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FARM CREDIT EAST, ACA

Quarterly Report

June 30, 2016



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

The following commentary is a review of the financial condition and results of operations of Farm Credit East, ACA (the Association) for the six month period ended June 30, 2016. This commentary should be read in conjunction with the accompanying unaudited consolidated financial statements and notes included in this report, as well as the 2015 Annual Report. Dollar amounts are in thousands unless otherwise noted.

The accompanying financial statements were prepared under the oversight of the Audit Committee.

### Business Structure

Farm Credit East is a lending institution of the Farm Credit System (the System). The System is a federally chartered network of borrower-owned lending institutions composed of cooperatives and related service organizations. We are a mission-based lender with authority to make loans and provide related financial services to eligible borrowers for qualified agricultural purposes. As a cooperative, the Association is owned by the members it serves. The territory served extends across a diverse agricultural region covering the entire states of Connecticut, Maine, Massachusetts, New Jersey and Rhode Island, six counties of New Hampshire and all of New York except two counties. The Association makes short and intermediate term loans for agricultural production and long term real estate mortgage loans. Our success begins with our extensive agricultural experience and knowledge of the market.

Farm Credit East's annual and quarterly reports to stockholders are available on the Association's website, **Farmcrediteast.com** or can be obtained free of charge by calling the Association's main office at 860-741-4380. Annual reports are available 75 days after year end and quarterly reports are available 40 days after each calendar quarter end. The financial condition and results of operations of CoBank, ACB (Bank), materially affect the risk associated with stockholder investments in Farm Credit East, ACA. To obtain a free copy of the CoBank Annual Report to Stockholders, please contact us at one of our offices or by accessing **CoBank.com**.

### Results of Operations

Farm Credit East posted strong financial results for the six month period ending June 30, 2016. Net income was \$78.2 million for the six months ending June 30, 2016, an increase of \$5.1 million (6.9%) as compared with the same period in 2015. Our strong earnings primarily reflect higher net interest income and higher noninterest income offset by higher operating expenses.

The following table reflects key performance results (*\$ in millions*).

<b>For the six months ending June 30</b>	<b>2016</b>	<b>2015</b>
Net income	\$ 78.2	\$ 73.1
Net interest income	\$ 93.1	\$ 87.5
Net interest margin	3.09%	3.08%
Return on average assets	2.47%	2.44%
Return on average members equity	13.10%	13.20%

The following table provides detail of changes in the significant components of net income (*\$ in millions*).

<b>For the six months ending June 30</b>	<b>2016 versus 2015</b>	<b>2015 versus 2014</b>
Increase in net interest income	\$ 5.5	\$ 3.6
Increase in noninterest income	2.6	0.3
Increase in noninterest expenses	(3.8)	(3.2)
Decrease (increase) in provision for income taxes	0.8	(1.0)
Total increase in net income	\$ 5.1	\$ (0.3)

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**Net Interest Income**

Net interest income increased \$5.5 million to \$93.1 million for the six months ended June 30, 2016 compared to \$87.5 million for the same prior year period. The increase in net interest income was primarily driven by higher average loan volume and increased earnings on balance sheet positioning, somewhat offset by lower overall spreads in the loan portfolio.

Information regarding the average daily balances and average rates earned and paid on our portfolio are presented in the following table.

<b>As of June 30</b>	<b>2016</b>	<b>2015</b>
Net interest income	\$ 93,082	\$ 87,541
Average balances:		
Average interest earning loans	\$ 6,041,655	\$ 5,727,953
Average interest bearing liabilities	\$ 5,043,847	\$ 4,810,696
Average yields and rates:		
Interest earning loan yield	4.02%	3.93%
Rate paid on interest bearing liabilities	1.28%	1.11%
Interest rate spread	2.74%	2.82%
Net interest margin (interest income as a percentage of average earning loans)	3.09%	3.08%

The Association's average loan rate as a percent of earning assets was 4.02% as of June 30, 2016, up from 3.93% as of June 30, 2015. Average cost of debt funding also increased from 1.11% in 2015 to 1.28% in 2016. Interest income and cost of debt are both higher due to recent increases in publicized short term rates which increases both Farm Credit East's and our customer's cost of borrowing. The average interest rate spread over cost of funding decreased slightly year over year from 2.82% to 2.74%. The decrease in yields from 2015 was due to slightly lower average yield on variable rate loans, reflective of spread compression resulting from increased competition for the business of our customers.

**Noninterest income**

Noninterest income was \$30.3 million for the six months ending June 30, 2016, a \$2.6 million increase over the same period in 2015.

Patronage income from CoBank is a significant part of the Association's noninterest income. Patronage income is based on the average balance of the Association's note payable to CoBank. For the six month period ending June 30, 2016, CoBank patronage income totaled \$11.3 million, compared to \$10.8 million in 2015. The patronage rate paid by CoBank on the Association's note payable was 45 basis points in 2016 and 2015.

The Association also receives patronage income from CoBank and other Farm Credit entities that purchased interest in loans originated by the Association. For the six months ended June 30, 2016 this revenue totaled \$3.5 million compared to \$2.5 million in 2015.

Noninterest income also includes fees for financial services, loan fees, compensation on participation loans and other noninterest income. These other noninterest income sources totaled \$15.5 million for the six months ending June 30, 2016, an increase of \$1.1 million compared to 2015. Financial services fee income is the largest component with \$13.2 million in revenue for the six months ended June 30, 2016 an increase of \$1.3 million compared to 2015.

**Noninterest expense**

Total noninterest expenses for the six month period ending June 30, 2016 increased \$3.8 million to \$44.4 million from \$40.6 million for the same period last year.

Salaries and employee benefits is the primary component of noninterest expense and totaled \$27.2 million, an increase of \$1.8 million (6.9%) compared to 2015. The increase is primarily due to slightly higher staffing levels and higher retirement plan expenses as a result of changes in actuarial assumptions.

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Insurance Fund premiums increased to \$3.7 million (27.7%) due to an increase in premium rates as well as growth in loan volume. Insurance Fund premium rates are set by the Farm Credit System Insurance Corporation and were 16 basis points of adjusted insured debt obligations in 2016 compared to 13 basis points throughout 2015. The premium rate will increase to 18 basis points for the second half of 2016. Noninterest expenses also include fees paid to our technology service provider, occupancy and equipment expense and other operating expenses.

### **Income Taxes**

The provision for income taxes totaled \$0.8 million for the six months ending June 30, 2016, a decrease of \$0.8 million from 2015. The decrease in income taxes is primarily related to a prior year tax expense adjustment that was recorded in 2015. The Association's effective tax rate is significantly less than the applicable federal and state tax statutory income tax rates primarily due to tax deductible patronage distributions and our tax exempt business activities.

### **Patronage Distributions**

The Association has a patronage program that allows it to distribute its available net earnings to its stockholders. The patronage program consists of a qualified cash distribution and a non-qualified distribution.

At December 31, 2015, liabilities included a \$53.0 million patronage distribution payable to members, which has since been distributed in cash. An anticipated patronage distribution payable to members of \$24.7 million was accrued during the first six months of 2016 which will be payable to members in cash early in 2017 provided the capital and earnings goals for the Association are achieved.

### **Loan Portfolio**

The loan portfolio consists primarily of agricultural real estate loans, agricultural production operating loans and intermediate installment loans. Loans are originated and serviced within the Association's local service area (LSA) in New York, New Jersey, Maine and throughout Southern New England, as well as outside the LSA through purchased loan participations.

<b>As of June 30</b>	<b>2016</b>	<b>2015</b>
New York	48%	47%
New Jersey	12%	12%
Maine	7%	8%
Massachusetts	6%	6%
Connecticut	6%	6%
Rhode Island, New Hampshire and other states	21%	21%
<b>Total</b>	<b>100%</b>	<b>100%</b>

Loan volume totaled \$6.1 billion at June 30, 2016, an increase of \$35.3 million (0.6%) from December 31, 2015. Compared to June 30, 2015 loan volume grew 4.8%. The period to period growth was driven by our branch based farm loan portfolio which grew \$138.5 million (3.4%) as demand for agricultural products benefited producers. Our residential country living mortgage program grew \$42.3 million (7.6%) and our capital markets group grew \$109.3 million (9.7%).

### **Credit Quality Conditions and Measurements in the Loan Portfolio**

The following table presents loans classified, by management, pursuant to our regulator's Uniform Loan Classification System, as a percent of total loans and related accrued interest.

<b>As of June 30</b>	<b>2016</b>	<b>2015</b>
Acceptable	92.74%	94.08%
Special mention	3.90%	3.07%
Substandard/doubtful	3.36%	2.85%
<b>Total</b>	<b>100.00%</b>	<b>100.00%</b>

The overall credit quality measures remain strong at June 30, 2016. Adversely classified loans ('Substandard' and 'Doubtful') increased to 3.4% of total loans at June 30, 2016 compared to 2.9% a year ago while 'Special Mention'

loans also increased to 3.9% of loans from 3.1% a year ago. The increases reflect a slight deterioration in credit quality in our dairy and timber portfolios.

Credit risk arises from the inability of an obligor to meet its repayment obligation and exists in our outstanding loans, unfunded loan commitments and letters of credit. We manage credit risk associated with our lending activities through an assessment of the credit risk profile of an individual borrower based on an analysis of the borrower's credit history, repayment capacity, financial position and collateral. Repayment capacity focuses on the borrower's ability to repay the loan based on cash flows from operations or other sources of income. The Association also manages single borrower hold positions and industry concentrations based on underlying risk. The geographic and commodity diversity in the loan portfolio, coupled with disciplined underwriting reduces the potential for significant credit losses. Also worth noting, Farm Credit East's underwriting standards do not allow for subprime lending which is evident based on the current and historical delinquency percentages of the loan portfolio.

To further manage portfolio risk, the Association participates in the USDA's Farm Service Agency guarantee program and as of June 30, 2016 has guarantees totaling \$252.7 million. The Association also participates in the Farmer Mac Long Term Standby Commitment to Purchase Program. As of June 30, 2016, commitments totaling \$35.6 million were in this program.

### **Nonearning Assets**

Nonaccrual loans represent all loans where there is a reasonable doubt as to collection of principal and/or interest. At June 30, 2016 nonaccrual loans totaled \$50.7 million, a decrease of \$9.2 million from December 31, 2015. Nonaccrual loans as a percentage of gross loans decreased slightly to 0.83%. In general, the Association is adequately secured on much of the \$50.7 million in nonaccrual loan volume at June 30, 2016. However, the Association has established specific loan loss allowances of \$2.1 million in relation to \$9.4 million of the nonaccrual portfolio.

Other property owned is comprised of real or personal property that has been acquired through foreclosure or deed in lieu of foreclosure. Other property owned totaled \$1.0 million at June 30, 2016, a decrease of \$0.9 million from December 31, 2015. During the first six months, the Association added three properties totaling \$0.9 million and disposed of four properties totaling \$1.8 million. The Association is actively marketing all other property owned assets and intends to dispose of all properties in an orderly and timely fashion.

The following table summarizes high risk assets and delinquency information.

<b>As of</b>	<b>June 30, 2016</b>	<b>December 31, 2015</b>
Nonaccrual loans	\$ 50,719	\$ 59,883
Accruing loans 90 days or more past due	2,875	2,759
Accruing restructured loans	70	72
<b>Total Impaired Loans</b>	<b>\$ 53,664</b>	<b>\$ 62,714</b>
Other Property Owned	1,004	1,946
<b>Total High Risk Assets</b>	<b>\$ 54,668</b>	<b>\$ 64,660</b>
Impaired Loans to Total Loans	0.88%	1.03%
High Risk Assets to Total Loans	0.89%	1.06%
Nonaccrual Loans to Total Loans	0.83%	0.98%
Delinquencies as a % of total performing loans	0.43%	0.23%

For additional loan type information, see Note 2 to the consolidated financial statements "Loans, Loan Quality and Allowance for Credit Losses".

### **Provision for Loan Losses and Allowance for Credit Losses**

The provision for loan losses reflects our expense estimates for credit losses inherent in our loan portfolio, including unfunded commitments. The allowance for loan losses reflects an adjustment to the value of our total loan portfolio for inherent credit losses related to outstanding balances. We provide line of credit financing to customers to cover short-term and variable needs. As a result, Farm Credit East has significant unfunded commitments for which we

maintain a separate reserve. This reserve is reported as a liability on the Association's consolidated balance sheet. We refer to the combined amounts of the allowance for loan losses and the reserve for unfunded commitments as the "allowance for credit losses." The allowance for credit losses (ACL) reflects our assessment of the risk of probable and estimable loss related to outstanding balances and unfunded commitments in our loan portfolio. The allowance for credit losses is maintained at a level consistent with this assessment, considering such factors as loss experience, portfolio quality, portfolio concentrations, current and historical production conditions, modeling imprecision, or mission and economic and environmental factors specific to our portfolio segments. The allowance for credit losses at each period end was considered by management to be adequate.

As a result of overall favorable credit quality, Farm Credit East did not record a provision for loan losses for the six months ended June 30, 2016 and 2015.

Information regarding comparative allowance coverage, as a percentage of key loan categories, are presented in the following table.

<u>As of June 30</u>	<u>2016</u>	<u>2015</u>
Components:		
Allowance for loan losses	\$ 78,148	\$ 74,637
Reserve for unfunded commitments	8,703	11,025
<u>Allowance for Credit Losses (ACL)</u>	<u>\$ 86,851</u>	<u>\$ 85,662</u>
ACL as a percentage of:		
Total loans	1.42%	1.46%
Nonaccrual loans	171.24%	147.90%
<u>Impaired loans</u>	<u>161.84%</u>	<u>137.73%</u>

For further discussion regarding the allowance for loan losses, refer to Note 2 to the consolidated financial statements "Loans, Loan Quality and Allowance for Credit Losses".

### **Liquidity and Funding Sources**

The Association's primary source of funding is CoBank. Funds are obtained through borrowing on a revolving line of credit governed by a General Financing Agreement. At June 30, 2016 the Association's note payable to CoBank totaled \$5.1 billion. The Association is in full compliance with its financing agreement with CoBank and has capacity under the agreement to borrow funds needed to meet anticipated loan demand.

### **Members' Equity**

In conjunction with its annual financial planning process, the Association's Board of Directors reviews and approves a Capitalization Plan. The objective of the plan is to build and maintain adequate capital for continued financial viability and to provide for growth necessary to meet customer needs.

Members' equity, which is available as loanable funds, was \$1.2 billion at June 30, 2016 and consisted of capital stock and participation certificates of \$14.2 million, additional paid in capital of \$229.2 million, unallocated retained earnings of \$1,015.6 million, and accumulated other comprehensive loss of (\$39.9) million.

Farm Credit East, along with other System institutions, is subject to regulatory oversight by the Farm Credit Administration (FCA). In addition to the Association's Board approved Capitalization Plan, a number of rules and regulations are imposed under the Farm Credit Act on the operations of System entities, including requirements to maintain a minimum permanent capital ratio, total surplus ratio and core surplus ratio. As displayed in the following table, the Association exceeded the minimum regulatory requirements, which are noted parenthetically.

<u>As of June 30</u>	<u>2016</u>	<u>2015</u>
Members' equity as a % of assets	19.16%	18.66%
Permanent capital ratio (7.0%)	16.54%	16.13%
Total surplus ratio (7.0%)	16.32%	15.90%
<u>Core surplus ratio (3.5%)</u>	<u>16.32%</u>	<u>15.80%</u>

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Financial condition ratios for 2016 are consistent with Farm Credit East's current Capitalization Plan and long term objectives. Association management knows of no reason that would cause the Association not to meet these standards in the foreseeable future.

On March 10, 2016, the Farm Credit Administration (FCA) adopted final rules relating to regulatory capital requirements for System Banks and Associations, including Farm Credit East. The new capital regulations will become effective January 1, 2017. The stated objectives of the new capital regulations are as follows:

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

We continue to analyze this final rule and based on our assessment, we do not believe the new rule will impose any significant constraints on our business strategies or growth prospects.

### **Critical Accounting Estimates**

The financial statements are reported in conformity with accounting principles generally accepted in the United States of America. The Association's significant accounting policies are critical to the understanding of the results of operations and financial position because some accounting policies require management to make complex or subjective judgments and estimates that may affect the value of certain assets or liabilities. Management considers these policies critical because it has to make judgments about matters that are inherently uncertain. For a complete discussion of significant accounting policies, see Note 1 to the consolidated financial statements "Organization and Significant Accounting Policies".

### **Forward-Looking Statements**

Certain information included in this report contains forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Words such as "believes," "could," "estimates," "anticipates," "may," "should," "will," or other variations of these terms or similar expressions are intended to identify forward-looking statements. These statements are based on assumptions and analyses made in light of experience, historical trends, current conditions, and expected future developments. However, actual results and developments may differ materially from our expectations and predictions due to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties include, but are not limited to fluctuations in the economy, the relative strengths and weaknesses in the agricultural credit sectors and in the real estate market, and the actions taken by the Federal Reserve in implementing monetary policy.

**FARM CREDIT EAST, ACA**  
**CONSOLIDATED BALANCE SHEETS**  
*(unaudited and dollars in thousands)*

	June 30, 2016	December 31, 2015
<b>ASSETS</b>		
Loans	\$ 6,129,854	\$ 6,094,507
Less: Allowance for loan losses	78,148	76,361
Net loans	6,051,706	6,018,146
Cash	21,201	14,463
Accrued interest receivable	20,360	18,683
Investment in CoBank, ACB	208,017	207,106
Premises and equipment, net	19,990	19,500
Other property owned	1,004	1,946
Other assets	41,996	46,462
<b>Total Assets</b>	<b>\$ 6,364,274</b>	<b>\$ 6,326,306</b>
<b>LIABILITIES</b>		
Notes payable to CoBank, ACB	\$ 5,063,224	\$ 5,050,959
Patronage distributions payable	24,681	53,000
Accrued interest payable	5,390	5,010
Reserve for unfunded commitments	8,703	10,859
Other liabilities	43,168	46,492
<b>Total Liabilities</b>	<b>5,145,166</b>	<b>5,166,320</b>
<b>MEMBERS' EQUITY</b>		
Capital stock and participation certificates	14,223	14,124
Additional paid-in capital	229,198	229,198
Unallocated retained earnings	1,015,577	962,070
Accumulated other comprehensive loss	(39,890)	(45,406)
<b>Total Members' Equity</b>	<b>1,219,108</b>	<b>1,159,986</b>
<b>Total Liabilities and Members' Equity</b>	<b>\$ 6,364,274</b>	<b>\$ 6,326,306</b>

The accompanying notes are an integral part of these statements.



**FARM CREDIT EAST, ACA**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

*(unaudited and dollars in thousands)*

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
<b>INTEREST INCOME</b>				
Loans	\$61,436	\$56,391	\$122,228	\$111,502
Other	22	68	203	221
Total interest income	61,458	56,459	122,431	111,723
<b>INTEREST EXPENSE</b>				
Notes payable to CoBank, ACB	15,147	14,958	29,347	24,180
Other	1	1	2	2
Total interest expense	15,148	14,959	29,349	24,182
Net interest income	46,310	41,500	93,082	87,541
Provision for loan losses	0	0	0	0
Net interest income after provision for loan losses	46,310	41,500	93,082	87,541
<b>NONINTEREST INCOME</b>				
Patronage distributions from Farm Credit Institutions	7,123	6,416	14,779	13,265
Financially related services income	7,395	6,999	13,200	11,928
Compensation on participation loans, net	701	716	1,327	1,460
Loan fees	525	631	1,021	1,073
Other noninterest income	2	1	4	17
Total noninterest income	15,746	14,763	30,331	27,743
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	13,245	12,151	27,225	25,460
Fees paid to technology service provider	2,098	1,828	3,999	3,653
Insurance Fund premiums	1,783	1,459	3,718	2,911
Occupancy and equipment	853	774	1,729	1,649
Other noninterest expenses	3,869	3,694	7,723	6,883
Total noninterest expenses	21,848	19,906	44,394	40,556
Income before income taxes	40,208	36,357	79,019	74,728
Provision for income taxes	417	386	831	1,594
<b>Net Income</b>	<b>39,791</b>	<b>35,971</b>	<b>78,188</b>	<b>73,134</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>				
Net change in cash flow hedge	1,336	3,108	5,516	2,953
Other Comprehensive Income	1,336	3,108	5,516	2,953
<b>Comprehensive Income</b>	<b>\$41,127</b>	<b>\$39,079</b>	<b>\$83,704</b>	<b>\$76,087</b>

The accompanying notes are an integral part of these statements.

**FARM CREDIT EAST, ACA**  
**CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY**  
*(unaudited and dollars in thousands)*

	Capital Stock and Participation Certificates	Additional Paid-in-Capital	Allocated Retained Earnings	Unallocated Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Members' Equity
<b>Balance at December 31, 2014</b>	\$ 13,913	\$ 229,198	\$ 6,048	\$ 871,829	\$ (41,641)	\$ 1,079,347
Comprehensive Income (Loss)				73,134	2,953	76,087
Capital stock and participation certificates issued	552					552
Capital stock and participation certificates retired	(429)					(429)
Allocated retained earnings retired			(6)			(6)
Patronage Distribution				(24,919)		(24,919)
<b>Balance at June 30, 2015</b>	<b>\$ 14,036</b>	<b>\$ 229,198</b>	<b>\$ 6,042</b>	<b>\$ 920,044</b>	<b>\$ (38,688)</b>	<b>\$ 1,130,632</b>
<b>Balance at December 31, 2015</b>	\$ 14,124	\$ 229,198	\$ 0	\$ 962,070	\$ (45,406)	\$ 1,159,986
Comprehensive Income (Loss)				78,188	5,516	83,704
Capital stock and participation certificates issued	568					568
Capital stock and participation certificates retired	(469)					(469)
Patronage Distribution				(24,681)		(24,681)
<b>Balance at June 30, 2016</b>	<b>\$ 14,223</b>	<b>\$ 229,198</b>	<b>\$ 0</b>	<b>\$ 1,015,577</b>	<b>\$ (39,890)</b>	<b>\$ 1,219,108</b>

The accompanying notes are an integral part of these statements.

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# Notes to Consolidated Financial Statements

*(unaudited and dollars in thousands except as noted)*

## **NOTE 1 – Organization and Significant Accounting Policies**

Farm Credit East, ACA (the Association or ACA) and its subsidiaries are part of the Farm Credit System. A description of the organization and operations of the Association, the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2015, are contained in the 2015 Annual Report to Stockholders. These unaudited second quarter 2016 financial statements should be read in conjunction with the 2015 Annual Report to Stockholders.

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. (GAAP) for interim financial information. Accordingly, they do not include all of the disclosures required by GAAP for annual financial statement and should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2015 as contained in the 2015 Annual Report to Stockholders. Certain reclassifications have been made to amounts reported in the prior period to conform to the current period presentation.

In the opinion of management, the unaudited financial information is complete and reflects all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of results for the interim periods. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statement and accompanying notes. Actual results could differ from those estimates. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year ending December 31, 2016. Descriptions of the significant accounting policies are included in the 2015 Annual Report to Stockholders. In the opinion of management, these policies and the presentation of the interim financial condition and results of operations conform to GAAP and prevailing practices within the banking industry.

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

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

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

In August 2014, the Financial Accounting Standards Board (FASB) issued guidance entitled “Presentation of Financial Statements — Going Concern.” The guidance governs management’s responsibility to evaluate

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whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. This guidance requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year after the date the financial statements are issued or within one year after the financial statements are available to be issued, when applicable. Substantial doubt exists if it is probable that the entity will be unable to meet its obligations for the assessed period. This guidance becomes effective for interim and annual periods ending after December 15, 2016, and early application is permitted. Management will be required to make its initial assessment as of December 31, 2016.

In May 2014, the FASB issued guidance entitled, "Revenue from Contracts with Customers." The guidance governs revenue recognition from contracts with customers and requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Financial instruments and other contractual rights within the scope of other guidance issued by the FASB are excluded from the scope of this new revenue recognition guidance. In this regard, a majority of our contracts would be excluded from the scope of this new guidance. In August 2015, the FASB issued an update that defers this guidance by one year, which results in the new revenue standard becoming effective for interim and annual reporting periods beginning after December 15, 2017. The Association is in the process of reviewing contracts to determine the effect, if any, on our financial condition or results of operations.

## NOTE 2 – Loans, Loan Quality and Allowance for Credit Losses

### Loans Outstanding

Loans outstanding by loan type are shown below.

As of	June 30, 2016		December 31, 2015	
Real estate mortgage	\$ 2,814,137	45.9%	\$ 2,762,868	45.3%
Production and intermediate term	2,163,510	35.3%	2,236,709	36.7%
Agribusiness:				
Loans to cooperatives	179,654	2.9%	140,016	2.3%
Processing and marketing	577,003	9.4%	558,363	9.2%
Farm related business	252,329	4.1%	257,287	4.2%
Rural infrastructure:				
Communication	8,694	0.1%	4,380	0.1%
Energy	77,691	1.3%	74,204	1.2%
Water/Waste water	0	0.0%	3,000	0.1%
Rural residential real estate	56,836	1.0%	57,680	0.9%
Total Loans	\$ 6,129,854	100.0%	\$ 6,094,507	100.0%

The Association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the Association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the Association's lending activities is collateralized and the Association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the Association's credit risk exposure is considered in the determination of the allowance for credit losses.

<b>As of</b>	<b>June 30, 2016</b>		<b>December 31, 2015</b>	
<b>Commodity</b>	<b>Amount</b>		<b>Amount</b>	
Dairy	\$ 1,333,813	21.8%	\$ 1,324,955	21.7%
Timber	685,729	11.2%	689,534	11.3%
Cash Field	651,780	10.6%	649,246	10.7%
Processing & Marketing	561,736	9.2%	523,152	8.6%
Livestock	560,668	9.1%	560,172	9.2%
Fruit	522,799	8.5%	530,699	8.7%
Nursery	252,611	4.1%	250,345	4.1%
Farm Services	244,767	4.0%	239,704	3.9%
Greenhouse	232,551	3.8%	252,478	4.1%
Aquatic	221,482	3.6%	224,227	3.7%
Vegetables	205,733	3.4%	182,881	3.0%
Potato	162,946	2.7%	179,183	2.9%
All Other	493,239	8.0%	487,931	8.1%
<b>Total</b>	<b>\$ 6,129,854</b>	<b>100.0%</b>	<b>\$ 6,094,507</b>	<b>100%</b>

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock as well as receivables. Long-term real estate loans are secured by the first liens on the underlying property. Federal regulations state that long-term real estate loans are not to exceed 85% (97% if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

#### **Allowance for Credit Losses**

The following table presents the changes in the components of the allowance for credit losses. The allowance for credit losses includes the allowance for loan losses and the reserve for unfunded commitments.

The following table presents the changes in the components of our allowance for loans.

<b>For the six months ended June 30,</b>	<b>2016</b>	<b>2015</b>
<b>Allowance for Loan Losses</b>		
Beginning balance at January 1	\$ 76,361	\$ 74,039
Charge-offs	(569)	(78)
Recoveries	200	412
Transfers from (to) Reserve for Unfunded Commitments	2,156	264
Ending balance at June 30,	\$ 78,148	\$ 74,637
<b>Reserve for Unfunded Commitments</b>		
Beginning balance at January 1	\$ 10,859	\$ 11,289
Transfers (to) from Allowance for Loan Losses	(2,156)	(264)
Ending balance June 30,	\$ 8,703	\$ 11,415
<b>Allowance for Credit Losses</b>	<b>\$ 86,851</b>	<b>\$ 85,662</b>

#### **Credit Quality**

One credit quality indicator utilized by the Bank and Associations is the Farm Credit Administration Uniform Loan Classification System that categorizes loans into five categories. The categories are defined as follows:

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

The following tables show loans and related accrued interest classified, by management, under the FCA Uniform Loan Classification System as a percentage of total loans and related accrued interest receivable by loan type.

<b>As of June 30, 2016</b>	<b>Acceptable</b>	<b>OAEM</b>	<b>Substandard/ Doubtful</b>	<b>Total</b>
Real estate mortgage	42.8%	1.5%	1.7%	46.0%
Production and Intermediate term	32.8%	1.6%	0.9%	35.4%
Agribusiness	15.0%	0.6%	0.8%	16.4%
Rural infrastructure	1.2%	0.2%	0.0%	1.3%
Rural residential real estate	0.9%	0.0%	0.0%	0.9%
<b>Total</b>	<b>92.7%</b>	<b>3.9%</b>	<b>3.4%</b>	<b>100.0%</b>

<b>December 31, 2015</b>	<b>Acceptable</b>	<b>OAEM</b>	<b>Substandard/ Doubtful</b>	<b>Total</b>
Real estate mortgage	42.5%	1.2%	1.6%	45.3%
Production and Intermediate term	34.9%	1.1%	0.7%	36.7%
Agribusiness	14.5%	0.6%	0.7%	15.8%
Rural infrastructure	1.1%	0.2%	0.0%	1.3%
Rural residential real estate	0.9%	0.0%	0.0%	0.9%
<b>Total</b>	<b>93.9%</b>	<b>3.1%</b>	<b>3.0%</b>	<b>100.0%</b>

To mitigate the risk of loan losses, the Association may enter into long-term standby commitments to purchase agreements with the Federal Agricultural Mortgage Corporation (Farmer Mac). The agreements, which are effectively credit guarantees that will remain in place until the loans are paid in full, give the Association the right to sell the loans identified in the agreements to Farmer Mac in the event of default (typically four months past due), subject to certain conditions. The balance of loans under long-term standby commitments was \$35.6 million at June 30, 2016 and \$38.7 million at December 31, 2015. Fees paid to Farmer Mac for such commitments totaled \$0.1 million for the six months ended June 30, 2016 and June 30, 2015. These amounts are classified as noninterest expense. In addition to Farmer Mac, the Association has credit enhancements with federal government agencies totaling \$252.7 million at June 30, 2016 and \$257.8 million at December 31, 2015.

#### Impaired Loans

Impaired loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms. Interest income recognized and payments received on nonaccrual impaired loans are applied in a similar manner as for nonaccrual loans, as described in Note 2 of the 2015 Annual Report to Stockholders.

Impaired loan information is shown in the following table. Loans past due 90 days or more and still accruing interest are adequately secured and in process of collection.

<b>As of</b>	<b>June 30, 2016</b>	<b>December 31, 2015</b>
Nonaccrual loans	\$ 50,719	\$ 59,883
Accruing loans 90 days or more past due	2,875	2,759
Accruing restructured loans	70	72
<b>Total impaired loans</b>	<b>\$ 53,664</b>	<b>\$ 62,714</b>

The following table presents information on impaired loans and related amounts in the allowance for loan losses.

<b>As of</b>	<b>June 30, 2016</b>	<b>December 31, 2015</b>
Impaired loans with related allowance	\$ 9,442	\$ 10,831
Impaired loans with no related allowance	44,222	51,883
<b>Total impaired loans</b>	<b>\$ 53,664</b>	<b>\$ 62,714</b>
Total specific allowance	\$ 2,105	\$ 1,984
<b>For the six months ending June 30,</b>	<b>2016</b>	<b>2015</b>
Average impaired loans	\$ 61,342	\$ 57,844
Interest income recognized on impaired loans	\$ 359	\$ 544

### Commitments on Impaired loans

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at June 30, 2016.

### Aging Analysis

The following tables present an aging of past due loans.

As of June 30, 2016	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Accruing Loans 90 Days or More Past Due
Real estate mortgage	\$ 11,855	\$ 17,331	\$ 29,186	\$ 2,784,951	\$ 2,814,137	\$ 1,969
Production and intermediate term	7,916	9,162	17,078	2,146,432	2,163,510	906
Agribusiness	4,254	645	4,899	1,004,087	1,008,986	0
Rural infrastructure	0	0	0	86,385	86,385	0
Rural residential real estate	334	166	500	56,336	56,836	0
<b>Total Loans</b>	<b>\$ 24,359</b>	<b>\$ 27,304</b>	<b>\$ 51,663</b>	<b>\$ 6,078,191</b>	<b>\$ 6,129,854</b>	<b>\$ 2,875</b>

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

As of December 31, 2015	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Accruing Loans 90 Days or More Past Due
Real estate mortgage	\$ 8,500	\$ 18,624	\$ 27,124	\$ 2,735,744	\$ 2,762,868	\$ 1,764
Production and intermediate term	4,273	8,544	12,817	2,223,892	2,236,709	995
Agribusiness	409	660	1,069	954,597	955,666	0
Rural infrastructure	0	0	0	81,584	81,584	0
Rural residential real estate	431	171	602	57,078	57,680	0
<b>Total Loans</b>	<b>\$ 13,613</b>	<b>\$ 27,999</b>	<b>\$ 41,612</b>	<b>\$ 6,052,895</b>	<b>\$ 6,094,507</b>	<b>\$ 2,759</b>

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

### Troubled Debt Restructuring

Troubled debt restructurings (TDRs) are loans in which the Association has granted a concession because the borrower is experiencing financial difficulty. Concessions may include payment deferrals, term extensions and /or interest rate reductions.

The Association had one TDR totaling \$0.1 million that occurred during the six months ended June 30, 2016. There were no TDR's that occurred during the six months ended June 30, 2015. During the previous 12 months, there have been no payment defaults on TDR classified loans.

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

	Loans Modified as TDRs		TDRs in Nonaccrual Status*	
	June 30, 2016	December 31, 2015	June 30, 2016	December 31, 2015
Real estate mortgage	\$ 14,364	\$ 15,109	\$ 14,364	\$ 15,109
Production and intermediate term	(336)	7,459	(406)	7,387
<b>Total</b>	<b>\$ 14,028</b>	<b>\$ 22,568</b>	<b>\$ 13,958</b>	<b>\$ 22,496</b>

\* represents the portion of loans modified as TDRs (first column) that are in nonaccrual status

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### **NOTE 3 – Members' Equity**

A description of the Association's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below. Members' equity is described and governed by the Association's capitalization policies. Farm Credit East's capitalization policies are specified in the Bylaws and in the Capitalization Plan approved by the Board of Directors. Copies of the Association's Bylaws and Capitalization Plan are available to members at any time.

The components of Association capital that are allocated directly to members are capital stock, participation certificates, and allocated surplus.

#### **Capital stock and participation certificates**

In accordance with the Farm Credit Act, and the Association's capitalization Bylaws and Capitalization Plan, each Association borrower, as a condition of borrowing, is required at the time the loan is made, to invest in Class B Stock for agricultural loans or Class B Participation Certificates for country home and farm related business loans. Association Bylaws require that borrowers acquire capital stock or participation certificates, as a condition of borrowing, at least the lesser of \$1,000 or 2% of the amount of the loan, and not more than 10% of the amount of the loan.

Pursuant to the Association Capitalization Plan, the Association Board has determined that Class B stock and Class B participation certificates shall be issued as follows:

For all loans (except where indicated below) Class B stock and Class B participation certificates shall be issued equal to one thousand dollars per customer as a condition of borrowing from this Association. For purposes of borrower stock, a customer is defined as the primary borrower on a loan. The intent of this policy is for each primary customer to have one thousand dollars of stock, regardless of the number of loans or balance on those loans to that customer. Stock shall be purchased at the beginning of a customer's relationship and will not be retired until all loans to that customer are paid in full and there are no funds available for advances.

Exceptions to this policy are:

- At the time of the Farm Credit East mergers in 2010 and 2014, certain customers with less than one thousand dollars of stock were "grandfathered" at the stock level at conversion. Grandfathered customer stock will be frozen at converted levels until all loans are repaid, at which time the stock will be retired, or increased to one thousand dollars at the time of a future advance or credit action.
- Certain small borrowers (customers with total commitment less than ten thousand dollars initially) will be issued at 10% of the initial commitment, consistent with By-Law limitations.
- Certain interests in loans sold to other financial institutions.
- Loans to be sold into the secondary market

All stock and participation certificates are retired at the discretion of the Association's Board of Directors after considering the capitalization plan as well as regulatory and other requirements.

#### **Regulatory capitalization requirements and restrictions**

The Farm Credit Administration's (FCA) capital adequacy regulations require the Association to achieve permanent capital of seven percent (7.0%) of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the 7.0% capital requirement can initiate certain mandatory and possibly additional discretionary actions by FCA that, if undertaken, could have a direct material effect on the Association's financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to stockholders unless prescribed capital standards are met. FCA regulations also require that additional minimum standards for capital be achieved. These standards are summarized below:



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	<b>FCA Regulatory Minimum</b>	<b>Ratios at June 30, 2016</b>
Permanent Capital Ratio	7.0%	16.54%
Total Surplus Ratio	7.0%	16.32%
Core Surplus Ratio	3.5%	16.32%

### **Patronage Distribution**

In December 2015, the Board of Directors approved a patronage resolution. This resolution will allow the Association to pay a patronage refund on 2016 income provided the capital goals and earnings for the Association are achieved. The patronage program is described more fully in the 2015 Annual Report to Stockholders.

### **Accumulated Other Comprehensive Income/Loss**

The Association reports accumulated other comprehensive income (loss) as a component of members' equity. Other comprehensive income refers to revenue, expenses, gains and losses that under GAAP are reported as an element of members' equity and comprehensive income but excluded from net income. Other comprehensive income/loss results from the recognition of the retirement plans net unamortized gains and losses and prior service costs or credits of (\$45.0) million at June 30, 2016 and December 31, 2015. Also included in accumulated other comprehensive income/loss is the unrealized holding gain or loss on cash flow derivatives of \$5.1 million and (\$0.4) million at June 30, 2016 and December 31, 2015, respectively. There are no other items affecting comprehensive income or loss.

### **NOTE 4 – Fair Value Measurements**

Accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market for the asset or liability. The fair value measurement is not an indication of liquidity. See Note 2 and Note 13 to the 2015 Annual Report to Stockholders for additional information.

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

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

### **Quantitative Information about Recurring and Nonrecurring Fair Value Measurements**

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

Assets and liabilities measured at fair value on a recurring basis at period end for each of the fair value hierarchy values are summarized below:

<b>Fair Value Measurement Using</b>				
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Fair Value</b>
<b>Assets:</b>				
<b>June 30, 2016</b>				
Derivative assets	\$ 0	\$ 5,612	\$ 0	\$ 5,612
Assets held in trust	\$ 7,234	\$ 0	\$ 0	\$ 7,234
<b>December 31, 2015</b>				
Derivative assets	\$ 0	\$ 665	\$ 0	\$ 665
Assets held in trust	\$ 6,907	\$ 0	\$ 0	\$ 6,907
<b>Liabilities:</b>				
<b>June 30, 2016</b>				
Derivative liabilities	\$ 0	\$ 11	\$ 0	\$ 11
<b>December 31, 2015</b>				
Derivative liabilities	\$ 0	\$ 1,066	\$ 0	\$ 1,066

Assets measured at fair value on a non-recurring basis at period end for each of the fair value hierarchy values are summarized below:

<b>Fair Value Measurement Using</b>				
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Fair Value</b>
<b>Assets:</b>				
<b>June 30, 2016</b>				
Impaired loans	\$ 0	\$ 0	\$ 51,559	\$ 51,559
Other Property Owned	\$ 0	\$ 0	\$ 1,154	\$ 1,154
Rural Investments, LLC	\$ 0	\$ 0	\$ 841	\$ 841
<b>December 31, 2015</b>				
Impaired loans	\$ 0	\$ 0	\$ 60,731	\$ 60,731
Other Property Owned	\$ 0	\$ 0	\$ 2,172	\$ 2,172
Rural Investments, LLC	\$ 0	\$ 0	\$ 1,044	\$ 1,044

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

	<b>June 30, 2016</b>			<b>December 31, 2015</b>		
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Fair Value Hierarchy</b>	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Fair Value Hierarchy</b>
<b>Financial assets:</b>						
Loans, net	\$ 6,051,706	\$6,108,187	Level 3	\$6,018,146	\$6,023,019	Level 3
Cash	\$ 21,201	\$ 21,201	Level 1	\$ 14,463	\$ 14,463	Level 1
<b>Financial liabilities:</b>						
Notes payable to ACB	\$ 5,063,224	\$5,100,799	Level 3	\$5,050,959	\$5,055,032	Level 3

## Valuation Techniques

As more fully discussed in Note 2 to the 2015 Annual Report to Stockholders, accounting guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the Association's assets and liabilities.

### Cash

The carrying value of cash is a reasonable estimate of fair value.

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### **Assets Held in Trust**

Assets held in trust funds related to deferred compensation and supplemental retirement plans and are classified within Level 1. These assets include investments that are actively traded and have quoted net asset values that are observable in the marketplace.

### **Loans**

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

### **Other Property Owned**

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

### **Impaired Loans**

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

### **Notes payable to CoBank, ACB**

The notes payable are segregated into pricing pools according to the types and terms of the loans (or other assets) which they fund. Fair value of the note payable is estimated by discounting the anticipated cash flows of each pricing pool using the current rate that would be charged for additional borrowings. For purposes of this estimate it is assumed the cash flow on the notes is equal to the principal payments on the Association's loan receivables plus accrued interest on the notes payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.

### **Rural Investments, LLC**

For these investments, the fair value is based upon the underlying loans contained in the investment. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the collateral is less than the principal balance of the investment a loss is realized.

### **Derivatives**

Exchange-traded derivatives valued using quoted prices are classified within Level 1 of the valuation hierarchy. However, few classes of derivative contracts are listed on an exchange; thus, the Association's derivative positions are valued using internally developed models that use as their basis readily observable market parameters and are classified within Level 2 of the valuation hierarchy. Such derivatives include basic interest rate swaps. Derivatives that are valued based upon models with significant unobservable market parameters and that are normally traded less actively or have trade activity that is one way are classified within Level 3 of the valuation hierarchy. The Association does not have any derivatives classified within Level 3.

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

#### **NOTE 5 – Derivative Instruments and Hedging Activities**

The Association maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. The Association's goal is to manage interest rate sensitivity by modifying the repricing or maturity characteristics of certain balance sheet assets or liabilities so that the net interest margin is not adversely affected by movements in interest rates. As a result of interest rate fluctuations, the Association's interest income and interest expense of hedged variable-rate assets, will increase or decrease. The effect of this variability in earnings is expected to be substantially offset by the Association's gains and losses on the derivative instruments that are linked to these hedged assets. The Association considers its strategic use of derivatives to be a prudent method of managing interest rate sensitivity, as it prevents earnings from being exposed to undue risk posed by changes in interest rates.

The Association enters into interest rate swaps to stabilize net interest income on variable priced loan assets, to the extent they are funded with equity. Under interest rate swap arrangements, the Association agrees with other parties (CoBank) to exchange, at specified intervals, payment streams calculated on a specified notional principal amount, with at least one stream based on a specified floating rate index.

The Association's interest-earning assets, to the degree they are funded with debt, are matched with similarly priced and termed liabilities. Volatility in net interest income, comes from equity funded, variable priced assets. To the degree that variable priced assets are funded with equity, interest rate swaps in which the Association pays the floating rate and receives the fixed rate (receive fixed swaps) are used to reduce the impact of market fluctuations on the Association's net interest income.

By using derivative instruments, the Association exposes itself to credit and market risk. If a counterparty fails to fulfill its performance obligations under a derivative contract, the Association's credit risk will equal the fair value gain in a derivative. Generally, when the fair value of a derivative contract is positive, this indicates that the counterparty owes the Association, thus creating a repayment risk for the Association. When the fair value of the derivative contract is negative, the Association owes the counterparty and, therefore, assumes no repayment risk. The Association minimizes the credit (or repayment) risk by entering into transactions only with CoBank, its funding bank. The Association's derivative activities are monitored by senior management and the Board of Directors.

#### **Cash flow hedges**

The Association uses interest rate swaps to hedge the risk of overall changes in the cash flows of an asset. The asset is defined as a pool of long term variable rate loans equal to the notional amount of the swaps, and not exceeding the Association's equity position. These swaps, which qualify for hedge accounting, have up to a three-year term, with a pay rate indexed to three month LIBOR.

As of June 30, 2016, the Association has executed interest rate swap contracts with CoBank, ACB having a notional amount of \$932 million. The fair value of the swap contracts at June 30, 2016 is \$5.6 million of which \$5.1 million is reflected in accumulated other comprehensive income due to the highly effective nature of the hedge transaction and \$0.5 million of income is recorded in interest expense due to the ineffectiveness of the hedge transactions. The carrying value of the hedged assets was \$5.6 million and the carrying value of the hedged liabilities was zero. The Association is exposed to credit loss in the event of nonperformance by other parties to the interest rate swap agreement; however, the Association does not anticipate nonperformance by CoBank, ACB.

#### **NOTE 6 – Asset/Liability Offsetting**

As noted previously, all the Association's derivative transactions are with CoBank and collateralized through loan agreements. Notwithstanding collateral and netting provisions, our derivative assets and liabilities are not offset in the

accompanying consolidated balance sheets. The following table summarizes derivative assets and liabilities, related accrued interest and amounts of collateral exchanged pursuant to our agreements.

As of June 30, 2016	Gross Amounts of Assets/Liabilities Presented in the Consolidated Balance Sheets	Amounts Not Offset In the <u>Consolidated Balance Sheets</u>		Net Amount
		Cash Collateral Received/ Pledged	Investment Securities Received/Pledged as Collateral	
<b>Assets:</b>				
Interest Rate Swaps:				
Dealer	\$ 5,612	\$ 0	\$ 0	\$ 5,612
Accrued Interest Receivable on Derivative Contracts	\$ 175	\$ 0	\$ 0	\$ 175
<b>Liabilities:</b>				
Interest Rate Swaps:				
Dealer	\$ 11	\$ 0	\$ 0	\$ 11
Accrued Interest Payable on Derivative Contracts	\$ 3	\$ 0	\$ 0	\$ 3

#### **NOTE 7 – Subsequent Events**

The Association has evaluated subsequent events through August 8, 2016 which is the date the financial statements were issued or available to be issued. No subsequent event items met the criteria for disclosure.

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## Report on Internal Control over Financial Reporting

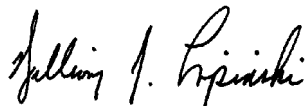
The Association maintains a system of internal control over financial reporting. For purposes of this report, “internal control over financial reporting” is defined as a process designed by, or under the supervision of the Association’s principal executives and principal financial officers, or persons performing similar functions, and effected by its boards of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting information and the preparation of the combined financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Association, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial information in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the Association, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Association’s assets that could have a material effect on its combined financial statements.

The Association continually assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have been no significant changes in our internal controls or in other factors that could significantly affect such controls subsequent to the date we carried out our evaluations. In accordance with our internal control procedures, these financial statements were prepared under the oversight of the Audit Committee of our Board of Directors.

### Certification

The consolidated financial statements of Farm Credit East, ACA (the Association) are prepared by management, who are responsible for their integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The consolidated financial statements, in our opinion, fairly present the financial position of the Association.

The undersigned certify that we have reviewed the June 30, 2016 Quarterly Report to Stockholders and it has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



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William J. Lipinski  
Chief Executive Officer



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Matthew W. Beaton  
Chair of the Board



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Andrew N. Grant  
Chief Financial Officer

Dated: August 8, 2016

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## FARM CREDIT EAST, ACA

### MAIN OFFICE

240 South Road  
Enfield, CT 06082-4451  
860.741.4380 / 800.562.2235

### BRANCH OFFICES

Auburn, ME  
Matthew Senter, Manager  
615 Minot Avenue  
Auburn, ME 04210  
800.831.4230 / 207.784.0193

Batavia, NY  
Edward Urbanik, Manager  
4363 Federal Drive  
Batavia, NY 14020-4105  
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Bedford, NH  
David Bishop, Manager  
2 Constitution Drive  
Bedford, NH 03110-6010  
800.825.3252 / 603.472.3554

Bridgeton, NJ  
Scott Andersen, Manager  
29 Landis Avenue  
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Burrville, NY  
Kathryn Canzonier, Manager  
25417 NYS Route 12  
Watertown, NY 13601-5730  
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Claverack, NY  
Timothy Slavin, Manager  
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Hudson, NY 12534  
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Cobleskill, NY  
Robert Yurkewecz, Manager  
2668 State Route 7, Suite 21  
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Cortland, NY  
Janice Bitter, Manager  
One Technology Place, Suite 2  
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David Pugh, Director  
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Dayville, CT  
Lynn Weaver, Manager  
785 Hartford Pike  
Dayville, CT 06241-1739  
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Keith Stechschulte, Manager  
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Geneva, NY  
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Christopher Truso, Manager  
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David Van Lieshout, Manager  
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Mayville, NY  
James Warner, Manager  
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Mayville, NY 14757  
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Middleboro, MA  
Cynthia Stiglitz, Manager  
67 Bedford Street, PO Box 720  
Middleboro, MA 02346-0720  
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Middletown, NY  
Blane Allen, Manager  
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Potsdam, NY  
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Presque Isle, ME  
Peter Hallowell, Manager  
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Riverhead, NY  
Stephen Weir, Manager  
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Sangerfield, NY  
Craig Pollock, Manager  
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