase in net income was largely driven by continued high loan growth and investments. See figure 1. The $642 million increase in net interest income was attributable to the more favorable funding and net interest spread. Net interest spread increased by 26 basis points to 1.99 percent from 1.73 percent.

Despite substantial asset growth, net income was sufficient to keep the return on average assets and the return on average capital at acceptable levels. As table 1 shows, the System's return on average assets declined to 1.41 percent in 2008 from 1.53 percent the prior year. The return on average capital, however, increased to 10.70 percent in 2008 from 10.38 percent in 2007.

As cooperative institutions, the FCS banks and associations pass a portion of their earnings on to their borrower-owners as patronage distributions. During 2008, System institutions declared a total of $958 million in patronage distributions, 33 percent of Systemwide net income. Of that amount, $589 million was paid in cash, $275 million was issued in the form of allocated retained earnings, and $94 million was issued as stock. The System also distributed $121 million in cash from patronage allocations of earlier years.

Asset Growth

The System experienced substantial loan and asset growth in 2008, as shown in table 3. FCS assets grew to $214.4 billion, up $27.9 billion (15.0 percent) from year-end 2007. This increase was led by continued growth in gross loans, which increased from $142.9 billion in 2007 to $161.4 billion at year-end 2008 (figure 2).

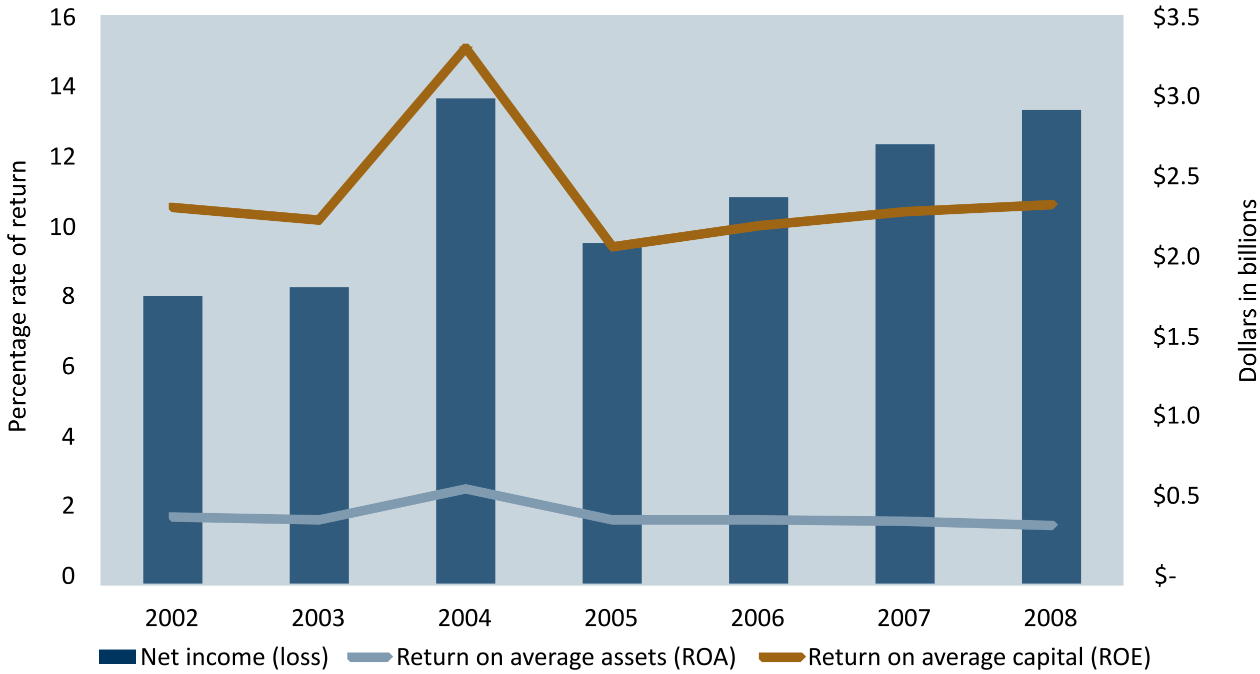
Generally high agricultural commodity prices stimulated loan demand, especially for seasonal agribusiness loans. These higher prices, particularly for corn, were the result of strong demand from foreign buyers and the domestic biofuels industry during the first half of 2008. However, later in 2008, many of these factors shifted. Oil prices and consumption dropped, which reduced the demand for ethanol. Crop production improved in certain regions of the world, and the U.S. dollar strengthened in the latter half of 2008, decreasing exports. The combination of these factors produced a dramatic drop in commodity prices in late 2008 to levels more in line with commodity prices at December 31, 2007. While the System's loan growth rate was much higher in the year's first half than in the second, generally increasing farm land prices, volatile but higher commodity prices, and higher input costs caused the demand for farm lending to continue to increase during all four quarters of 2008. The FCS was able to meet the demand even when other financial institutions were affected by the credit crunch of the fourth quarter.

The AgriBank, U.S. AgBank, AgFirst, and CoBank districts experienced at least 10 percent growth as gross loans increased by 19.9 percent, 16.9 percent, 11.1 percent, and 10.0 percent, respectively. The Farm Credit Bank of Texas grew by 4.9 percent. The AgriBank district had the largest dollar growth at $8.7 billion, followed by the CoBank district at $4.1 billion. Asset growth from 2005 to 2008 averaged more than 14 percent. The growth rates of the past four years are higher than any experienced by the System over the past 25 years. However, we anticipate 2009 will be a year of much slower growth given the state of the general economy and the weaker farm economy.

Investment Assets

Investments available for sale (based on fair value) grew from $31.1 billion in 2007 to $35.1 billion in 2008, with the greatest increases in money market instruments and U.S. Government securities (see table 4). The System's portfolio of mortgage-backed securities available for sale grew by only 2.5 percent compared with 17.7 percent in 2007 (table 4). The overall weighted average yield decreased appreciably since year-end 2007 from 5.0 percent to 2.8 percent for available-for-sale securities as a result of the lower interest rate environment. The overall weighted average yield on held-to-maturity securi-

Figure 1
FCS Net Income, 2001–2007
As of December 31



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

Note: The net income for 2004 includes $1.167 billion in net reversals of the allowance for loan losses.

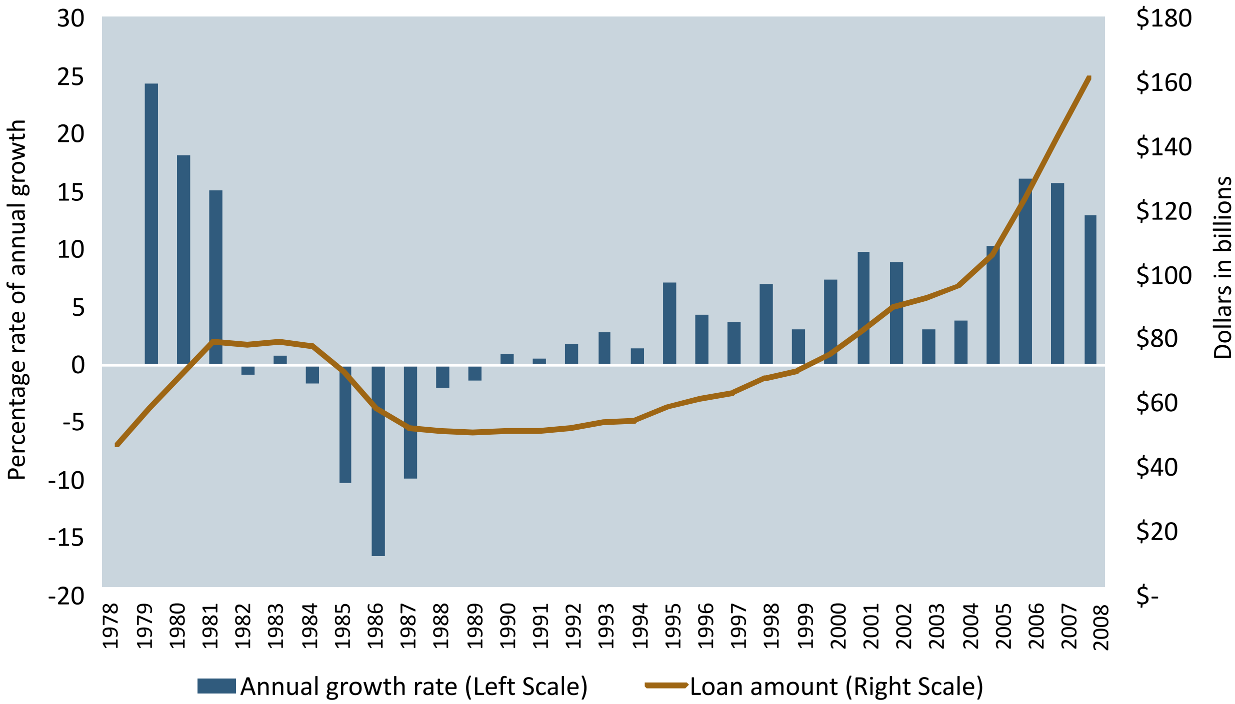
Table 3
FCS Assets
Dollars in Millions

	As of December 31		Change	
	2007	**2008**	**Dollars**	**Percent**
Cash	718	3,758	3,040	423.4
Federal funds sold and repossessed	1,907	1,029	(878)	(46.0)
Investments				
Available for sale (fair value)	30,378	35,144	4,178	13.8
MRIs available for sale (fair value)	683	588	(95)	(13.9)
MRIs held to maturity (amortized cost)	2,774	3,876	1,102	39.7
Total investments	33,835	39,020	5,185	15.3
Gross loans	142,906	161,423	18,517	13.0
ALL	(781)	(936)	(155)	19.8
Net loans	142,125	160,487	18,362	12.9
Accrued interest receivable	2,013	1,970	(43)	(2.1)
Premises and equipment	552	605	53	9.6
Other assets	2,702	4,569	1,867	69.1
Restricted assets	2,599	2,915	316	12.2
Total assets	**186,451**	**214,353**	**27,902**	**15.0**

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

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

Figure 2
FCS Loans Outstanding, 1978–2008
As of December 31



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

Table 4
FCS Investments
Dollars in Millions

	As of December 31				Change		
	2007		2008		Amount		WAY
	Dollars	**WAY %**	**Dollars**	**WAY %**	**Dollars**	**%**	**bp**
Available for sale (fair value)							
Money market instruments	1,878	5.1	4,613	1.7	2,735	145.6	(343)
U.S. Government securities	1,337	4.7	3,033	3.8	1,696	126.9	(91)
Mortgage-backed securities	24,926	5.1	25,544	3.0	618	2.5	(215)
Other asset-backed securities	2,237	5.1	1,366	2.1	(871)	(38.9)	(297)
Mission-related and other investments	683	5.2	588	3.9	(95)	(13.9)	(135)
Total	**31,061**	**5.0**	**35,144**	**2.8**	**4,083**	**13.1**	**(218)**
Held to maturity (amortized cost)							
Money market instruments	162	6.4	234	6.2	72	44.4	(24)
Mortgage-backed securities	2,302	5.7	2,447	5.4	145	6.3	(31)
Other asset-backed securities	310	6.5	1,195	4.3	885	285.5	(224)
Total	**2,774**	**5.8**	**3,876**	**5.1**	**1,102**	**39.7**	**(71)**

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

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

ties declined from 5.8 percent to 5.1 percent as a result of the decrease in yield on all held-to-maturity securities.

The quality of System investments has been adversely affected by the historic declines in the Nation's mortgage markets. System banks are restricted by regulation to acquiring only investments with a triple-A rating from at least one major rating agency. If an investment loses its triple-A rating, the investing bank must dispose of the investment within six months or receive written approval from FCA to divest the investment over a longer period of time. FCA approved divestiture plans that allowed the FCS to hold 43 securities that became ineligible because of a ratings downgrade. Of the ineligible investments, the FCS had 14 securities for $529 million, with recognized losses of $82 million. These other-than-temporarily-impaired investments were small in comparison to the available-for-sale investment portfolio of $35.1 billion.

Asset Quality

The quality of FCS assets declined in 2008 from the very high level of 2007. Nonperforming loans increased to 1.49 percent of gross loans by year-end 2008 from 0.44 percent at the end of 2007 (figure 3). In 2008, nonaccrual loans rose to $2.3 billion from the 2007 year-end total of $512 million. Loan delinquencies (that is, total accruing loans that are 30 days or more past due) remained relatively low at 0.53 percent of accruing loans at year-end 2008. With the economic slowdown, we do anticipate the level of nonperforming loans to increase in 2009, but the overall level will remain well within the System's risk-bearing capacity.

The FCS established a provision for loan losses of $408 million in 2008 compared with $81 million in 2007. The significant increase in the 2008 provision resulted primarily from credit deterioration caused by volatility in commodity prices, which adversely impacted the livestock, poultry, and ethanol sectors. Another, though lesser, cause of the increase in the provision for loan losses was a decline in the condition of the overall economy.

Net charge-offs increased in 2008 to $99 million from $34 million in 2007. Also, the allowance for loan losses increased to $936 million in 2008 from $781 million the year before. Although the System's asset quality is strong, the current riskier lending environment may lead to further deterioration in coming years.

Liabilities, Funding, and Liquidity

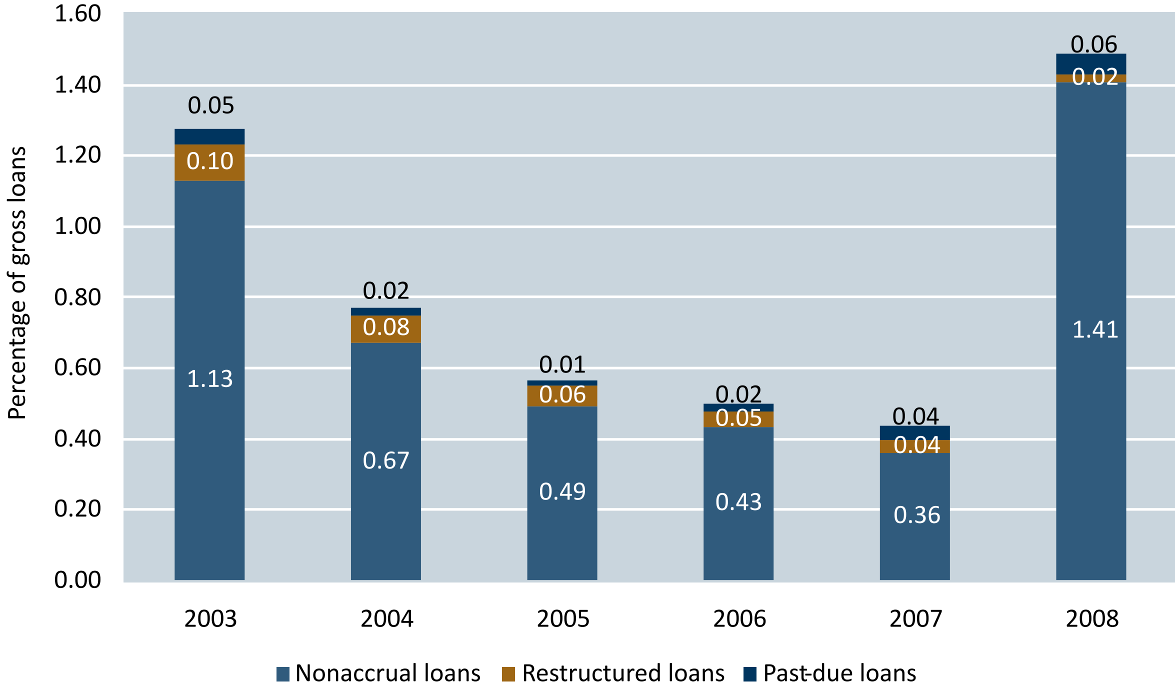
In 2008, the System's funding composition remained relatively constant. Short-term debt securities made up 36.9 percent of total Systemwide debt securities at December 31, 2007, and 36.8 percent at December 31, 2008. Debt securities due within a year increased by 15.2 percent in 2008, and those due after one year increased by 15.6 percent. Although the System continues to have regular and flexible access to the short-term debt markets, issuance of securities with maturities greater than one year became more challenging in the latter half of 2008, and the cost of such term issuances has increased as a result of the more limited access to the debt capital markets. (See section titled "Funding Activity in 2008" (page 35) for further discussion of how the System's funding environment has changed.)

As noted in figure 4, the System's liquidity position remained significantly above the regulatory minimum[6] and widened somewhat from 122 days at year-end 2007 to 177 days at year-end 2008. The liquidity position widened because the System's banks extended the maturities of Systemwide debt securities. This extension of maturities and the additional liquidity provide each bank with a cushion against significant negative events in the U.S. and global markets, and also create financial flexibility to address a challenging funding environment.

The duration[7] gap (that is, the gap between the estimated duration of interest-earning assets and the estimated duration of interest-bearing liabilities) is a primary measure of asset-liability risk exposure. A positive duration gap (that is, a gap in which asset duration exceeds liability duration) of more than three months indicates a greater exposure to rising

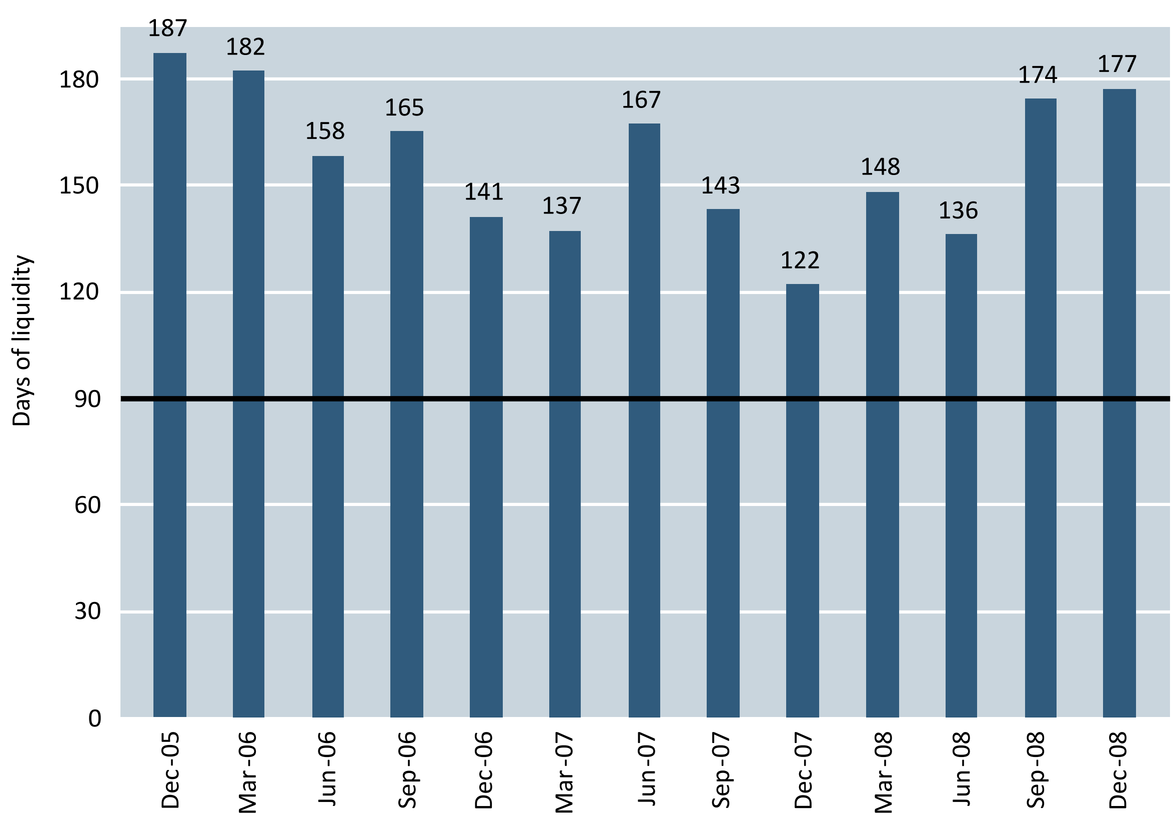
6. The regulatory liquidity standard requires each FCS bank to maintain a minimum of 90 days of liquidity on a continuous basis to guard against a possible interruption in its access to the capital markets. The number of days of liquidity is calculated by comparing maturing Systemwide debt securities 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.
7. Duration is the weighted average maturity of cash flows. It is a useful way to estimate the direction and size of changes in the value of a financial instrument when market interest rates change. When the duration gap is small, changing market interest rates pose less interest rate risk than when the gap is large. The Funding Corporation considers a gap of no more and no less than three months to be small.

Figure 3
FCS Nonperforming Loans, 2002–2008
As of December 31



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

Figure 4
FCS Liquidity, 2005–2008



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

Note: The regulatory liquidity standard requires each FCS bank to maintain a minimum of 90 days of liquidity on a continuous basis, with no access to capital markets.

interest rates. A duration gap within the range of a positive three months to a negative three months generally indicates a small exposure to changes in interest rates. Since the duration gap for the FCS was a positive 0.2 months on December 31, 2008 (down slightly from a positive 1.4 months at December 31, 2007), the interest rate risk is still limited.

Capital

Capital levels were strong and increased slightly during 2008, going from $26.4 billion at year-end 2007 to $27.1 billion at year-end 2008. The increase was the result of increases in net income earned and retained, as well as from the issuance of preferred stock. As figure 5 shows, surplus accounts for the overwhelming majority of capital (85.3 percent), compared with 81.3 percent as of December 31, 2007. Overall, the System's capital-to-assets ratio fell from 14.2 percent at year-end 2007 to 12.7 percent at year-end 2008, caused principally by the growth in loans and investments. In addition, accumulated other comprehensive losses increased to $2.1 billion, which consisted primarily of net unrealized losses on investments available for sale and pension and other benefit plans.

System banks, both as a whole and as individual institutions, are capitalized in excess of the System's regulatory requirements. The minimum permanent capital ratio is 7.0 percent, and, as of December 31, 2008, the permanent capital ratio ranged between 14 percent and 18.9 percent for the System's banks and between 10.1 percent and 27.5 percent for the associations. Despite their strong capital positions, the banks and associations are evaluating further opportunities to improve and diversify their capital positions in light of their significant asset growth and the current difficulty in raising third-party capital.

BORROWERS SERVED

The System fulfills its overall mission by lending to agriculture and rural America. Through changes in the law since the first part of the FCS was established in 1916, the System's lending authorities have evolved to include the following loan products:

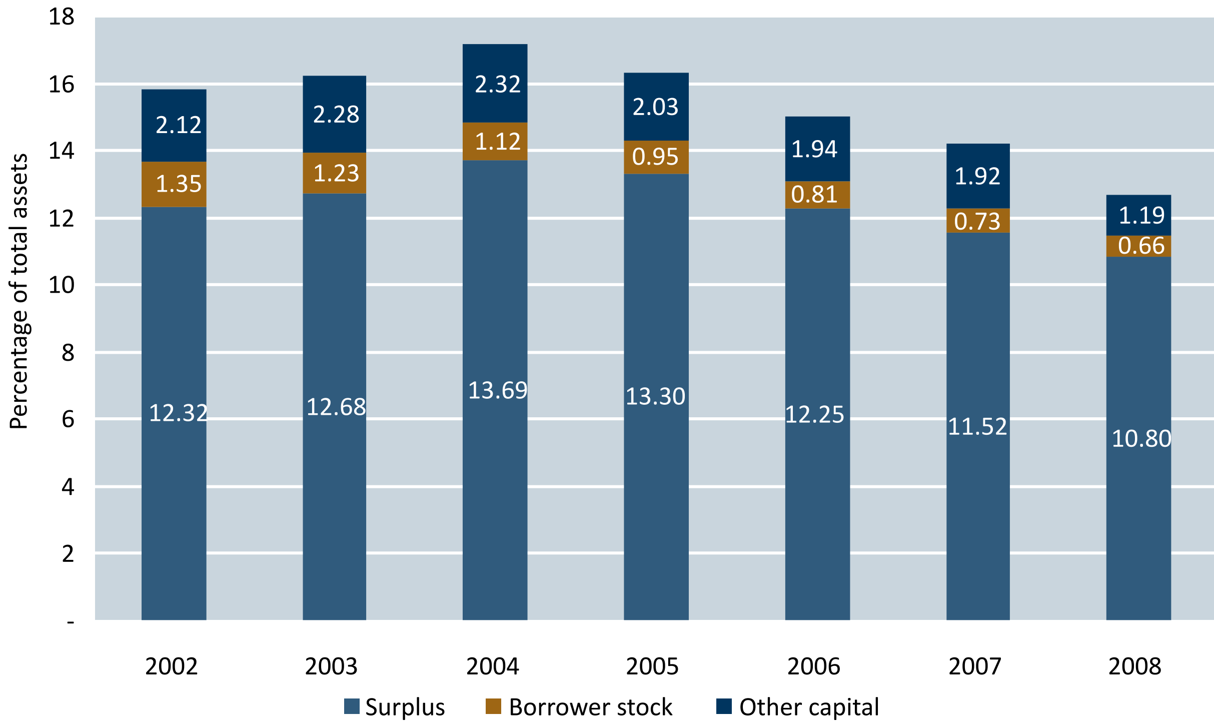
- Long-term agricultural real estate loans and rural home loans
- Short- and intermediate-term agricultural loans
- Loans to producers and harvesters of aquatic products
- Loans to certain farmer-owned agricultural processing facilities and farm-related businesses
- Loans to farmer-owned agricultural cooperatives
- Loans that finance agricultural exports and imports
- Loans to rural utilities
- Limited portions of loans to entities that qualify under the System's similar-entity authority[8]

Nationwide, the System had $161.4 billion in gross loans outstanding as of December 31, 2008, (see table 5). Agricultural producers represented by far the largest borrower group, with $109.4 billion, or 67.7 percent, of the total dollar amount of loans outstanding.[9] As required by law, all borrowers own stock or participation certificates in System institutions. The FCS had more than 840,000 loans and approximately 476,000 stockholders at the end of 2008. Approximately 84 percent of the stockholders were farmers, or their cooperatives, with voting stock. The remaining voting stockholders were cooperative associations. (The System also has non-voting 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 $18.5 billion, or 13.0 percent, during the year ended December 31, 2008. Both the dollar volume and the percentage growth in 2008 were less than the gain in 2007. In 2007, gross loans grew 15.8 percent, which followed gains of 16.2 percent in 2006 and 10.3 percent in 2005. Since year-end 2004, total System loans outstanding have increased by $65.1

8. A similar-entity borrower is not eligible to borrow directly from an FCS institution, but because the similar-entity borrower's operation is functionally similar to that of an eligible borrower, the System can participate in these loans (the participation interest must be less than 50 percent).
9. This amount does not include loans to "rural homeowners" (as defined in section 613.3030 of the FCA regulations) and leases.

Figure 5
FCS Capital, 2002–2008
As of December 31



Sources: Federal Farm Credit Banks Funding Corporation Annual Imformation Statements.

Table 5
FCS Gross Loans Outstanding, 2004–2008
As of December 31
Dollars in Millions

	2004	2005	2006	2007	2008	Percent change from 2004
Production agriculture						
Long-term real estate mortgage loans	47,695	51,690	56,489	63,458	71,892	50.7
Short- and intermediate-term loans	22,789	24,935	28,731	32,267	37,468	64.4
Agribusiness loans*	12,053	14,673	21,141	28,091	26,901	123.2
Rural utility loans	7,200	8,063	9,569	10,846	13,931	93.5
Rural residential and real estate loans	2,482	2,950	3,408	3,965	4,611	85.8
International loans	2,624	2,277	2,183	2,135	4,077	55.4
Lease receivables	1,168	1,290	1,489	1,708	1,952	67.1
Loans to other financing institutions	356	394	426	436	591	66.0
Total	**96,367**	**106,272**	**123,436**	**142,906**	**161,423**	**67.5**

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

* At December 31, 2008, agribusiness loans consisted of loans to cooperatives of $12.2 billion, processing and marketing loans of $12.2 billion, and farm-related business loans of $2.5 billion.

billion, or 67.5 percent. However, we expect loan growth to slow more significantly in 2009 because of the effects of a weakening farm economy and recessionary conditions on loan demand.

As of December 31, 2008, 44.5 percent of the dollar volume of the System's loans outstanding was in long-term real estate loans, 23.2 percent in short- and intermediate-term loans to agricultural producers, and 16.7 percent in agribusiness loans. Agribusiness loans are broken down further into 7.6 percent for loans to cooperatives, 7.5 percent for processing and marketing enterprises, and 1.6 percent for farm-related businesses. Loans to finance rural utilities represented 8.6 percent of the System's loan volume, while rural residential real estate loans made up about 2.9 percent of the System's total loans. International loans (export financing) represented 2.5 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 important and growing segment of the System's portfolio.

The System's increased loan volume over the past 12 months stemmed primarily from long-term real estate loans (up $8.4 billion, or 13.3 percent) and short- and intermediate-term loans (up $5.2 billion, or 16.1 percent). However, while less significant in absolute dollars, several loan categories posted notable percentage increases in 2008. Rural utility loans (energy, water, waste disposal, and communication loans) were up 28.4 percent ($3.1 billion), while processing and marketing loans (a subcategory of agribusiness loans) increased by 24.4 percent ($2.4 billion) mostly because of the expansion in biofuel production. The international loans category reversed the steady downtrend of recent years to post a 91.0 percent increase ($1.9 billion) during 2008. To some degree, this growth resulted from the tightening of world credit markets in the latter part of 2008.[10]

As a group, the agribusiness loans category was the only segment of the FCS portfolio that experienced a decrease in loan volume (down $1.2 billion, or 4.2 percent) during 2008. The largest decline occurred in the loans to cooperatives subcategory, which decreased by $3.6 billion, or 23.0 percent, from year-end 2007, mainly because of the decline in commodity prices in late 2008. As commodity prices collapsed, grain cooperatives realized profits in their hedging operations and used the proceeds to repay loans taken out earlier to cover their margin requirements when prices were skyrocketing.

Several factors facilitated the System's lending activity in 2008. The key driver was strong farm income, which not only produced cash to support debt repayment capacity but also increased the upward pressure on land values, which boosted the demand for mortgage debt. In both absolute and relative terms, long-term real estate loans increased sharply last year. However, the upsurge in production costs, especially during the first half of the year, also created strong credit demands to finance fuel, fertilizer, feed, and farm equipment purchases. The decline in agribusiness loans was offset, in part, by a moderate pickup in business from non-System lenders as the financial crisis widened, along with the System's new business in rural utility and international loans. Many of these aspects of the agricultural economy will likely not be factors in 2009, and we do anticipate growth to slow in 2009.

In 2008, System institutions continued to mount effective marketing campaigns to finance a broad range of activities and to expand their patronage programs. Despite considerable turmoil in the capital and credit markets last year, the FCS was able to meet its mission as a reliable source of reasonably priced debt capital for U.S. agriculture and rural America.

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). OFIs include com-

10. A majority of the System's international loan portfolio is guaranteed by the Commodity Credit Corporation through USDA's GSM-102 and GSM-103 export credit programs. Overall, 81 percent of the System's international loans in 2008 carried a CCC guarantee.

mercial 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, 2008, the System served 27 OFIs, up from 26 the year before. Outstanding loan volume to OFIs was $591 million at year-end, up $155 million, or 35.6 percent, from 2007. While that increase appears dramatic, OFI loan volume continues to be less than one percent of the System's loan portfolio. About 77 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 work with other financial institutions, including commercial banks, in making loans to agriculture and rural America. System institutions generally work with these financial institutions through loan participations and syndications.

- A loan participation is 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 or internally established 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.

- A loan syndication (or "syndicated bank facility") is a large loan in which a group of financial institutions works together to provide funds for a borrower. Usually one financial institution 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.

Financial institutions primarily use loan participations and syndications to reduce credit 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. As Figure 6 shows, activity from loan participations and syndications with non-System lenders has grown over the past five years.

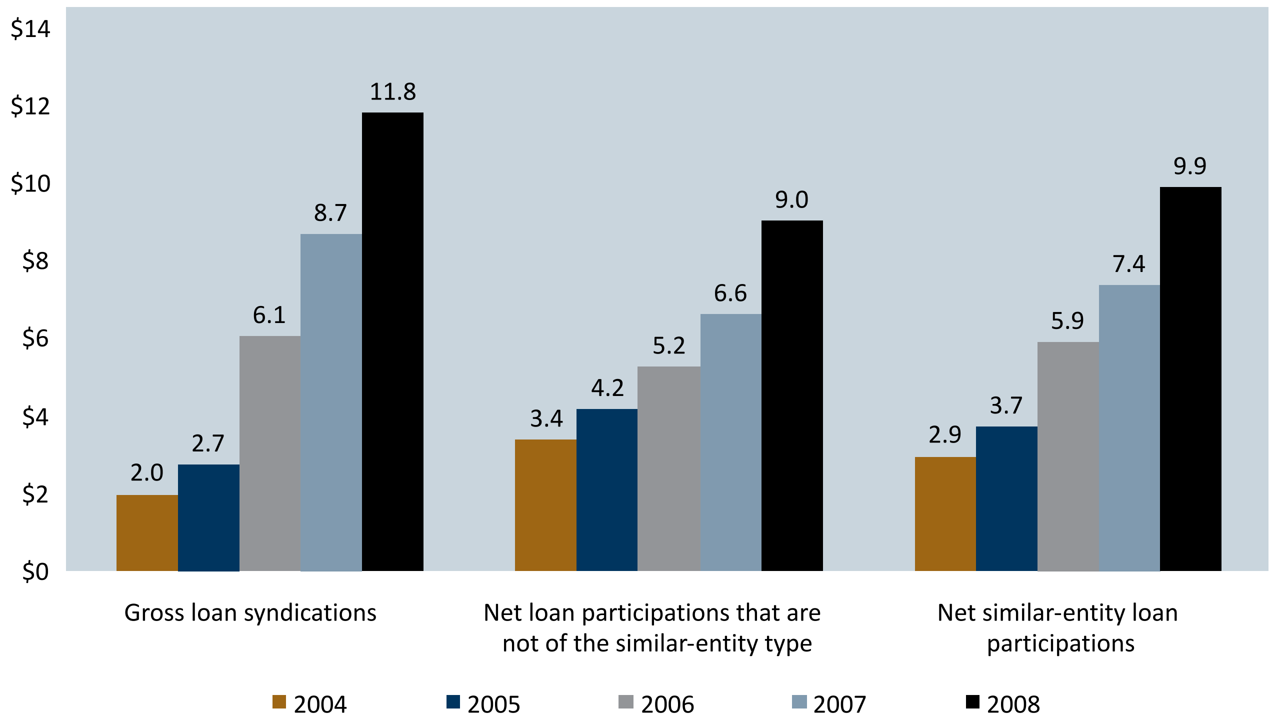
The first group of bars shows gross loan syndication activity by FCS banks and associations.[11] Gross loan syndications by the System with non-System lenders totaled $11.8 billion at year-end 2008, almost 36 percent higher than the $8.7 billion in gross syndication volume at year-end 2007, and almost twice the $6.1 billion figure posted for 2006. As a result, syndication volume continued to expand in relation to the System's loan portfolio, rising from 6.1 percent of gross loans at the end of 2007 to 7.3 percent a year later. This development reflects general market trends in which commercial credits are becoming more complex. In effect, lenders are switching from single-lender originators with participation sales to other institutions to syndicates where a group of lenders originates the loan. This allows multiple lenders to have a direct contractual agreement with the customer as a way to manage risk while satisfying the credit needs of their customers.

The second and third groups of bars show net loan participation activity involving non-System lenders for two lending categories for the past five years.

- The second group shows net loan participations with institutions that are originating loans with

11. Typically, some of the syndication volume is sold and often reported as part of net loan transactions (purchases less sales) with non-FCS lenders (see second group of bars). Net loan transactions include traditional loan participations and assignments or other interest in loans.

Figure 6
Syndications and Net Loan Participations Involving Non-System Lenders, 2004–2008
As of December 31
Dollars in Billions



Note: A similar-entitiy borrower is not eligible to borrow directly from an FCS institution, but because the borrower's operation is functionally similar to that of an eligible borrower, the System can participate in some of these loans (the participation interest must be less than 50 percent).

- customers who are also eligible to borrow from the FCS. The net total of these participations was $9.0 billion, up $2.4 billion, or 36 percent, from 2007. However, much of the lending activity in this group probably results from gross loan syndications (the first group of bars in this figure) and the subsequent sale of pieces to other System institutions.

- In addition to participating in loans to eligible borrowers, FCS institutions have authority to work with non-System lenders that originate "similar-entity" loans (third group of bars in Figure 6). 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 participation interest must be less than 50 percent). At the end of 2008, the net amount of similar-entity participations in the System amounted to $9.9 billion, up $2.5 billion, or 34 percent, from 2007.

The net total of all loan participations was $18.9 billion at year-end 2008, compared with $14.0 billion the year before.

While the unsettled situation in credit markets that is expected through 2009 may slow new activity, the partnering between System and non-System lenders is an important development that is expanding the availability of credit to rural America.

MARKET SHARE OF FARM DEBT

According to USDA preliminary data, total farm business debt for the year ended December 31, 2008, was a record $215.1 billion (nominal dollar basis), up less than 2 percent from year-end 2007.[12] After accounting for inflation, farm debt is still well below the peak level of 1980. Only in recent years has farm debt reached record-high levels on a nominal basis. Farm debt previously peaked at $189 billion at the end of 1984 and then fell during the farm financial crisis to $131 billion by the end of 1989. After the crisis, farm debt increased steadily, eventually surpassing the 1984 nominal record at the end of 2005 when it rose to $193.2 billion. Farm debt has been increasing modestly in recent years in response to rising land values and higher production costs. USDA expects farm debt to reach $217.1 billion in 2009, a modest increase over 2008 but an estimate subject to change if the demand for farm loans softens more than expected from a weak economy.

The most current market share information from USDA is for year-end 2007.[13] The information for 2008 will not be available until USDA issues its planned update in August 2009. Total farm business debt was $211.5 billion at the end of 2007. USDA estimated debt by lenders shows that commercial banks held 45.4 percent of this debt, while the System's share was 36.7 percent. Both lender groups enjoyed market share increases in 2007 as they expanded their business more than other lenders, such as life insurance companies, the Farm Service Agency, and merchants and dealers, did. As a result, the two groups now represent more than 80 percent of the total farm business debt market, 15 percentage points above their 1999 market share. When the information is released for 2008, the System's overall market share will likely show another increase, given the 14 percent increase in its farm real estate and production credit loans in 2008. (Figure 7 shows market share shifts for the major lenders since 1980.)

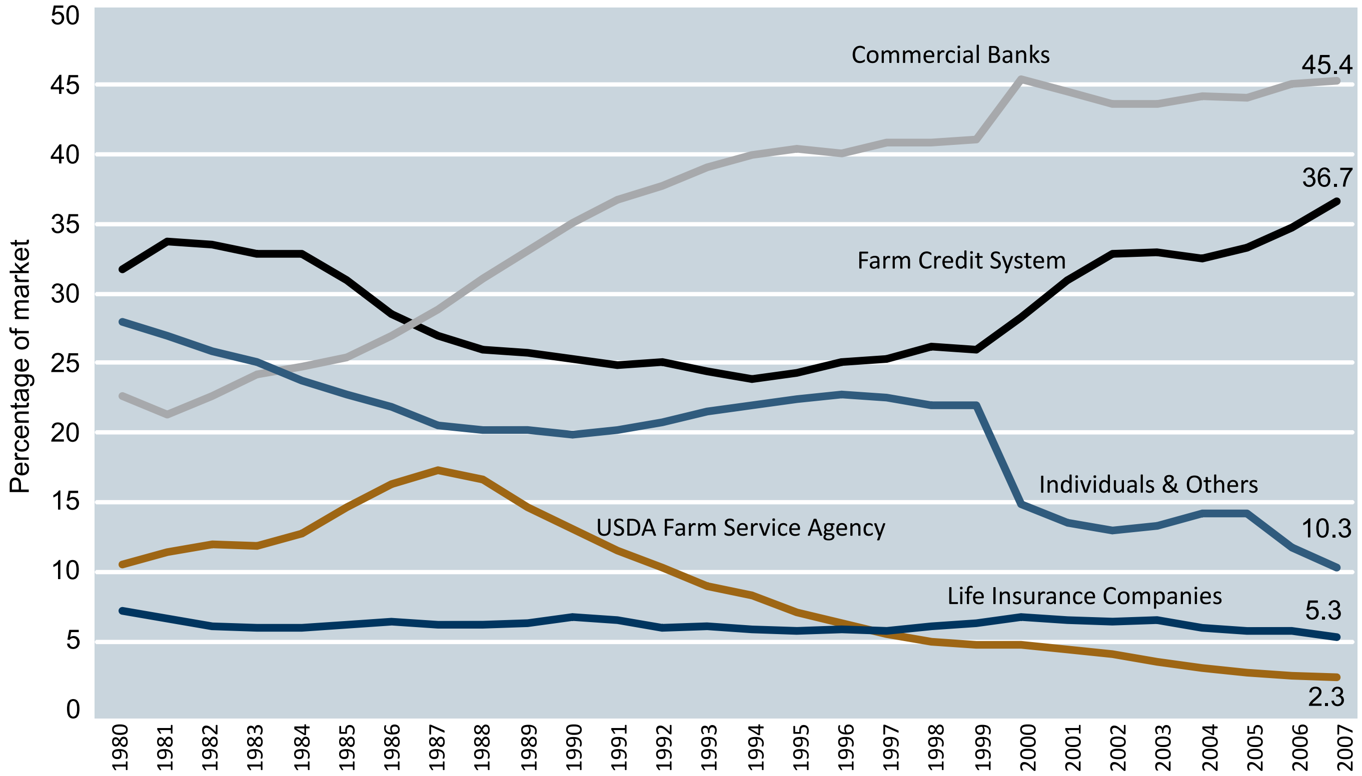
Except for the unusual period of the 1980s and a brief time in the 1990s, the FCS has typically been the dominant lender for farm real estate mortgages, enjoying the largest market share. Commercial banks have always dominated non-real estate lending. The System's share of debt secured by farm real estate increased to 42.1 percent at year-end 2007, continuing the steady upward trend of the past 10 years. The System's share of non-real estate farm debt was 31.1 percent at year-end 2007, again continuing a solid upward trend and up sharply from the late 1990s when it was slightly less than 20 percent.

In 2000, after several years of steady gains, commercial banks edged ahead of the System in the debt market

12. In 2007, USDA revised its farm debt estimates, beginning with 2000, after obtaining data that enabled it to adjust for the non-farm use of reported farm debt. The revision lowered the earlier estimates of farm debt by between 7.7 and 10.7 percent, depending on the year.
13. Market share is calculated by USDA for farm business debt only. Market share information is not available for the other portions of the System's portfolio, such as agribusiness lending, rural utility lending, or rural home lending.

Figure 7

Market Shares of U.S. Farm Business Debt, 1980–2007



Sources: USDA, Economic Research Service.

Note: Year-end 2007 figure is a preliminary estimate.

secured by farm real estate, with a 35.1 percent share. However, their share slipped during the next couple of years before stabilizing and climbing to 37.7 percent at the end of 2007, a few percentage points behind the System. In the non-real estate market, the market share held by commercial banks was 53.5 percent at the end of 2007, down slightly from 2006 and from 56.6 percent in 2000, when the FCS was still regaining its financial footing from the crisis of the mid-1980s.

FARMER MAC AS A SECONDARY MARKET

FCA also examines and regulates the Federal Agricultural Mortgage Corporation (Farmer Mac). Farmer Mac provides a secondary market arrangement for agricultural real estate, Government-guaranteed portions of certain loans, rural housing mortgage loans, and rural utility loans; in doing so, it provides greater liquidity and lending capacity to rural 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, Farmer Mac purchases and securitizes portions of certain loans guaranteed by the U.S. Department of Agriculture, including farm ownership and operating loans and rural business and community development loans. Farmer Mac also guarantees the timely payment of principal and interest on the securities created from these loans. In May 2008, the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill) expanded Farmer Mac's program authorities by allowing it to purchase and guarantee securities backed by eligible rural utility loans made by cooperative lenders.

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 statutory 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 2007 Census of Agriculture found that 29.7 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 declined from 13.3 percent in 1987 to 5.4 percent in 2007.[14] The 2007 results show that almost 13 percent of all farm operators are not principal operators. Moreover, 20 percent of the members in this group are young. Therefore, when everything is included, young operators represented 8.0 percent of the total number of farm operators in 2007, as compared with 8.6 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. This self-assessment increases the mission awareness of System institutions 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 2008, 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 2007 levels.[15] Table 6A contains information on loans outstanding in each category at the end of 2008; table 6B provides information on loans made during the year.

In the section on YBS borrowing trends (page 29), 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 153,380 loans totaling $19.5 billion at the end of 2008. During 2008, 52,856 loans totaling $7.7 billion were made to young borrowers. These loans represented 16.7 percent of all loans the System made for the year, which totaled 316,000, and 11.1 percent of the dollar volume of loans made, which totaled $69.0 billion for the associations. The average loan size of loans made in 2008 was $144,892. 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 loans made to young farmers dur-

14. The System's definition of a young farmer differs slightly from USDA's definition. See the note below table 6B.
15. 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 (both number of loans and dollar volume of loans), as well as loans outstanding at year-end (both number of loans and dollar volume of loans). The volume measure includes loan commitments to borrowers, which typically exceed actual loan advances.

Table 6A

YBS Loans Outstanding

As of December 31, 2008

	Number of loans	Percentage of total number[a]	Dollar volume of loans in millions[b]	Percentage of total volume[a]	Average loan size[b]
Young farmers/ranchers	**153,380**	**18.2**	**$19,529**	**11.4**	**$127,324**
Beginning farmers/ranchers	**216,674**	**25.8**	**$32,977**	**19.3**	**$152,194**
Small farmers/ranchers, by loan size[c]					
$50,000 or less	256,659	64.8	5,030	64.4	19,597
$50,001–$100,000	99,425	60.1	6,937	59.6	69,776
$100,001–$250,000	87,648	52.7	13,180	51.7	150,379
More than $250,000	31,546	27.9	17,542	13.9	556,061
Total loans to small farmers/ranchers[d]	**475,278**	**56.5**	**$42,689**	**25.0**	**$89,819**

Table 6B

YBS Loans Made During 2008

As of December 31

Dollars in Millions

	Number of loans	Percentage of total number[a]	Dollar volume of loans in millions[b]	Percentage of total volume[a]	Average loan size[b]
Young farmers/ranchers	**52,856**	**16.7**	**$7,658**	**11.1**	**$144,892**
Beginning farmers/ranchers	**66,559**	**21.1**	**$11,958**	**17.3**	**$179,664**
Small farmers/ranchers, by loan size[c]					
$50,000 or less	84,938	63.8	1,594	62.8	18,763
$50,001–$100,000	29,514	49.5	1,986	50.7	67,281
$100,001–$250,000	24,908	40.8	3,818	42.5	153,287
More than $250,000	11,429	18.4	6,831	12.7	597,728
Total loans to small farmers/ranchers[d]	**150,789**	**47.7**	**$14,229**	**20.6**	**$94,363**

Sources: Annual Young, Beginning, and Small Farmer Reports submitted by each System lender through the Farm Credit banks.

Note: A "young" farmer/ rancher is defined as 35 years old or younger when the loan is made; a "beginning" farmer /rancher has been operating for not more than 10 years; and a "small" farmer/rancher generates less than $250,000 in annual sales of agricultural or aquatic products. Since the totals are not mutually exclusive, one cannot add across young, beginning, and small categories to count total YBS lending.

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 2008. Each of the four percentages in the other rows indicates percentages for loans to small farmers in the respective loan size range.

b. The volume figures for loans made and loans outstanding include both advances and commitments.

c. 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.

d. Total loans represent all lending by associations.

ing 2008 was 4.6 percent higher than in 2007, and the volume of loans made was 22.1 percent higher.

Beginning—Beginning farmers, defined as those with 10 or fewer years of farming experience, constituted 216,674 of the System's loans, totaling $33.0 billion at year-end 2008. During 2008, 66,559 loans totaling $12.0 billion were made to beginning borrowers. Loans made to beginning farmers in 2008 represented 21.1 percent of all loans made in 2008 and 17.3 percent of the dollar volume of loans made. The average loan size of loans made in 2008 was $179,664. The number of loans made during 2008 was 3.7 percent higher than in 2007, and the volume of loans made was 15.1 percent higher than in the previous year.

Small—FCS institutions had 475,278 outstanding loans, totaling $42.7 billion, to small farmers (those with gross annual sales of less than $250,000) at the end of 2008. During 2008, 150,789 loans were made to small borrowers for a total of $14.2 billion. Loans made in 2008 to small farmers represented 47.7 percent of all loans made in 2008 and 20.6 percent of the volume of loans made in 2008. The average loan size of loans made in 2008 was $94,363. Although the number of loans made during 2008 was 2.8 percent lower than in 2007, the volume of loans made was 9.5 percent higher than in the previous year. Many producers moved out of the small farm category in 2008 because of the sharp run-up in commodity prices, which pushed farm marketings above the $250,000 threshold.

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. Some institutions may have a high number or dollar volume of loans in one category and be low in another, while activity levels for other institutions may be just the opposite. However, every FCS institution reported at least some activity in each category in 2008. The lowest figure was from an association reporting that only 2.3 percent of the loans it made in 2008 went to young farmers, while the highest figure came from an association reporting that 82.9 percent of its outstanding loans were to small farmers. Beginning with 1999, specific YBS data by institution, by district, and for the System as a whole are available on FCA's Web site at www.fca.gov.

The significant diversity in farm types and sizes and farmer demographics across the United States inevitably leads to wide differences among institutions' YBS results. For example, in 2007, the average value of farm production in three States was more than $250,000 per farm, compared with 21 States with average production values of less than $100,000 per farm. Census of Agriculture data also show that the average age of farmers varies by State, ranging from 52.8 years in Pennsylvania to 57.1 years in New Mexico. 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, the availability of State and USDA/Farm Service Agency (FSA) guarantees, and local economic conditions—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 2007 Census of Agriculture classified 90.5 percent of all U.S. farms as small, using the same definition for a small farm as that used for YBS reporting. However, less than a third of all small farms show interest paid as a farm business expense, which means that more than two-thirds of all small farms have no farm debt and likely would not be FCS bor-

rowers. An interesting fact is that, according to the new census, more than 40 percent of all farms had annual sales of $2,500 or less in 2007. Most of these farms would have little or no need for agricultural credit.

As noted earlier, the System reported that loans to small farmers represented 56.5 percent of the total number of loans in association portfolios at the end of 2008. Moreover, 47.7 percent of System loans made in 2008 were to small farmers. Since small farms are less likely to carry debt than large farms, these statistics reveal a strong commitment by the System to serve the credit needs of small producers.

YBS BORROWING TRENDS, 2001–2008

FCA now has eight 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 2008. (Similar trends exist for the number of loans in each category.)

Although the volume of outstanding YBS loans over the past eight years points to a good upward trend, YBS results as a percentage of total loans outstanding present a different picture. Basically the percentages for all three categories have either dipped a few points or remained relatively flat over the past several years. However, given the downward trend in the percentages of young and small farm operators in agriculture, the System's YBS dollar results are noteworthy in that institutions have managed to expand loan volume in a shrinking market segment. 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 loan growth over the past three years. The number of loans made to small farmers in 2008 was also affected by the sharp run-up in commodity prices, which pushed many farmers out of the small category even though they may have done nothing to change their operations. Finally, record farm income levels in recent years have enabled many farmers to use cash instead of debt to finance their operations. Thus, the number of farms reporting interest as an expense has decreased.

Comparisons between the System's YBS lending results and the results reported by other organizations are difficult to make. For example, comparisons 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 status as a Government-sponsored enterprise, the FCS is in a unique position to develop YBS programs; to coordinate these programs with other Government programs, which reduces risk; and to make a continuing commitment to lend to YBS borrowers. 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-value ratios or lower debt coverage requirements for YBS borrowers. One institution operates a starter-farmer program under investment authorities approved by the Agency. Almost all programs utilize Federal or State sources to obtain guarantees on loans to qualifying YBS borrowers.

Figures 8A, 8B, and 8C

Loans Made to, and Loans Outstanding for, YBS Farmers and Ranchers, 2001–2008

As of December 31

Figure 8A

Young Farmers and Ranchers

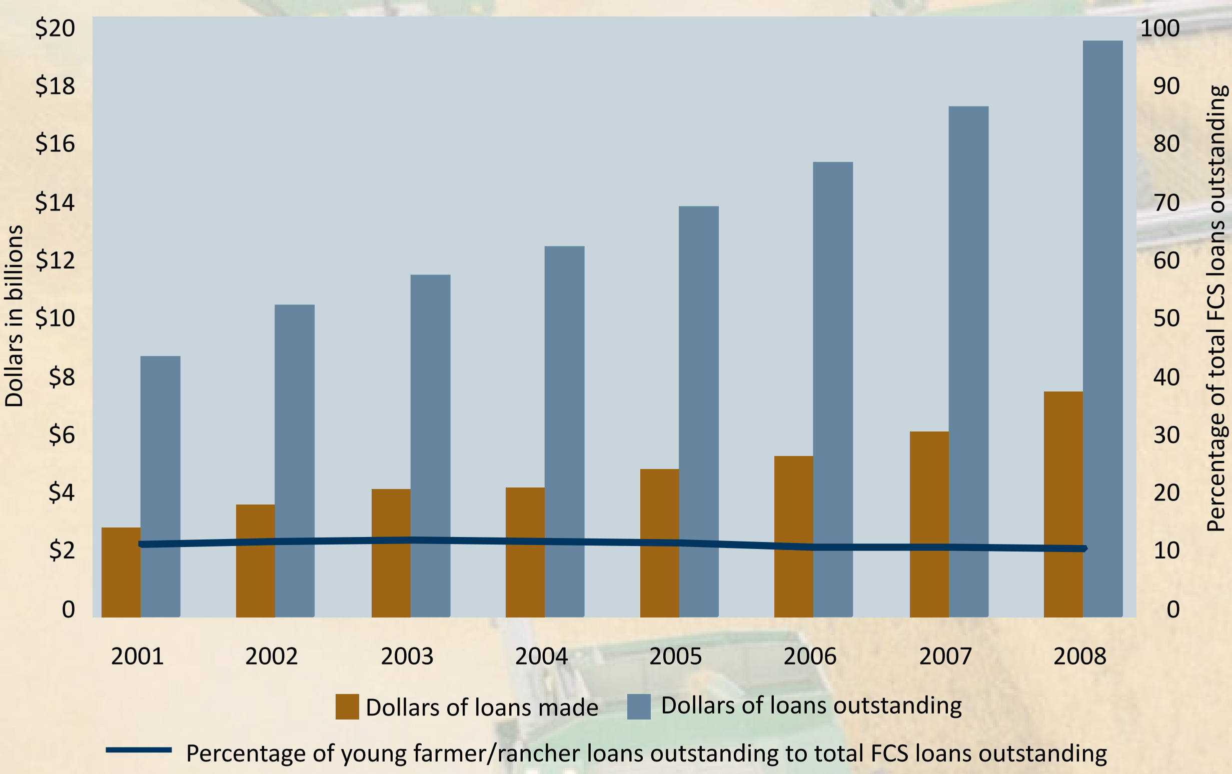


Figure 8B
Beginning Farmers and Ranchers

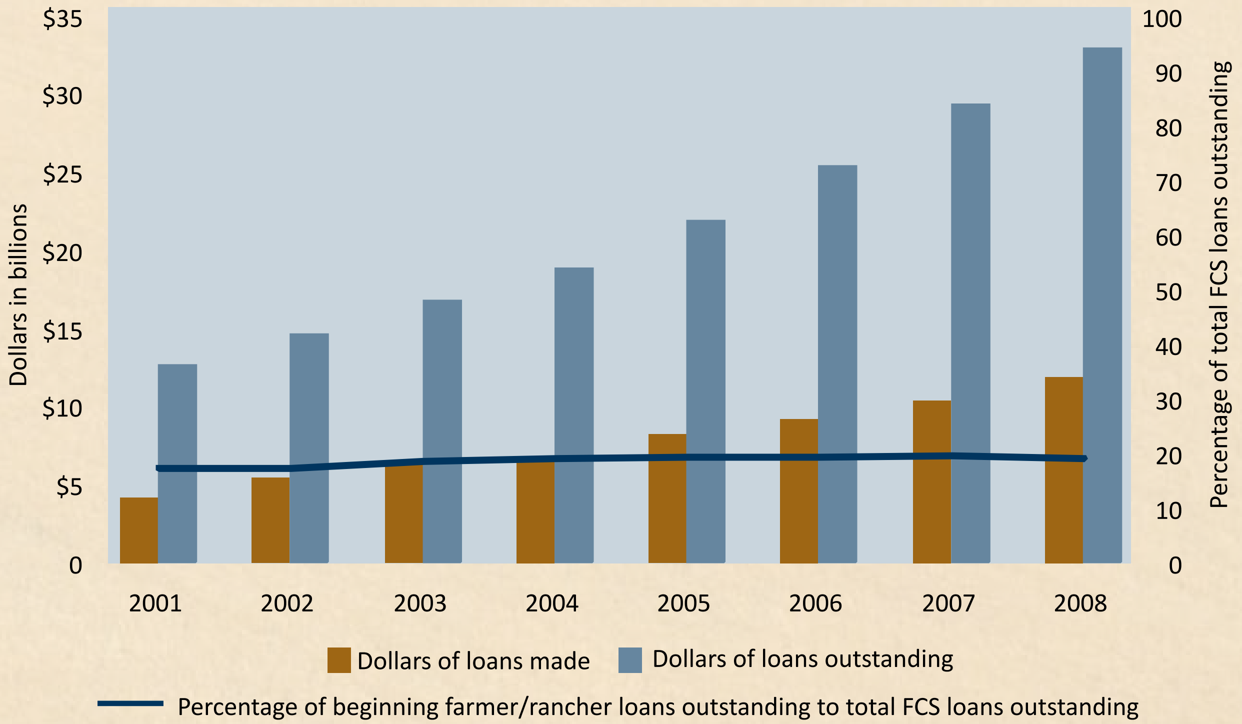
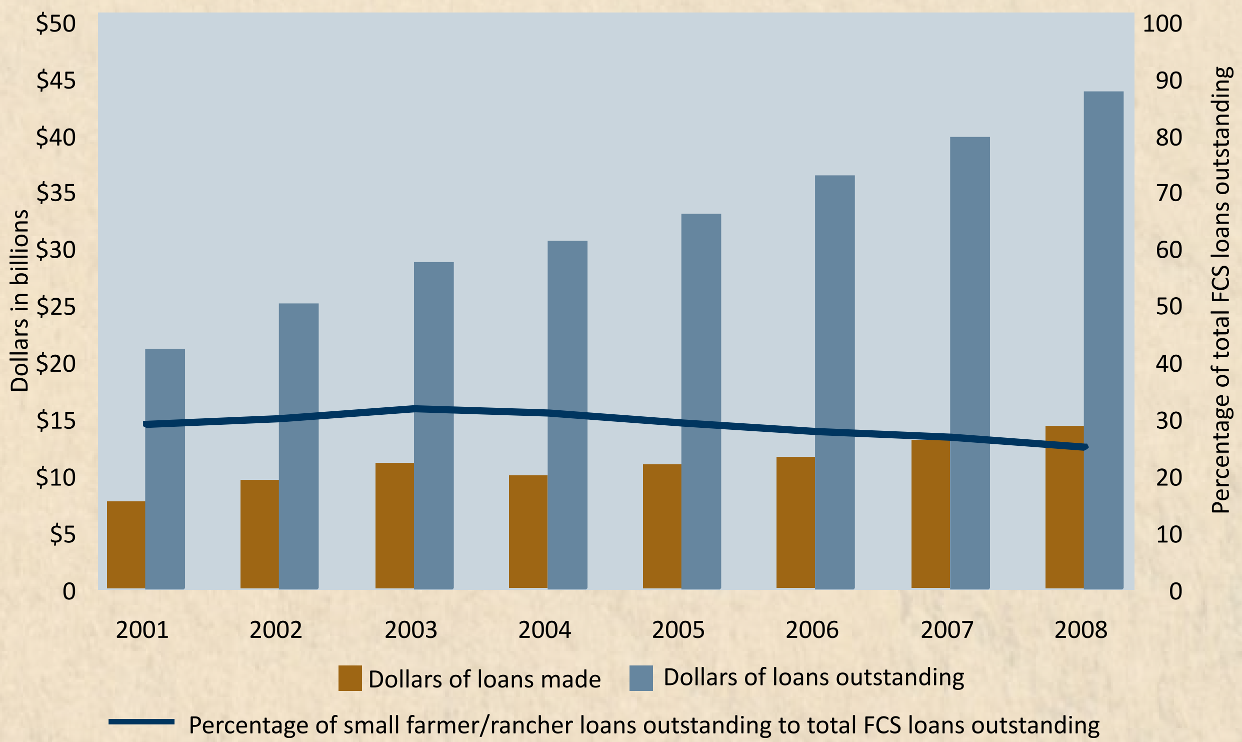


Figure 8C
Small Farmers and Ranchers



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

Most of the loan concessions made by System institutions to YBS borrowers favor the young and the beginning categories. Obviously these borrower groups face many challenges in raising enough capital to enter the industry and remain viable. During 2008, 37 associations offered interest rate concessions to their young borrowers. In addition, 49 associations provided exceptions to their underwriting standards, 26 associations charged lower loan fees, and 15 associations offered differential loan covenants. Altogether, 60 out of the System's 91 associations[16] provided some form of loan concessions to young borrowers in 2008. In addition, 58 of the 91 institutions applied one or more of these four features to the beginning category, and 57 out of the 91 used one or more of these four features for small farmers.

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. USDA's Farm Service Agency 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. In 2008, 83 of the 91 FCS associations used FSA guarantees for YBS lending, while 17 associations used SBA guarantees and 16 associations used State and local programs.

FCS institutions actively use FSA's guaranteed lending program for both conventional and YBS lending.[17] Agency surveys indicate that about 44 percent of the System's overall volume of FSA-guaranteed loans outstanding was to young farmers; about 56 percent was to beginning farmers; and about 62 percent was to small farmers (numbers are not additive). However, the volume of YBS loans with FSA guarantees represents only 3 to 5 percent of the overall YBS program figures. This percentage is similar to that of 2007, when it was only 3 to 4 percent of the overall YBS program figures. At year-end 2008, the guaranteed loan volume figures for young, beginning, and small farmer/rancher loans were $1.0 billion, $1.2 billion, and $1.5 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 providing insurance services; almost 80 percent of the associations offered this service in 2008. The development of business and financial management skills is another important training objective, and in 2008, approximately 70 percent of the associations provided training in this area. FCS associations also offer training opportunities in estate planning, recordkeeping, tax planning and preparation, and farm business consulting. In some cases, they discount or waive the cost of these programs for YBS borrowers.

In addition to the training tools for YBS farmers at individual associations, System institutions are working together on System-wide training programs to be available online for YBS farmers. For example, an online business plan development training course is anticipated to be available in 2009.

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 college scholarships and for FFA, 4-H, and other agricultural organizations.

At year-end 2008, 39 associations reported that they had revised their YBS policies and/or procedures in the past year in response to guidance issued in an August 2007 FCA Bookletter.[18] Additionally, 25 associations expect to revise their policies and procedures in 2009. FCA's oversight activities are accomplishing the goal of helping institution management and boards stay focused on this important mission area.

16. By the end of 2008, the System had only 90 associations because two of them merged.
17. The FCS accounts for about 28 percent of the dollar volume of all FSA farm loan guarantees outstanding.
18. The Bookletter provides guidance to all FCS institutions on interpreting the phrase "sound and constructive credit" when applied to YBS farmers and ranchers and on extending credit to part-time YBS farmers who demonstrate a commitment to be full-time agricultural producers. The Bookletter further encourages System lenders to provide credit enhancements so that YBS farmers can qualify for financing, and it encourages System lenders to mitigate the risk of lending to YBS farmers by increasing coordination with other lending entities and sharing best practices.

REGULATORY POLICY AND APPROVALS

FCA routinely issues regulations, policy statements, and other documents to ensure that the Farm Credit System complies with the law, operates in a safe and sound manner, and efficiently carries out its statutory mission. The regulatory philosophy of FCA is to establish a flexible regulatory environment that enables the System to safely and soundly offer high-quality, reasonably priced constructive credit and related services to farmers and ranchers and their cooperatives; rural residents; and other entities on which farming operations depend.

The Agency makes every effort to develop balanced, well-reasoned, and flexible regulations whose benefits outweigh their 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 System institutions.

REGULATORY ACTIVITY IN 2008

The following paragraphs describe some of FCA's regulatory efforts in 2008, along with several projects that will remain active in 2009.

Financing for Processing or Marketing Operations—The FCA Board approved a final rule in April 2008 that revised the eligibility and scope-of-lending regulations for processing and marketing operations to make them more responsive to changing ownership structures of such operations.

Farmer Mac Risk-Based Capital Stress Test Revisions—The FCA Board approved a final rule in April 2008 that revised FCA regulations governing the Risk-Based Capital Stress Test (RBCST) for the Federal Agricultural Mortgage Corporation (Farmer Mac). The RBCST calculates the minimum amount of regulatory capital that Farmer Mac is required to hold. The rule (1) adds a component to the RBCST to recognize the risk-reducing characteristics of structures such as off-balance-sheet AgVantage securities, a unique loan product that accounts for a significant percentage of Farmer Mac's program volume; (2) adds a component to the RBCST to recognize counterparty risk on nonprogram investments; and (3) revises the estimated carrying costs of nonperforming loans.

Capital Adequacy—Basel Accord—The Agency issued an advance notice of proposed rulemaking (ANPRM) in October 2007 that considers possible modifications to its risk-based capital rules for FCS institutions that are similar to the standardized approach delineated in the New Basel Capital Accord. In view of the mortgage crisis and the complexity of the questions asked in the ANPRM, FCA extended the comment period to December 31, 2008.

Questions and Answers Regarding Flood Insurance—The FCA Board approved a notice with request for comment in March 2008 regarding loans in areas having special flood hazards. The notice contained an updated set of interagency questions and answers regarding flood insurance. The updated questions and answers will help Farm Credit System institutions better understand the flood insurance statutes, regulations, and Federal Emergency Management Agency guidance.

Regulatory Burden Notice—The FCA Board approved a regulatory burden notice of intent in June 2008 seeking public input on targeted parts of FCA's regulations that may duplicate other requirements, are not effective in achieving stated objectives, are not based on law, or impose burdens that are greater than the benefits received.

Disclosure and Accounting Requirements—The FCA Board approved a proposed rule in October 2008 to amend FCA regulations on disclosure to shareholders and accounting and reporting requirements. The proposed amendment will ensure that FCA regulations are consistent with System structural changes, and that they include changes in accounting, auditing, and reporting standards.

Inflation Adjustments to Civil Money Penalties—The FCA Board adopted a direct final rule in December 2008 that made the required cost-of-living adjustments to FCA civil money penalties issued (1) under section 5.32 of the Farm Credit Act for violation of the act or regulations issued under the act to the maximum amount of $750 per day for each violation, and (2) under the National Flood Insurance Reform Act of 1994 to not exceed $120,000 for the total civil money penalties that may be assessed against any single institution during any calendar year for violations of the Reform Act.

Investments in Rural America—FCA continues to evaluate how System partnerships and investments could help increase the availability of funds to agriculture and rural America. FCA is reviewing investments made under pilot projects to determine if these investments assist institutions in fulfilling mission objectives. FCA considered projects emanating from this review as support for a proposed rule on Rural Community Investments. These projects may also be considered in future rulemakings.

Rural Community Investments—The FCA Board approved a proposed rule in May 2008 that would authorize System banks, associations, and service corporations to invest in rural communities across America under certain conditions.

Floor Nomination Procedures—FCA issued a Bookletter that provides guidance to System associations and banks on procedures they may use in accepting nominations of director candidates from the floor.

Distribution of Director Candidate Information—FCA issued a Bookletter clarifying that campaign material does not include educational material, thus allowing System institutions to provide stockholders educational material on director candidates without violating the prohibition on distributing campaign material.

Effect of FAS 158 on Regulatory Capital—FCA issued a Bookletter to System banks requiring them to adjust their net collateral ratio calculations to eliminate the effects, if any, of adopting Statement of Financial Accounting Standards No. 158.

Collateral Evaluation Requirements and Frequently Asked Questions—FCA issued an Informational Memorandum that provided guidance to System institutions to ensure that their collateral evaluation review programs are sufficient (1) to minimize risk to their assets from adverse trends in real property values and (2) to ensure compliance with FCA regulations.

Asset Growth, Market Volatility, and the Best Practices for Fast-Growing Institutions—FCA issued an Informational Memorandum to continue communication with the System regarding growth and emerging risks in agriculture, and to provide best practices FCA has observed for institutions experiencing rapid growth.

National Oversight and Examination Program for 2009—FCA issued an Informational Memorandum that provides a summary of the National Oversight and Examination Program for 2009, which focuses resources on the most significant risks to the FCS in accordance with FCA's risk-based philosophy. The National Oversight and Examination Program is ongoing and dynamic.

Capital Adequacy—Risk Weighting of Certain Off-Balance-Sheet Exposures—FCA issued an Informational Memorandum to provide guidance to System institutions for determining regulatory capital treatment of certain off-balance-sheet exposures, specifically commitments, letters of credit, direct credit substitutes, and recourse obligations.

Foreign Currency Transactions—FCA issued an Informational Memorandum to provide guidance on the permissible scope of foreign currency transactions by System institutions.

Loan Syndications and Assignment Markets Study—FCA continued to study loan syndication and assignment markets to determine whether its regulations should be modified to reflect significant changes in the markets.

CORPORATE ACTIVITY IN 2008

In 2008, FCA analyzed and approved eight applications, compared with six applications processed in 2007.

1. On December 31, 2008, a stand-alone FLCA merged into the FLCA subsidiary of an ACA in the U.S. AgBank, FCB, district. The resulting entity is an ACA with one FLCA subsidiary and one PCA subsidiary.

2. On December 31, 2008, two ACAs affiliated with AgFirst Farm Credit Bank merged their operations. The PCA and FLCA subsidiaries associated with the ACAs also merged.

3. On December 1, 2008, an ACA and its PCA and FLCA subsidiaries changed their headquarters location. The ACA and its subsidiaries are affiliated with AgriBank, FCB.

4. On October 16, 2008, a stand-alone FLCA received FCA approval to convert its charter to that of an ACA with PCA and FLCA subsidiaries. The FLCA is affiliated with the Farm Credit Bank of Texas. Following stockholder approval, the conversion to the new structure took effect January 1, 2009.

5. On October 1, 2008, an ACA affiliated with AgriBank, FCB, changed its name and the names of its PCA and FLCA subsidiaries.

6. On October 1, 2008, two ACAs affiliated with the Farm Credit Bank of Texas merged their operations. The PCA and FLCA subsidiaries associated with the ACAs also merged.

7. On June 1, 2008, an ACA affiliated with AgFirst Farm Credit Bank changed its name and the names of its PCA and FLCA subsidiaries.

8. On April 30, 2008, two ACAs affiliated with U.S. AgBank, FCB, merged their operations. The PCA and FLCA subsidiaries associated with the ACAs also merged.

The total number of associations as of December 31, 2008, was 90. 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 at www.fca.gov.

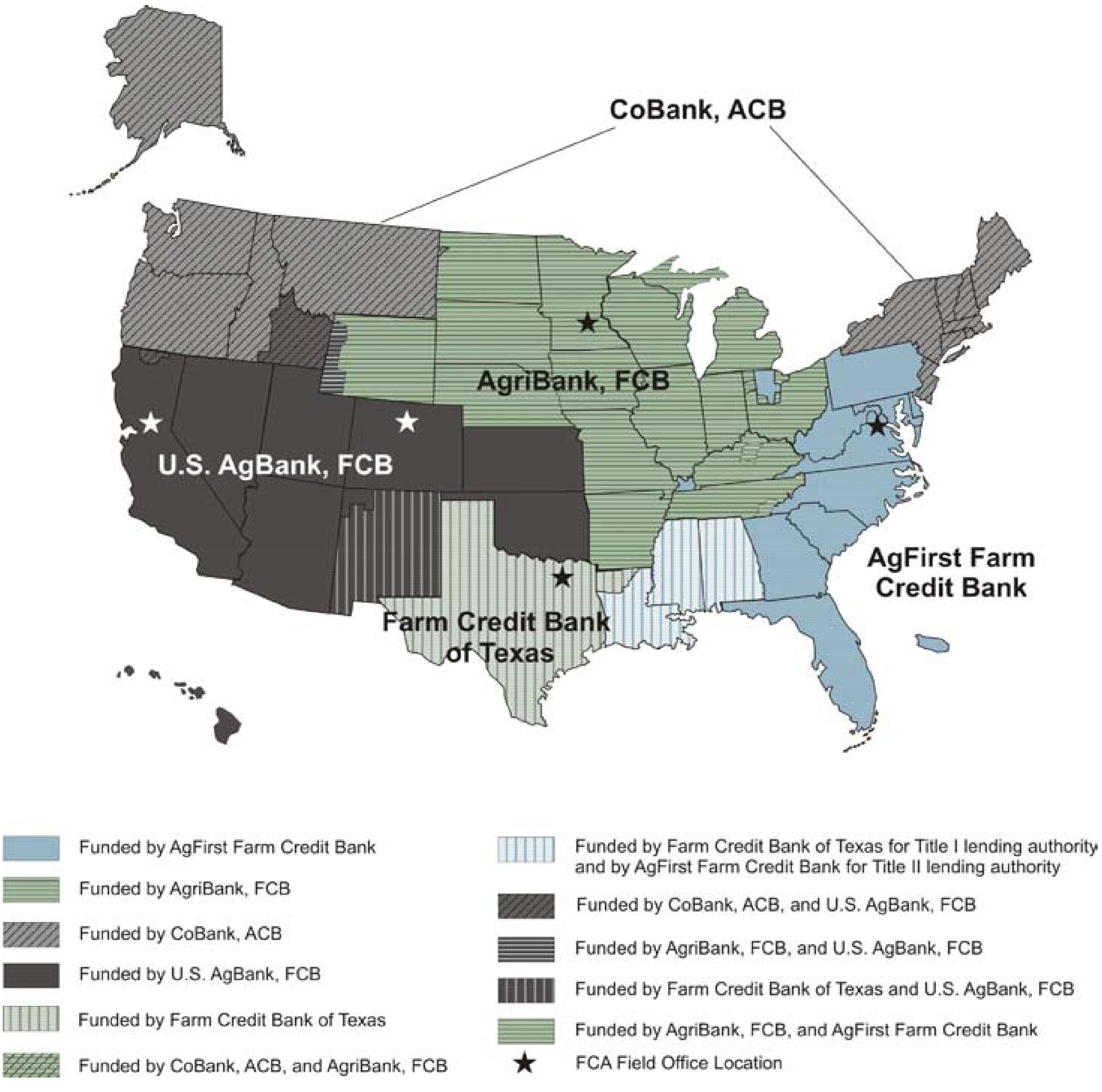
FUNDING ACTIVITY IN 2008

While the System continued to have regular and flexible access to short-term debt markets during 2008, its flexibility in issuing securities with maturities greater than one year was reduced, and the spreads over similar Treasury securities for such term issuances increased. Also, certain traditional buyers of the System's long-term securities significantly reduced their purchases, with corresponding negative impact on the market and cost of these securities. The System has begun to adjust to these conditions with changes in issuance strategies and in the structure and pricing of loans to borrowers.

In addition, some of the Federal Government's responses to the severe dislocation and volatility in the U.S. and global financial markets had, and may continue to have, the unintended consequences of increasing System institutions' funding costs. The responses also impact the System's ability to issue debt with preferred maturities and structures. Examples of the Federal Government's responses include the Federal Deposit Insurance Corporation's approval of a program that guarantees senior unsecured debt newly issued by commercial banks and others, the Federal Reserve's purchase of debt obligations of the housing GSEs, and the U.S. Treasury's creation of a line of credit for the housing GSEs.

Finally, conditions in the markets substantially reduced, if not eliminated, the ability of individual System institutions to issue third-party capital (preferred stock and subordinated debt) at a cost acceptable to the issuing institution.

Figure 9
Chartered Territories of FCS Banks
As of April 30, 2009



Note: CoBank funds 5 associations in the indicated areas and serves cooperatives nationwide; U.S. AgBank, FCB, funds 27 associations; Farm Credit Bank of Texas funds 19 associations; AgriBank, FCB, funds 17 associations; and AgFirst Farm Credit Bank funds 22 associations. The FCS contains a total of 95 banks and associations.

The System funds its loans with a combination of consolidated Systemwide debt and capital. The Funding Corporation, the fiscal agent for the five System banks, sells debt securities such as discount notes, master notes, bonds, and designated bonds on behalf of the System.[19] This process allows funds to flow from worldwide capital-market investors to agriculture and rural America, providing rural communities with efficient and expansive access to global resources. At year-end 2008, outstanding Systemwide debt was $178.4 billion, up from $154.4 billion a year earlier, representing a 15.5 percent increase. The $23.9 billion increase in outstanding debt funded the $18.5 billion, or 13.0 percent, increase in gross loans outstanding, with the balance going primarily to fund investments for liquidity and other purposes.

FCA has various responsibilities pertaining to System funding activities. As required by the Farm Credit Act, the System must obtain FCA approval before distributing or selling debt issuances. FCA has systems and processes that enable it to respond to these requests quickly and efficiently. For example, FCA has a program that allows the System to issue discount notes at any time up to a certain amount as long as it provides FCA with periodic reports on this activity. As a result of the worldwide liquidity crisis, FCA raised that maximum in 2008 from $40 billion to $60 billion. In addition, FCA approves the majority of longer-term debt issuances through a monthly "shelf" approval program. For 2008, FCA approved $166 billion in longer-term debt issuance 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 that 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. All System banks have managed their operations to achieve net collateral ratios that are higher than the required minimum, with 104.6 percent being the lowest ratio for any single bank as of December 31, 2008.

As another safe and sound practice, FCA regulations require the banks to maintain a minimum of 90 days of liquidity to guard against a possible interruption in its access to the capital markets. In November 2008 the FCA Board adopted a Market Emergency Standby Resolution that authorizes a waiver of the 90-day liquidity reserve requirement whenever a financial, economic, agricultural, or national defense emergency is deemed to exist. This resolution would go into effect only in the event of a serious market disruption, and it would temporarily allow banks (for no more than 14 days) to fund their assets with short-term liabilities even if doing so would cause the liquidity reserve of one or more banks to drop below the minimum requirement.

The Funding Corporation and the System banks have also entered into voluntary agreements to provide for mutual protection in the support of joint and several liability on Systemwide debt obligations. The amended and restated Market Access Agreement[20] establishes certain financial thresholds that provide the Funding Corporation with operational oversight and control over the System banks' participation in Systemwide debt obligations. The amended and restated Contractual Interbank Performance Agreement establishes certain measures that monitor the financial condition and performance of the institutions in each System bank district. The System banks have also adopted a common liquidity standard to help ensure their collective ability to meet their obligations under these mutual agreements.[21]

Between 2002 and 2005, the volume of new issuances declined as System banks extended the maturity of debt to comply with the common liquidity standard and to capitalize on historically low interest rates. From

19. 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.

20. The amended and restated Market Access Agreement began in the late 1990s and is periodically amended (updated) pertaining to financial targets, economic incentives, etc.

21. The common liquidity standard 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.

2006 through 2008, debt issuances increased as a result of favorable economic conditions in agriculture and strong loan demand from System borrowers. For the 12 months ended December 31, 2008, the System issued $519 billion in debt securities, compared with $484 billion for 2007 and $387 billion for 2006.[22]

The System's ability to extend its debt maturities in 2008 was challenged as investors preferred shorter-term debt instruments. The System's weighted-average remaining maturity for all outstanding insured debt was 3.3 years as of December 31, 2008, compared with 3.6 years as of December 31, 2007, and 2.9 years as of December 31, 2006. The weighted-average interest rates for the insured debt decreased from 4.7 percent as of December 31, 2007, to 2.8 percent as of December 31, 2008.

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. Investments in rural communities can help create infrastructure improvements that promote the economic vitality of these communities for current and future generations of American farmers and rural residents. Farming families will increasingly benefit from investment projects that promote rural development and 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 System 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, 2008, the mission-related investment securities held under these regulatory authorities totaled $2.9 billion, including $888.7 million in AMBS as held-to-maturity and $557.9 million as available-for-sale. In addition, in 2005 FCA approved System institution holdings of investments in successor-in-interest contracts created as a result of the Tobacco Transition Payment Program.[23] As of December 31, 2008, investments in successor-in-interest contracts totaled $763.6 million (not including interest receivable). Also, at year-end, Farm Credit institutions held $589.0 million in asset-backed securities collateralized by the guaranteed portions of USDA loans and $58.4 million in securities backed by agricultural equipment loans.

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 capital to support economic growth and infrastructure improvements. In response, FCA issued guidance giving 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, 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. The investments made under the pilot programs are intended to provide FCS institutions an opportunity to support and supplement investments by government and community banks for worthwhile community projects. The pilot investment programs provide FCA with the opportunity to study these investments to determine how the System can use

22. Payment of principal and interest on Systemwide debt securities is insured by the Farm Credit System Insurance Corporation's Farm Credit Insurance Fund to the extent provided in the Farm Credit Act. Some FCS debt ($1.4 billion outstanding as of December 31, 2008) was issued by individual banks of the FCS. These individual banks are solely liable for the principal payments on this uninsured debt.
23. 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.

these investments to help it fulfill its mission and to increase the availability and efficiency of funding to rural areas.

FCA has placed controls on these pilot investment programs to ensure their legal sufficiency, safety and soundness, and consistency with the FCS mission. These controls ensure a restricted authorizing environment that includes special examination and reporting for those institutions participating in the pilot programs. This pilot program structure also provides FCA with a unique opportunity to gain critical insight and understanding of rural financial markets.

Since 2005, FCA has approved a number of pilot programs and specific investments involving the following investment areas and structures.

Rural Housing Mortgage Securities (RHMS)—During 2008, three Farm Credit banks were authorized to purchase and hold RHMS under a three-year pilot program. 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, 2008, the investment securities of the Farm Credit banks participating in this program included $1.5 billion in RHMS classified as held to maturity.

Agriculture and Rural Community Bonds and Securities—During 2008, all FCS institutions were authorized to participate, under specific conditions, in pilot programs 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. 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. Many of these projects included collaboration with U.S. Department of Agriculture (USDA) Rural Development programs, rural community banks, and regional and local economic development authorities. As of December 31, 2008, FCS institutions held $491.4 million of investments under these programs.

Equity Investments—FCA has approved several mission-related equity investments, 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. In addition, since the Farm Security and Rural Investment Act of 2002 authorized any FCS institution, under limited conditions,[24] to invest in rural business investment companies (RBICs) to promote economic development and job opportunities in rural areas, several FCS institutions have made equity investments in RBICs. As of December 31, 2008, the amount of mission-related equity investments outstanding totaled $1.1 million for investments in the starter farmer program, $529,000 for investments in venture capital funds, and $1.3 million for investments in RBICs.

24. 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 Farm Credit System are limited-purpose lenders exposed to risk in making loans and investments to benefit their borrower-stockholders and meet their public mission. For FCS institutions to keep providing a dependable source of credit and financially related services for rural America, they must operate with sufficient capital and appropriately manage and control risk. That is why FCA deploys examination and supervisory resources to monitor systemic risks in the FCS as a whole and specific risks 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. Examiners also evaluate whether each institution is meeting its public mission. They do so by determining whether each institution is operating in compliance with applicable laws and regulations and if it is responsive to the credit needs of all types of agricultural producers and cooperatives that are eligible for credit, including young, beginning, and small (YBS) farmers and ranchers. This risk-based approach helps to ensure that FCA provides the most effective and efficient regulatory oversight to the System.

CONDUCTING A RISK-BASED EXAMINATION AND OVERSIGHT PROGRAM

FCA's examination and oversight program is designed to monitor and address FCS risk as effectively and efficiently as possible. Therefore, FCA assigns highest priority to institutions at greatest risk. This approach also relies in part on 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 takes 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. The oversight programs also ensure compliance with laws and regulations. For example, FCA regulations require FCS institutions to have effective loan underwriting and loan administration processes. FCA also has specific regulations requiring FCS institutions to maintain strong asset-liability management capabilities. For approximately 20 years, FCA has used 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 their own 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 conducts ongoing monitoring and interim examination activities in each institution as risk and circumstances warrant. FCA then integrates identified systemic risks into its national oversight strategies to mitigate risks Systemwide. This approach provides differential risk-driven examination activities for all institutions.

As of December 31, 2008, FCA was overseeing and examining the following:

- 90 FCS direct-lender associations
- 4 Farm Credit Banks
- 1 Agricultural Credit Bank
- 5 service corporations and 1 special-purpose entity
- Farmer Mac
- The National Consumer Cooperative Bank (NCB), which is not an FCS institution[25]

FCA's examination approach emphasizes the importance of proactive communication with regulated institutions through a combination of communication methods.

The Small Business Administration (SBA) and the U.S. Department of Agriculture (USDA) continued to use FCA's examiner expertise in 2008.

25. The National Consumer Cooperative Bank Act of 1978, as amended, provides for FCA to examine and report on the condition of NCB. Since the passage of this law, FCA has conducted safety and soundness examinations of NCB and issued reports to the bank's board.

SBA contracted with FCA to have the Agency conduct examinations of financial companies licensed by SBA to make guaranteed loans to small businesses. USDA contracted with FCA to have the Agency conduct examinations of financial companies authorized to make guaranteed loans under USDA's Business and Industry Guaranteed Loan program and Community Facilities Guaranteed Loan program. FCA examiners also completed reviews of the Business and Industry Guaranteed Loan program operations at selected USDA State Rural Development offices.

During 2008, as part of these contracted activities, the Agency issued 18 Reports of Examination or other agreed-upon deliverables on SBA- and USDA-guaranteed lenders. The Agency has found that enabling its examiners to assist SBA and USDA has broadened its examiners' skills and experiences. However, the safety and soundness of the FCS remains FCA's principal focus and responsibility. Therefore, because of the current riskier financial environment, FCA will reduce these contracting relationships in the coming year.

IDENTIFYING AND RESPONDING TO POTENTIAL THREATS TO SAFETY AND SOUNDNESS

Because of the dynamics and risks in the agricultural and financial industries, FCA must ensure that FCS institutions have the culture, governance, policies, procedures, and management controls to effectively identify and manage risks. To be fully effective in meeting this challenge, the Agency has various risk supervision 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. These risk supervision processes emphasize taking a proactive, nationally focused approach to addressing material risks and emerging issues. While numerous important risks and emerging issues are being addressed, the following topics have been receiving particular emphasis:

Internal audit and credit review programs, with emphasis on Audit Committee operations and program reliability.

Portfolio risk and stress analysis, with emphasis on techniques employed by institutions to proactively identify, quantify, and manage risks.

Shared assets initiative to assess System institutions' processes for obtaining and analyzing information to assess large credits funded or participated by multiple FCS institutions and their processes for facilitating FCA's identification of the System's shared credit exposures.

Capital management, with emphasis on capital trends, patronage and dividend programs, and strategies to determine appropriate capital management in FCS institutions.

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, assets, management, earnings, liquidity, and sensitivity 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.[26]

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. The FIRS benchmarks were updated in

26. See the Glossary for a complete description of the FIRS ratings.

2008. 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 communications 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 for 2008 show that the financial condition and performance of the FCS remained relatively strong throughout the year; however, risk did increase from the extremely low risk levels of the last five years. As shown in figure 10, FIRS ratings declined in 2008 as stresses from the general economy, the credit crisis, and volatility in commodity prices surfaced and impacted some institutions. At December 31, 2008, 58 FCS institutions were rated 1, 32 were rated 2, 6 were rated 3, and 1 was rated 4. There were no institutions with a rating of 5. (FCA applies FIRS ratings only to the banks and associations of the FCS, not to the System's service corporations. It also applies a FIRS rating to Farmer Mac, but Farmer Mac is not counted in figure 10.) Although there has been some decline, the ratings still reflect a financially safe and sound FCS. Stresses in the livestock and ethanol industries in the quarter ended December 31, 2008, largely drove the decline in the number of institutions with a rating of 1. The overall financial strength maintained by the System reduces the risk to investors in FCS debt, to the Farm Credit System Insurance Corporation (FCSIC), and to FCS institution stockholders.

In addition to the FIRS process, FCA examiners use another tool to assess prospective risk. This tool considers six risk criteria: credit, interest rate, liquidity, operational, compliance, strategic, and reputation. It measures quantity of risk, quality of risk management, and direction of risk (that is, whether risk is increasing or declining). This tool is used, along with FIRS ratings and other information, to assist the Office of Examination in allocating resources to where the risks are highest.

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 unacceptable risks, it takes action to ensure that the identified risks are appropriately mitigated. Corrective actions include reducing risk exposures; increasing capital, which improves an institution's ability to bear risk; 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, an institution is given clear and firm regulatory guidance to address identified weaknesses, and the institution is allowed time to correct the problems.

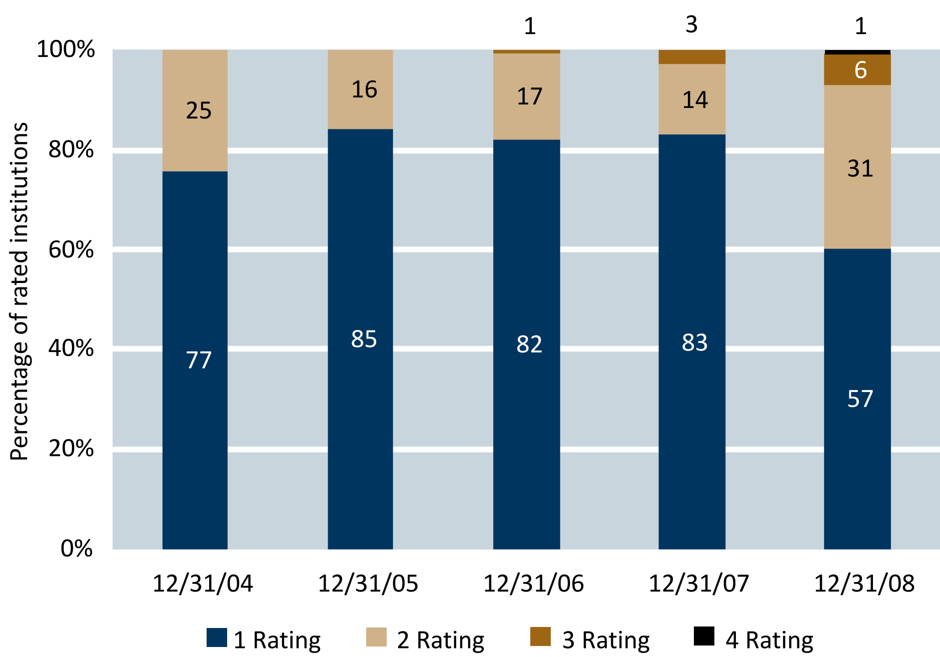
If informal supervisory approaches have not been or are not likely to be successful, FCA will use its formal enforcement authorities to ensure that the operations of FCS institutions are safe and sound and are in compliance with laws and regulations. FCA may take an enforcement action for a number of reasons:

- A situation threatens an institution's financial stability.
- An institution has a safety and soundness problem or has violated a law or regulation.
- An institution's board is unable or unwilling to correct problems FCA has identified.

Figure 10

Financial Institution Rating System (FIRS) Composite Ratings for the FCS, 2004–2008

As of December 31



FCA's enforcement authorities include the following powers:

- To enter into formal agreements
- To issue orders to cease and desist
- To levy civil money penalties
- 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.

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. The significant risks in agriculture can sometimes make it difficult for borrowers to repay loans. 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 the borrower rights provisions of the Farm Credit Act and examines institutions to make sure that they are complying with these provisions. It also receives and reviews complaints from borrowers regarding their rights as borrowers. 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. As the economy has deteriorated and affected FCS borrowers, FCA has received an increase in the number of borrower complaints. Generally, borrowers who contact FCA with complaints are seeking clarification, additional information, and options to redress their concerns. To the extent there are potential violations of law and regulations, FCA requires corrective actions by the institutions.

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, through which 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.

- Farmer Mac II, through which Farmer Mac purchases and securitizes portions of certain loans guaranteed by the U.S. Department of Agriculture, including farm ownership and operating loans and rural business and community development loans. Farmer Mac also guarantees the timely payment of principal and interest on the securities created from these loans.

- AgVantage, through which Farmer Mac buys or guarantees securities issued by agricultural and rural utility lenders.

In May 2008, the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill) expanded Farmer Mac's program authorities by allowing it to purchase and guarantee securities backed by eligible rural utility loans made by cooperative lenders.

Farmer Mac is regulated by FCA through the Office of Secondary Market Oversight (OSMO), which was established by the Farm Credit System Financial Safety and Soundness Act of 1991. 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 the following functions:

- Examines Farmer Mac at least annually for capital adequacy, asset quality, management performance, earnings, liquidity, and sensitivity

- Supervises Farmer Mac's operations

- Evaluates Farmer Mac's safety and soundness and mission achievement

OSMO reviews Farmer Mac's compliance with FCA's risk-based capital regulations and supervises its operations and condition throughout the year. Table 7 summarizes Farmer Mac's balance sheets at the end of the year for 2003 to 2008. Please note that certain prior-year amounts will differ from amounts published in some of the earlier annual reports because in late 2006 Farmer Mac provided a financial restatement for several reporting periods. 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 statute, secondary market GSEs like Farmer Mac are permitted to operate with lower statutory capital margins than are primary market lenders. Accordingly, monitoring the capital levels of Farmer Mac is a central component of FCA's oversight programs.

On December 31, 2008, Farmer Mac's net worth (that is, equity capital determined using generally accepted accounting principles [GAAP]) was $15.3 million, compared with $223.6 million a year earlier. Net worth was 0.3 percent of on-balance-sheet assets as of December 31, 2008, compared with 4.5 percent at the end of 2007. The reduction was primarily caused by impairment losses in its nonprogram investment portfolio and unrealized losses in its deriva-

Table 7

Farmer Mac Condensed Balance Sheets, 2003–2008

As of December 31

Dollars in Millions

	2003 Restated	2004 Restated	2005 Restated	2006	2007	2008	Percentage growth rate 2007–2008
Total assets	4,299.7	3,847.4	4,341.4	4,953.7	4,977.6	5,107.3	2.6
Total liabilities	4,089.2	3,612.2	4,095.4	4,705.2	4,754.0	4,947.7	4.1
Net worth or equity capital	210.5	235.2	246.0	248.5	223.6	159.6*	(28.6)

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

* Includes $144.3 million of preferred stock that is not included in GAAP equity.

tives portfolio. When Farmer Mac's off-balance-sheet program assets (that is, its guarantee obligations) are added to total on-balance-sheet assets, capital coverage is 0.1 percent. In August 2004, Farmer Mac established a new common stock dividend policy, which continued through 2008. Beginning in 2006 and continuing until first quarter 2008, Farmer Mac also authorized a Class C common stock repurchase program. These policies affect outstanding common equity, and in March 2009 Farmer Mac reduced its common stock dividend in response to the losses experienced in 2008. While these losses reduced Farmer Mac's capital significantly, Farmer Mac raised additional capital in the third and fourth quarters by issuing preferred stock to improve its capital position. Farmer Mac currently exceeds statutory and regulatory capital requirements, and it continues to build additional capital.

At year-end 2008, 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 as determined by the Risk-Based Capital Stress Test (RBC Model). Farmer Mac's core capital as of December 31, 2008, totaled $207 million, exceeding the statutory minimum capital requirement[27] of $193.5 million by $13.5 million. Farmer Mac's regulatory capital totaled $223.4 million as of December 31, 2008, exceeding the regulatory risk-based capital requirement of $57.3 million by $166.1 million. Regulatory capital was 2.8 percent of total Farmer Mac I program volume (including both on- and off-balance-sheet program volume). Table 8 offers a historical perspective on capital and capital requirements for 2004 to 2008.

In 2008, 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

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

Table 8

Farmer Mac Capital Positions, 2004–2008

As of December 31

Dollars in Millions

	2004 Restated	2005 Restated	2006	2007	2008
GAAP equity	$235.2	$246.0	$248.5	$223.6	$15.3
Core capital	$204.0	$230.8	$243.5	$226.4	$207.0
Regulatory capital	NA	$239.4	$248.1	$230.3	$223.4
Statutory requirement	$128.9	$142.5	$174.5	$186.0	$193.5
Regulatory requirement	NA	$29.5	$42.9	$42.8	$57.3
Excess over statutory or regulatory requirement*	$75.0	$88.3	$69.0	$40.4	$13.5
Capital margin excess > minimum	58.2%	62.0%	39.6%	21.7%	7.0%

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

NA = not available (because line items have not been restated for prior periods or because regulatory capital rulemaking had not yet been implemented)
> = greater than

* 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.

portfolio at Farmer Mac, as well as continued development of best industry practices among leading financial institutions. During 2009, FCA plans to issue a proposed rule revising the risk-based capital regulations to address new program authorities for rural utility financing.

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'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. However, because of the failure of Lehman Brothers and the conservatorship of the Federal National Mortgage Association (Fannie Mae), Farmer Mac was forced to take losses totaling $106 million in its investments in those two entities. These losses contributed to the significant overall net loss for the year.

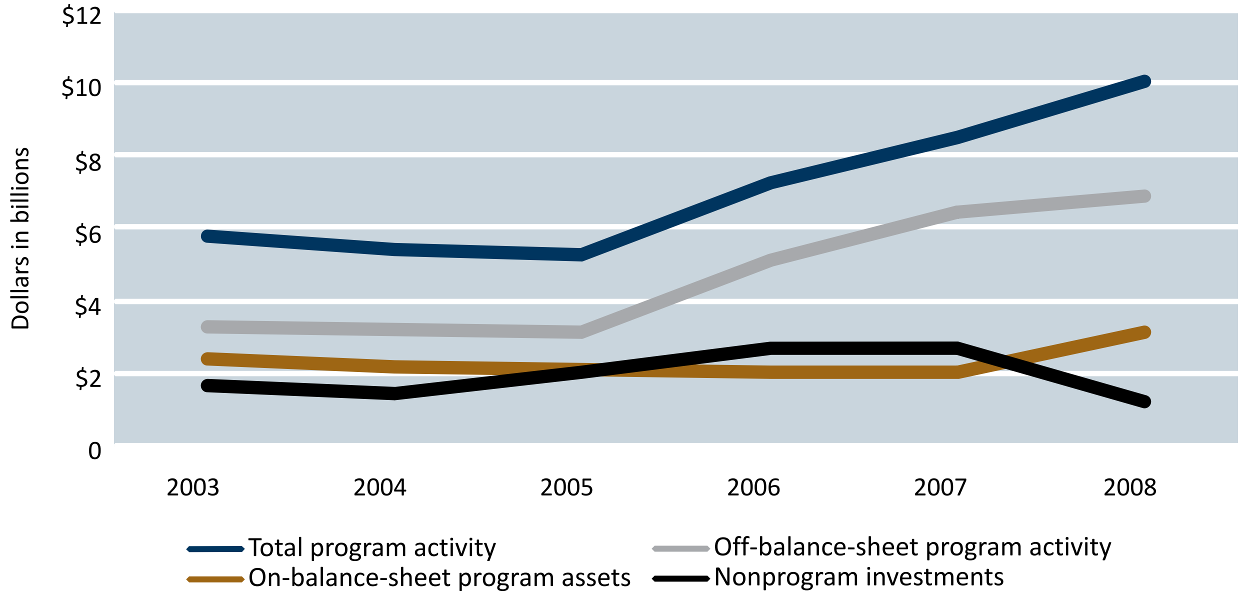
PROGRAM ACTIVITY

Farmer Mac's total program activity increased significantly over the past year to $10.1 billion on December 31, 2008, from $8.5 billion a year earlier (see figure 11). The increase was largely attributable to the shift of formerly nonprogram investments in rural utility cooperatives to the program portfolio,[28] as well as continued growth in the off-balance-sheet AgVantage program.

Off-balance-sheet AgVantage transactions are general obligations of the issuing financial institution that are, in turn, guaranteed by Farmer Mac. Farmer Mac's exposure is col-

28. In May 2008, the Food, Conservation and Energy Act of 2008 (2008 Farm Bill) expanded Farmer Mac's program authorities by allowing it to purchase and guarantee securities backed by eligible rural utility loans made by cooperative lenders.

Figure 11
Farmer Mac Program Activity and Nonprogram Investment Trends
As of December 31
Dollars in Billions



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

lateralized by eligible agricultural mortgage loans owned by the issuing institution. Farmer Mac's Long-Term Standby Purchase Commitment product has been another source of growth in program activity in the past. 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 although growth has moderated over 2007 and 2008. Lenders may elect to exchange Standby commitments for securities guaranteed by Farmer Mac. Standbys were up 14 percent in 2008 to $2.2 billion.

Off-balance-sheet program activity consists of Standbys, certain AgVantage securities, and AMBS sold to investors. At the end of December 2008, 68 percent of program activity consisted of off-balance-sheet obligations[29] (see figure 12).

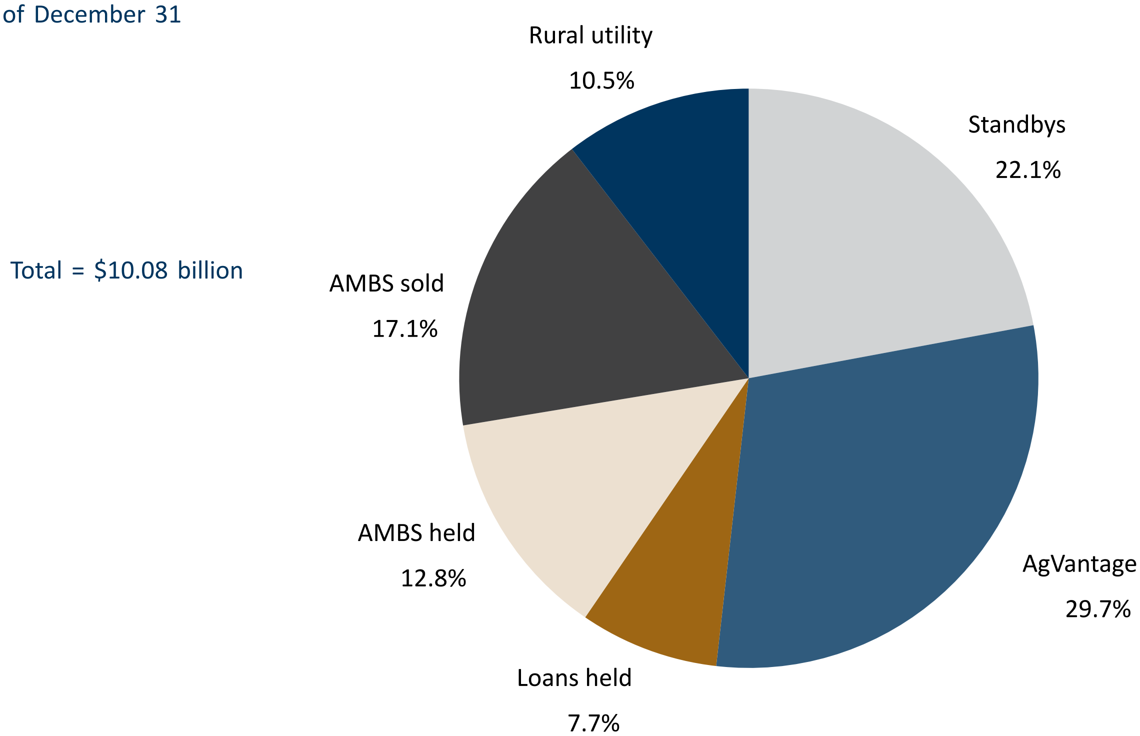
ASSET QUALITY

On December 31, 2008, the portion of the Farmer Mac I program portfolio that was nonperforming was $80.0 million, or 1.61 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).[30] This compares with $31.9 million, or 0.63 percent, on December 31, 2007. Nonperforming assets consist of assets that are 90 days or more past due, in foreclosure, or in bankruptcy, and real estate property acquired by Farmer Mac through foreclosure. Real estate owned as of December 31, 2008, was $606,000, up from $590,000 a year earlier. The total dollar amount and percentage of nonperforming assets moved up in 2008, reversing the trend toward unusually low levels in recent years. The shift in nonperforming loan volume was primarily the result of weakness in the ethanol portfolio. Farmer Mac reported no delinquencies or nonperforming loans in pools underlying its rural utility cooperative loan exposure.

29. Because of a small amount of on-balance-sheet AgVantage activity, this percentage does not correspond exactly to the total of percentages shown in figure 12 for AMBS, Standbys, and AgVantage program activity.

30. 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.

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

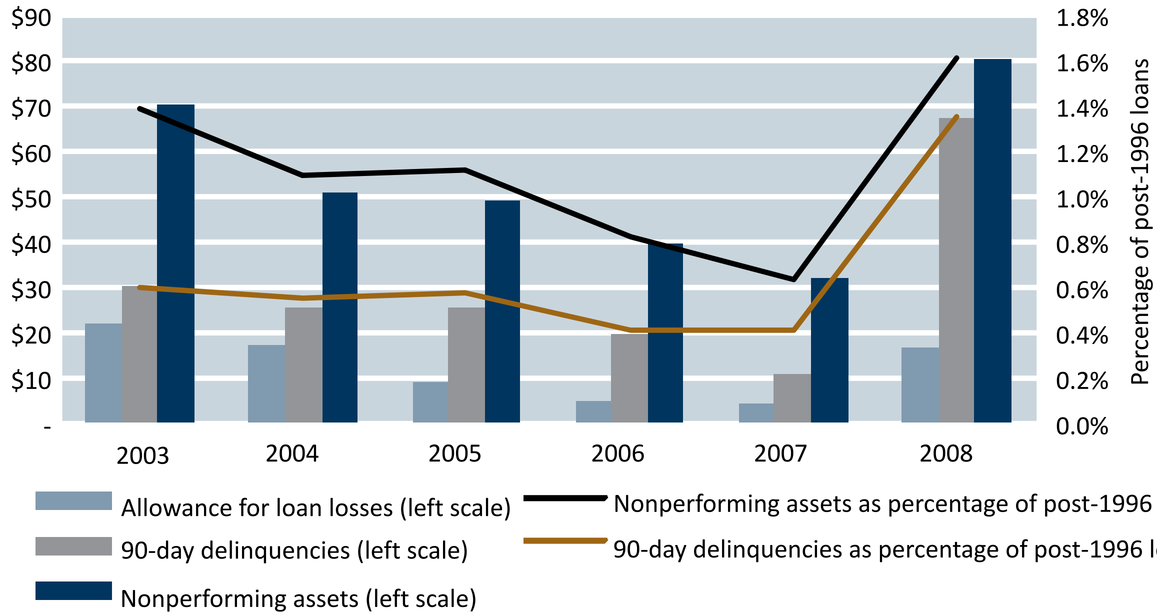
On December 31, 2008, Farmer Mac's allowance for losses totaled $16.4 million, compared with $3.9 million on December 31, 2007. Farmer Mac attributed the increase in the allowance for losses primarily to a $17.8 million provision for loan losses and charge-offs of $5.2 million recognized during the year, which were largely driven by defaults in the ethanol loan portfolio. Figure 13 shows the level of Farmer Mac's allowance and nonperforming assets relative to outstanding post-1996 Act program volume.

EARNINGS

Farmer Mac sustained a net loss of $154.1 million (in accordance with GAAP) for the year ended December 31, 2008, down significantly from $4.4 million in GAAP net income available to common stockholders reported at year-end 2007. This significant decrease in earnings is attributable primarily to losses on investments in Lehman Brothers and Fannie Mae and to significant unrealized losses resulting from the mark-to-market impact on derivatives and trading assets. Core earnings[31] for 2008 were $24.7 million, a decrease of 17.4 percent from 2007. Net interest income, which excludes guarantee fee income, was $88.2 million in 2008, nearly double what it was in 2007. This increase resulted largely from an unusually favorable drop in funding costs during 2008. Guarantee fee income, at $28.4 million, was 12.5 percent higher in 2008 than in 2007. This increase reflects the growth in the average balance of outstanding guaranteed securities. Neither of these favorable developments was sufficient to offset the significant realized and unrealized losses sustained in 2008. Nonprogram investments accounted for an estimated 52.3 percent of interest income for 2008, down from 58.5 percent for 2007. Table 9 shows a five-year trend for key income components.

31. 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 Farmer Mac's discretion.

Figure 13
Allowance, Nonperforming Assets, and Delinquency Trends, 2003–2008
As of December 31
Dollars in Millions



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

Table 9
Farmer Mac Condensed Statements of Operations, 2003–2008
As of December 31
Dollars in Millions

	2003 Restated	2004 Restated	2005 Restated	2006	2007	2008	Growth rate 2007–2008
Total revenues	76.3	77.3	83.9	67.8	31.5	(140.6)	(547.0%)
Total expenses	37.3	38.3	36.8	38.0	27.1	13.5	(50.2%)
Net income available to shareholders	39.0	39.0	47.0	29.8	4.4	(154.1)	(3602.3%)
Core earnings	23.0	27.4	28.7	25.9	29.9	24.7	(17.4%)

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

CHALLENGES FACING AGRICULTURE AND THE FCS

The Farm Credit System attained another year of solid earnings and asset growth in 2008 despite unprecedented instability in global financial markets and a dramatic downturn in the general economy. The System's resilient performance stems from its strong ties to a vibrant and well-diversified agricultural industry. For the fourth time in the last five years, net farm income set a new record in 2008 as a combination of abundant supplies, record-high grain prices, and strong export sales more than offset a sharp rise in production costs. However, USDA projects that net farm income will be down in 2009, due largely to the global economic slowdown. This outcome will likely erode the quality of the System's loan portfolio and its financial results for the next year.

Aside from the effect of the general economy and other factors on commodity prices, agriculture is inherently risky because its production processes are biological. Random weather events, crop and livestock diseases, and food safety concerns are ongoing risks that can suddenly transform into real-life catastrophes for individual producers or, worse yet, a large region of the country. Both producers and System institutions understand these risks and use a number of risk management techniques to mitigate their exposure. However, in any given year, individual producers can still suffer substantial losses and be unable to repay their loans.

Several challenges, both domestic and foreign, could affect the System's long-term ability to profitably finance the agricultural industry. In the following paragraphs, FCA identifies some of these challenges, including the macroeconomic outlook, key developments in the farm income picture, new public policy directions for agriculture and the economy, and important structural changes in the industry. Through its regulatory and examination activities, FCA will continue to closely monitor and address these challenges.

PROSPECTS FOR THE GENERAL ECONOMY

The global financial meltdown and a free-falling economy in late 2008 underscore the challenge of trying to predict future economic activity. A year ago, few foresaw the incredible events that would unfold during the year. The economy is now in a severe recession, and the only question now is its length and depth: will we see the end in 2009 or will it continue to slide well into 2010? Where is the bottom, and will the Government's fiscal stimulus plans, Treasury's financial rescue programs, and various Federal Reserve liquidity actions produce the desired effects of thawing out frozen credit markets and jump-starting consumer confidence and spending? While a few hopeful signs are emerging, the economy continues to be driven by fear as worries mount over the latest unemployment numbers and evaporating 401(k)s in the stock market. As a result, people are increasing their saving and cutting spending at the worst possible time for the economy.

The good news is that policymakers are responding with everything in their power to stop the downward spiral and establish a new foundation for future growth in the economy. Despite the unprecedented magnitude of these efforts, future risks abound.

As we look ahead, most of the risks appear to be abating. Many economists believe the economy will shrink between 2 and 3 percent in 2009 before resuming growth rates closer to trend in 2010. However, a few forecasts paint a grim picture, with sharper gross domestic product declines and higher unemployment. The unemployment rate is expected to approach 9 percent near the end of the year and may exceed 10 percent before conditions stabilize. The Government's expanded unemployment benefits in the fiscal stimulus program should help cushion these labor market dislocations. Inflation, after spiking in mid-2008 from soaring oil and commodity prices and then dropping to almost zero by year-end, will likely be low or negative in 2009 because of weak demand. While exports were a bright spot during most of 2008, they are expected to decrease significantly in 2009 because of the stronger dollar and the drying up of foreign demand as a result of the global recession. A

key assumption in these projections is that the American Recovery and Reinvestment Act (Recovery Act), along with additional Treasury and Federal Reserve actions, will have a positive effect on credit delivery and consumer confidence to help jump-start economic activity in the near future.

The economic outlook has several important implications for the FCS. One of the most significant implications concerns off-farm income because, on average, about 90 percent of farm household income is derived from off-farm employment, outside business interests, and other investments. Clearly, off-farm income is the lifeblood of small and part-time farms. But even large commercial farms (sales above $250,000) obtain about 25 percent of their household income from outside sources, giving many borrowers an important cushion for debt repayments. Thus, a deep economic recession likely would be detrimental to those farm families who rely on outside sources of income to repay their loans. In light of the prospects for 2009 farm income and off-farm employment, the System must remain vigilant about credit quality and the challenges of managing its portfolio in a troubled economy.

A second implication concerns the Federal Reserve's dramatic easing of monetary policy, which has reduced interest rates to historic lows. Even with the increased difficulties the System has experienced in issuing longer-term debt securities (see discussion on pages 35 to 38) and the wider spreads between System securities and U.S. Treasuries for long-term maturities, the FCS has been able to keep its interest rates on farm loans relatively low. While external events could change the picture as the year unfolds, investors are expected to continue purchasing System securities in 2009 because of their safety and good returns.

ECONOMIC SETTING FOR AGRICULTURE

A year ago, agriculture was riding a wave of record-high commodity prices, soaring exports, and strong asset values. As far as the eye could see, farm income prospects looked bright, driven in part by the boom in the ethanol industry and the positive outlook for renewable fuels. Although voices of caution were being raised about commodity price volatility, narrowing profit margins in livestock and ethanol production, and food price inflation, most people expected 2008 to be a banner year. And—for the most part—it was.

Net farm income was almost $90 billion in 2008, which is a new record, up slightly from the previous record in 2007. In addition, agriculture has a strong balance sheet. The debt-to-asset ratio is now less than 10 percent, one of the lowest figures in history and sharply below the crisis years of the 1980s when it was almost 20 percent. Yet the 40 to 50 percent decline in most commodity prices since last summer, the excess capacity problem in the ethanol and livestock industries, and a return of the traditional price-cost squeeze in agriculture have diminished the optimism of 2008.

Net farm income is expected to decline to around $70 billion in 2009, a 20 percent decrease, as smaller marketing receipts in both the crop and livestock sectors will more than offset an expected decline in production expenses. Although the new figure is still above the $65 billion average for the previous 10 years in inflation-adjusted constant dollars (2000), net farm income in nominal terms will be about 5 percent below the 10-year average. Thus, the income picture for the farm sector depends on which lens is used to examine it. In nominal terms, the picture looks reasonably good for 2009—despite notable shifts in likely winners and losers for the year. But the inflation-adjusted number is more worrisome because it exposes agriculture's weakening income situation.

It seems clear that the crop sector will be less profitable than it was in 2008. However, except for dairy producers, whose income will be down sharply, the livestock sector should fare better as profit margins improve from reductions in output and lower production expenses. The prospective decline in foreign demand from the global recession will be partly offset by continued expansion in ethanol production, especially if renewable fuel standards require higher ethanol blends. Any increase will tend to support the corn market, agriculture's largest crop.

Moreover, the fiscal stimulus programs should benefit agriculture in 2009 both directly and indirectly: directly, by providing tax credits and new spending on alternative fuels and infrastructure projects, and indirectly, by generating jobs and new off-farm income opportunities. However, financial outcomes likely will vary widely by region and by enterprise type and size as producers wrestle with volatile commodity prices, mounting labor and water supply issues, new Government policies, and a host of other variables. These conditions will complicate risk management strategies for farmers and increase the challenges for the FCS.

UNCERTAINTY OVER POLICY AND TRADE

Farm programs and trade agreements are two important policy forces that help shape the farm income picture. Both areas are important to the FCS because they can affect a borrower's repayment capacity and, ultimately, the overall safety and soundness of the lender. The new directions in farm policy and trade may create a new set of loan underwriting challenges for the System to manage.

Farm Policy Concerns

In May 2008, Congress enacted the Food, Conservation, and Energy Act of 2008, which made changes in the Federal safety net for agriculture. Although the new act leaves loan rates and target prices mostly unchanged, the safety net for the program crops is actually lower today because support prices were not adjusted to reflect recent increases in farm cost structures. In essence, the focus of farm policy is moving toward revenue protection and away from higher target prices. The 2008 act also shifts the spending priorities toward nutrition, renewable fuels, conservation, and rural development.

According to USDA, direct Government payments to producers in 2009 are projected to fall to $11.4 billion, their lowest level since 1997 and well below the $16 billion average under the 2002 farm act. Normally a payment drop alone is not worrisome if higher market prices or yields compensate producers for the loss. However, if market prices fall without any increase in Government payments, which may be the situation for most of the program crops this year (cotton is an exception), then borrower risks increase. Thus, lenders should closely monitor any declining trend in Government payments.

Producers face an important business decision under the 2008 act. They can choose to either operate under the old program's terms, thereby receiving all of their direct payments and remaining eligible for counter-cyclical and loan deficiency payments, or they can sign up for the new Average Crop Revenue Election (ACRE) program.[32] To participate in ACRE, producers must forfeit their counter-cyclical payments on the program crops and accept a 20 percent reduction in direct payments and a 30 percent reduction in marketing assistance loan rates. Producers are unlikely to participate unless they believe ACRE will pay off over time. While some preliminary studies show that a poor year (low crop revenue) could potentially generate large ACRE payments, most producers will have difficulty making decisions about ACRE because the answers are not clear cut.

The ACRE payoffs are determined by a "double-trigger" mechanism that uses two revenue benchmarks—one for the State and one for the individual farm—to establish eligibility and the size of the payment. This requires producers to calculate the likelihood of two unknown outcomes. For the farmer to receive an ACRE payment, both the State and the farm must have a revenue shortfall. The risk, of course, is that the farm falls below its revenue benchmark while the State does not, in which case the producer receives nothing. Lenders should carefully consider the implications of potentially lower Government payments under ACRE as they counsel customers about the program. In particular, farmers need to understand

32. Although ACRE is an optional program with annual enrollment opportunities, once a producer signs up for the program, the decision is irrevocable until 2012. USDA recently extended the sign-up deadline for 2009 to August, which will give producers more time to evaluate ACRE's potential benefits for this year's crops.

that ACRE is not intended to be a substitute for crop insurance since it provides very little protection against chronically low crop prices.

Government actions to shift spending priorities and introduce new farm program initiatives such as ACRE are aimed at accomplishing several objectives:

- To reduce the high cost of Government farm programs and redirect the benefits to a broader base of producers
- To refocus the safety net so that it protects farm revenue—not just prices—thereby making it more likely that payments would be distributed only in truly bad years
- To encourage more participation in Federal crop insurance programs
- To eliminate ad hoc disaster assistance programs by introducing permanent programs for adverse weather events.[33]

Concerns about the new priorities for farm programs are heightened by the prodigious deficits looming in the Federal budget. Proposals to cap payments to large farmers or high-income landlords or to cut subsidies for crop insurance premiums represent measures that may be employed at some point to save budget dollars. In all likelihood, the budget deficit issue will be front and center when the next farm bill is debated in the months leading up to 2013. A regime of rising production costs in agriculture remains a growing risk if money for the farm safety net fails to keep pace.

Foreign Trade Issues

Trade is governed by the World Trade Organization (WTO), which is a voluntary association of countries that periodically meets to set international trade rules and adjudicate disputes among its members. The Doha Round of multilateral negotiations was launched in 2001, but little progress has been made toward a new agreement. Despite efforts to keep the talks going, a new WTO agreement is unlikely this year. Because of the impasse, the United States continues to pursue both regional and bilateral trade agreements with its trading partners. It now has 17 such agreements in place, the largest of which is the North American Free Trade Agreement (NAFTA) with Canada and Mexico. However, the big trade issue for 2009 is not the Doha Round but the recession's effect on foreign demand. For the first time since World War II, world trade is expected to decline in the year ahead.

Exports are a critical part of the farm income picture because our domestic markets cannot absorb all that is produced each year. Foreign sales often account for a fourth of all agricultural sales in a given year. In fiscal year 2008, farm exports were more than $115 billion, up $33 billion from fiscal 2007, easily making it a new record. It is also a phenomenal achievement when viewed from a historical perspective because, as recently as 2004–05, sales were running around $60 billion per year. Because of this expansion in foreign sales (more volume and sharply higher prices), the net surplus from agricultural trade, after shrinking over several years to almost zero, is once more solidly in the black.

Because of the weak global economy and a stronger dollar, U.S. farm exports are expected to decrease sharply to about $95 billion in fiscal year 2009, a $20 billion drop but still the second highest figure on record. The decline will likely be broad-based, affecting most commodities, livestock, and value-added products. Unfortunately, our export prospects could dim further as the global recession takes stronger root and potentially moves countries toward protectionist policies. Such a scenario would further depress farm prices and increase credit risk in the FCS. In addition, the fear of human- or animal-borne disease can suddenly reduce the demand for U.S. farm products, as we saw in spring 2009 when fears about the spread of the H1N1 flu virus affected the export of pork.

33. The 2008 farm bill established a new disaster assistance program called the Supplemental Revenue Assistance Trust Fund (SURE) to help producers cover the deductible portions of their crop insurance policies. To be eligible for SURE, producers must insure all crops and suffer a loss in a declared disaster area.

RENEWABLE FUELS

2008 was a challenging year for the ethanol industry. Rapidly rising corn and natural gas costs in the first half of 2008 squeezed profitability at ethanol plants. Some companies failed to hedge their inputs properly, while others experienced start-up problems and other mechanical or technical difficulties. Slowing gasoline consumption and lower fuel prices in the second half of 2008 and early 2009 compounded the problems and ultimately caused a number of bankruptcies and plant closures. As of the end of March 2009, 168 ethanol plants, with production capacity of 10.34 billion gallons, were active, while 37 plants, with 2.21 billion gallons of capacity (or 17.6 percent of the total), were idle. Another 15 plants, with 1.46 billion gallons of capacity, were under construction.

At the end of 2008, the System's loan commitments to the biofuels industry totaled $4.4 billion, close to the figure a year earlier. Of the total commitments, System institutions had funded $3.0 billion at year-end, and that total had changed only slightly since mid-2008. Although total commitments at year-end represented 16 percent of the System's capital, biofuel loans outstanding were 11 percent of capital and less than 2 percent of total loan volume. These are both relatively small numbers when compared to the System's exposure to other industries or commodities, but these risks are concentrated among a relatively small number of borrowers (fewer than 140), and risks facing the industry have risen. In addition to its loan holdings in the biofuels industry, the System also originated and participated out a significant amount of biofuel loans to non-System lenders.

The outlook for the ethanol industry continues to revolve around the excess capacity problem, which will weigh on producer returns until enough improvements occur in the economy to widen the spread between corn and ethanol prices. The ethanol industry has asked the EPA to increase the amount of ethanol that refiners must blend with gasoline from the current requirement of 10 percent to 15 percent. If implemented, this increase would likely boost the demand for the renewable fuel additive by as much as 6 billion gallons a year and would generate numerous jobs. While preliminary studies suggest that a 20 percent blend is feasible, more testing will be done over the next year to make sure that higher ethanol blends do not harm gasoline engines. Meanwhile, the Administration's new spending proposals for the development of alternative fuels should augur well for the ethanol industry, while offering new investment opportunities for the FCS.

A major risk for the FCS is that the biofuels industry still requires large tax incentives, import protection, and mandated blending requirements to remain viable. In addition, energy policies can suddenly change and new technological developments can render existing plants obsolete. For these reasons, FCA will be closely watching System institutions for loan underwriting practices that do not consider the full risks associated with ethanol production and marketing.

NEW DIMENSIONS TO PORTFOLIO RISK

Asset growth rates, new business lines, counterparty relationships, and a changing economic and political landscape are important variables affecting portfolio risk for a financial institution. The System's loan portfolio has grown more than 15 percent a year since 2005, which has put downward pressure on key capital ratios. Although the System's loan growth slowed to 2 percent during the fourth quarter of 2008 as economic conditions deteriorated, other issues—such as asset quality—are becoming more worrisome. For instance, the System recognized $408 million in provisions for loan losses in 2008, up from $81 million a year earlier, and other credit quality measures also weakened significantly. These changes were an outgrowth of the exceptional volatility that occurred in commodity prices last year.

Efforts to have farmers bear more of the costs of doing business by reducing the subsidies on crop insurance premiums or limiting the time periods for forward contracting of grain

sales will magnify the risk profiles of many borrowers. However, other political and economic risks will require scrutiny, too:

Fiscal Stimulus Plan—The challenge for the System is to discover where the new plan offers potential opportunities for making new loans and investments in rural areas and then determine how to control exposure to these new risks.

Funding Costs—New actions by the Government and the Federal Reserve to restart the credit function and improve bank liquidity could increase the System's funding costs and borrower interest rates, thereby increasing credit and repayment risk. (See page 35)

Ethanol Blending Standards—Even with a possible increase in the blending standard, future profitability in the ethanol industry will still be heavily dependent on blending subsidies, new technologies, price spreads between ethanol and corn, and environmental requirements. Thus, the System must factor these risks into its management of portfolio exposure to the renewable fuels industry.

Farm Program Payments—Huge budget deficits and new interest group coalitions create mounting political pressure to revamp current farm programs to reduce payments and redistribute the amount going to large producers. Other prospective changes in farm program benefits could create new portfolio risk challenges for System institutions to manage, especially if commodity markets remain highly volatile.

The System's Public Mission—
Due to the economic meltdown and efforts to stimulate the economy, the public may look to the System to "stand tall" in this difficult environment by assuming more lending risks to help jump-start rural economies. The System's strong financial position makes it a candidate for these initiatives. However, new investments in unfamiliar business lines or loans to borrowers with weakened credit are inherently risky. Thus, System institutions must remain vigilant about safety and soundness in this environment.

Loan Participations and Syndication Activity—New business lines may help diversify an institution's loan portfolio and mitigate risk. However, in 2009, the System is not expected to have a significant amount of syndication activity because of the decline in credit demand from other lenders. Instead, the System's chief concern will be with some of its existing participations in large agribusiness loans. The key point is that lenders should periodically review their participation and syndication policies to ensure that they stay within their level of expertise, lending controls, and underwriting standards.

The real test for managing credit risk in the System's portfolio centers on the System's primary business lines. Farm mortgage loans and production credit for crop and livestock enterprises account for two-thirds of the loan portfolio. Prospects for a weak economy in 2009–10 will likely translate into less total demand for farm products, especially from the foreign sector, and fewer off-farm employment opportunities. The projected decline in net farm income in 2009 may affect borrower repayment capacity as well as collateral values if farm real estate values drop significantly. More than 40 percent of the System's loan portfolio is farm mortgages.

All of these factors point to more portfolio risk and growing challenges for System institutions to manage. FCA will continue to focus resources on monitoring and evaluating the underlying sources of portfolio risk, the overall quality of the System's assets, and management's ability to manage the associated risks of operating in a more turbulent period for agriculture.

OTHER CHALLENGES

On balance, the System's loan portfolio quality and capital levels were still adequate at the end of 2008. However, a number of additional factors will continue to challenge the System's ability to manage assets and ensure adequate capital levels to meet future borrower needs.

Commodity Price Volatility

Commodity markets experienced record volatility in 2008 as a record surge in prices in the first half of the year was followed by a precipitous decline in the second half. Principal factors for the run-up in prices included concerns over U.S. crop losses from major spring flooding in the Midwest; record increases in petroleum prices, which boosted the demand for grains, oilseeds, and sugar for biofuel production; strong export demand from the declining value of the dollar; sharp increases in speculative long positions in futures contracts; protectionist actions taken by a number of countries to ward off food price inflation; and generally low stocks of commodities worldwide, made worse by crop shortages in South America and other exporting countries. Most of these factors reversed direction in the second half of the year, sparked by the global financial crisis, the economic recession, and the increasing value of the dollar. In particular, the sharp decline in crude oil and gasoline prices had a pronounced effect on ethanol producers who saw their profit margins shrink as additional production capacity came online and consumers cut back on their driving and fuel consumption.

As we look ahead, commodity markets will likely remain subdued until a solid economic recovery takes hold, possibly in 2010. Meanwhile, a number of unfavorable events—such as a significant economic slowdown in China, India, and other developing countries, or a much stronger dollar—could result in a lasting downward movement in commodity prices that would affect the safety and soundness of the FCS and Farmer Mac.

Land Values

After climbing continuously for the 21 years since the collapse of the land market in the mid-1980s, U.S. farmland values started to decline in the latter part of 2008 as the economy weakened. The Federal Reserve estimated that land values decreased from 2 to 4 percent in several regions of the Nation during the fourth quarter of 2008, and a recent Iowa survey showed that land values in that State decreased almost 8 percent in the last six months of the year. The shrinking farm income picture and the global economic recession point to further softening of farmland values in 2009. In addition, the decline in the housing market is affecting collateral values of part-time farms and agricultural land in densely populated rural areas. A sharp decline in land values could significantly reduce the System's credit quality and financial performance.

Maintaining Market Flexibility

The most important strategic risk facing any financial institution is not being able to offer the products and services the market demands. Certainly, the System's GSE status and its access to attractive funding mechanisms allow FCS institutions to be a reliable source of funds to agriculture and rural America in both good times and bad. However, for several decades, the FCS has attempted to respond to strong global banking trends and the evolving needs of rural America without major revisions to its statutory authorities. Periodically, most financial institutions require both legal and market-based adjustments to maintain their flexibility in the marketplace.

Borrower Characteristics

Dynamic forces are changing the structure of agriculture at a rapid pace, creating tremendous diversity in size, income and wealth, and operator characteristics. The magnitude of these changes continues to challenge the System's creativity in meeting the financial needs of its rural customer base. For example, the growing significance of off-farm income to the welfare of farm families is causing the System to redesign the approaches it uses to satisfy the credit needs of its rural customer base. 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 264 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.

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, including 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 the Farm Credit System Insurance Corporation Board. In addition, the Secretary serves as the Parliamentarian and the 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 FCA 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, employees, 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 also provides information to external audiences through news releases, informational brochures and fact sheets, the annual FCA Performance and Accountability Report, and other publications. It manages media relations regarding Agency activities and is responsible for the content of the FCA Web site.

OCPA also coordinates special meetings, briefings for international visitors, and field hearings.

The Office of Examination is responsible for examining and supervising 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, complies with the law and regulations, 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 (OGC) provides the FCA Board and staff with legal counsel as well as guidance on general corporate, personnel, ethics, and administrative matters. OGC 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. OGC also handles Freedom of Information Act requests and matters pertaining to the Privacy Act.

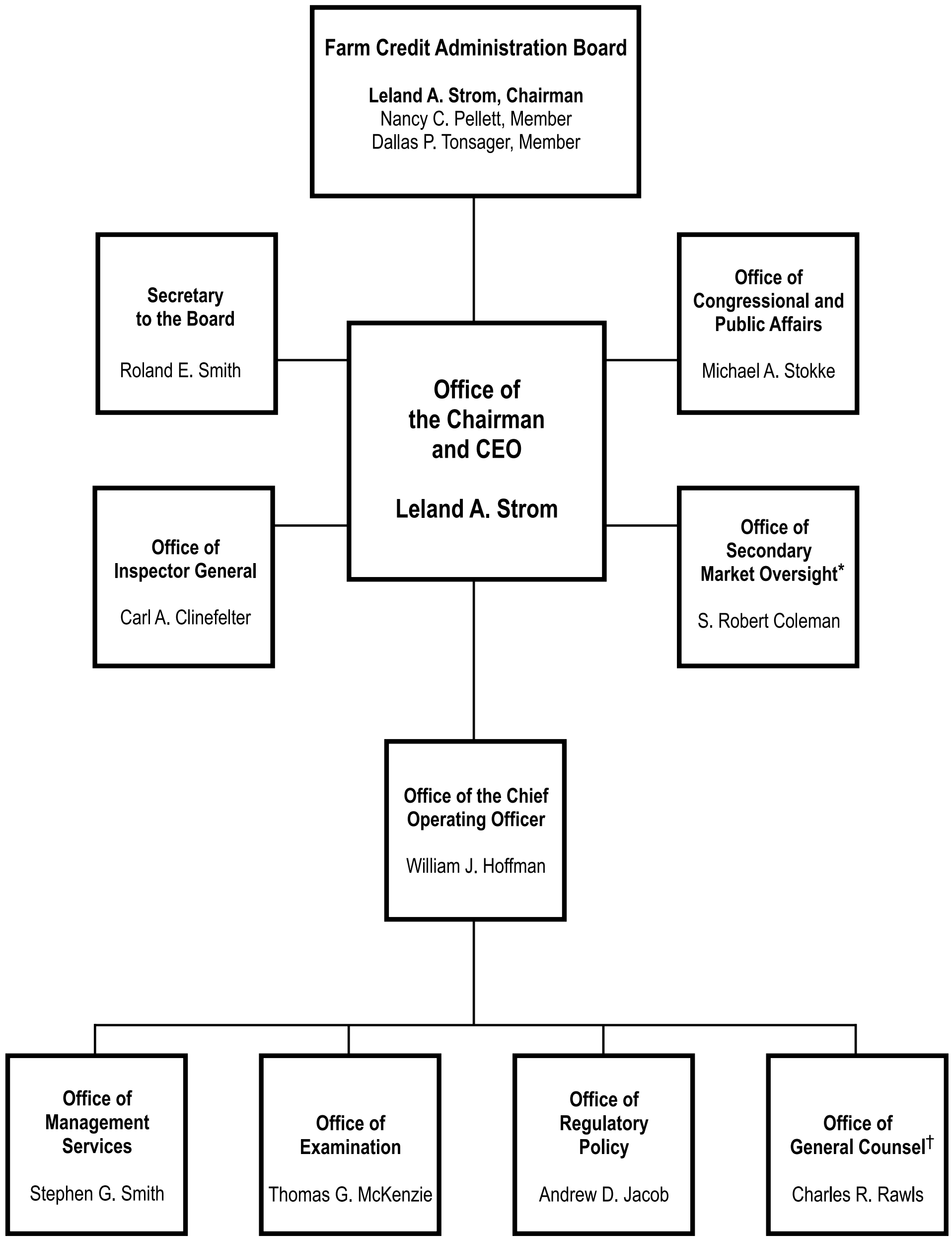
The Office of Inspector General provides independent and objective oversight of Agency programs and operations through audits, inspections, investigations, and the review of proposed legislation and regulations. The office promotes economy and efficiency within FCA and seeks to prevent and detect fraud,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

The Office of Regulatory Policy (ORP) manages all policy and regulation development activities that ensure 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 on the basis of economic trends and other risk factors. ORP also evaluates all regulatory and statutory prior approvals for System institutions on behalf of the FCA Board, including chartering and other corporate approvals as well as funding approvals.

The Office of Management Services (OMS) manages and delivers the Agency'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, OMS enables the Agency's program offices to fully focus their time and attention on their respective mission-related responsibilities.

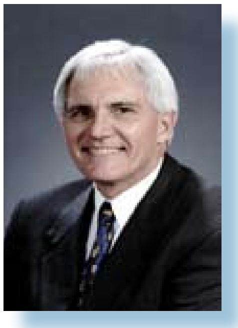
The Office of Secondary Market Oversight (OSMO) provides for the examination, regulation, and supervision of the activities of Farmer Mac to ensure its safety and soundness and the accomplishment of its public policy purpose as authorized by Congress. OSMO also ensures that Farmer Mac complies with applicable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

Figure 14
FCA Organizational Structure
As of December 31, 2008



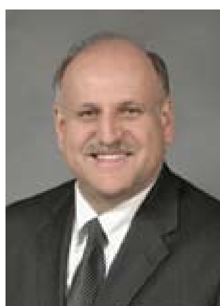
***Reports to the Board for policy and to the CEO for administration.**
†Maintains a confidential advisory relationship with each of the Board members.

AGENCY OFFICIALS



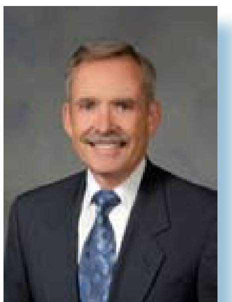
Carl A. Clinefelter is the Inspector General of FCA. Before assuming this position in July 2005, he concurrently served as Acting Director of the Office of Communications and Public Affairs and the Office of Congressional and Legislative Affairs. Prior to this, Mr. Clinefelter served as Director of the Office of the Ombudsman, Director of the Office of Secondary Market Oversight, Executive Assistant to FCA Board Member Doyle Cook, 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. Before assuming this position in September 2005, Mr. Coleman served as the Director of the Agency's Regulation and Policy Division. Mr. Coleman joined FCA in 1986 as an examiner in the Office of Examination. He held various positions in that office, providing technical and analytical support to the FCA field offices and in the Policy Development and Planning Division. During this period, Mr. Coleman completed the commissioning program and became a commissioned examiner in 1990. 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.



William J. Hoffman is Chief Operating Officer, responsible for planning, organizing, and directing a range of Agency functions. Before assuming this position in July 2008, Mr. Hoffman was Executive Assistant to Board Member and former Chairman and CEO Nancy C. Pellett. Prior to this, he served as the Associate Director for Examination and Supervision in the Office of Secondary Market Oversight, which oversees the Federal Agricultural Mortgage Corporation. He began his career as a credit representative in the Louisville Farm Credit District. Mr. Hoffman first joined FCA in 1976 as a credit and operations officer and went on to work in various divisions of the Office of Supervision. In 1980 he became director of the Eastern Division, Office of Supervision, where he served for four years before being named Associate Deputy Governor for the Office of Examination and Supervision. In 1986 he joined the St. Louis Farm Credit Bank as vice president of risk assets. He later was the CEO of PennWest Farm Credit, ACA, which served western Pennsylvania. Before rejoining FCA in 2004, he was involved in agricultural finance in the private sector and several international projects.

Andrew D. Jacob, CFA, is Director of the Office of Regulatory Policy. Before being named to this position in July 2005, he served as the 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 (CFA) designation, which the CFA Institute awarded him in 2000.

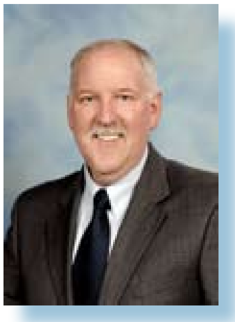


Mark McBeth is the Executive Assistant to Leland A. Strom, Chairman and CEO of FCA. His duties include advising the Chairman on policy, administrative, and management issues affecting FCA, the FCS, and the Farm Credit System Insurance Corporation. Mr. McBeth began his career with the former Farm Credit Banks of Omaha where he was director of public relations from 1973 to 1980. In 1980 he joined FCA, and his experience includes serving as a commissioned examiner in the Enforcement Division. Other positions Mr. McBeth held within the Agency include Assistant Director of the Office of Congressional and Public Affairs and, more recently, Executive Assistant to FCA Board Member Douglas L. Flory. Mr. McBeth also served as Executive Assistant to Leland Strom prior to Mr. Strom's appointment as Chairman and CEO.

Thomas G. McKenzie is Chief Examiner and Director of the Office of Examination. 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 the FCA General Counsel. 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 the General Counsel of the Senate Committee on Agriculture, Nutrition, and Forestry. From 1998 to 2001, he was General Counsel for the USDA, and from 1993 to 1998 he was 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. He was Counsel to the House Agriculture Subcommittee on Forests, Family Farms, and Energy from 1983 to 1985.

Roland E. Smith became Secretary to the FCA Board in January 2006. He 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. In 1984, he was promoted to Associate Regional Director. 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 the Chief Financial Officer and Director of the Office of Management Services. 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, directing all technology and information operations for FCA. Before joining the Agency, he worked at the North Central Jersey Farm Credit Associations.

Michael Stokke is Director of the Office of Congressional and Public Affairs. Prior to joining FCA, Mr. Stokke was founder and president of Prairie Strategies, a consulting firm based in Illinois, where he advised corporations and nonprofit organizations. He served as Deputy Chief of Staff to former Speaker of the House Dennis Hastert from February 1998 to October 2007. Prior to this, Mr. Stokke served as Chief of Staff for the Office of the Speaker in the Illinois House of Representatives from 1995 to 1998. He served as Chief of Staff for Representative Thomas W. Ewing of Illinois from 1991 through 1994. From 1984 to 1991, he was Assistant Director of Personnel for the Office of the Governor of Illinois. He also served as Assistant to the Secretary of the Illinois Department of Transportation from 1985 to 1987.

GLOSSARY

A

Agricultural Credit Association—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—An ACB results from the merger of a Farm Credit Bank 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—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—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. Currently there are 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 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 an FCA Board member other than the current Chairman of the FCA Board.

Federal Agricultural Mortgage Corporation—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—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 autho-

rized 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. The associations 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—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—The FIRS is similar to the Uniform Financial Institutions Rating System used by other Federal banking regulators. However, unlike the Uniform Financial Institutions Rating System, the FIRS was designed 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. These institutions give no cause for regulatory concern.

- **Rating 2—**Institutions in this group are fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. Since the nature and severity of deficiencies are not material, 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—A GSE is typically 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. 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—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
AMBS—agricultural mortgage-backed securities
CAMELS—capital, assets, management, earnings, liquidity, and sensitivity
CEO—chief executive officer
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
FCS—Farm Credit System
FCSIC—Farm Credit System Insurance Corporation
FIRS—Financial Institution Rating System
FLCA—Federal Land Credit Association
FSA—Farm Service Agency
GAAP—generally accepted accounting principles
GSE—Government-sponsored enterprise
OFIs—other financing institutions
PCA—Production Credit Association
RBC—Risk-Based Capital (Model)
RBIC—rural business investment company
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 2008 Annual Report on the Farm Credit System is available on FCA's Web site at www.fca.gov. For questions about this publication, contact

Office of Congressional and Public Affairs
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090
Telephone: 703-883-4056
Fax: 703-790-3260
E-mail: info-line@fca.gov

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

Federal Farm Credit Banks Funding Corporation
10 Exchange Place, Suite 1401
Jersey City, NJ 07302
Telephone: 201-200-8000

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

Farm Credit System Insurance Corporation
1501 Farm Credit Drive
McLean, VA 22102
Telephone: 703-883-4380

FARM CREDIT ADMINISTRATION

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