

# QUARTERLY REPORT



June 30, 2018



FARM CREDIT EAST

## Management's Discussion and Analysis

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, 2018. This commentary should be read in conjunction with the accompanying unaudited consolidated financial statements and notes included in this report, as well as the 2017 Annual Report. Dollar amounts are in thousands unless otherwise noted.

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

### Business Overview

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](http://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](http://CoBank.com).

### Results of Operations

Farm Credit East posted strong financial results for the six month period ending June 30, 2018. Net income was \$90.8 million for the six months ending June 30, 2018, an increase of \$8.8 million (10.8 percent) as compared with the same period in 2017. Our strong earnings primarily reflect higher net interest income and significantly higher noninterest income offset by slightly higher operating expenses.

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

<b>For the six months ending June 30</b>	<b>2018</b>	<b>2017</b>
Net income	\$ 90.8	\$ 82.0
Net interest income	\$ 100.6	\$ 98.0
Net interest margin	3.05%	3.12%
Return on average assets	2.62%	2.48%
Return on average members equity	13.09%	12.82%

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>2018 versus 2017</b>	<b>2017 versus 2016</b>
Increase in net interest income	\$ 2.7	\$ 4.9
Increase in noninterest income	6.4	1.3
Increase in noninterest expenses	(0.6)	(2.4)
Decrease in provision for income taxes	0.3	-
<b>Total increase in net income</b>	<b>\$ 8.8</b>	<b>\$ 3.8</b>

**Net Interest Income**

Net interest income was \$100.6 million for the six months ending June 30, 2018, a \$2.7 million increase over the same period in 2017. The increase in net interest income was primarily driven by higher average loan volume offset by lower earnings from the Association's hedging position of its equity and slightly higher cost of debt to fund the loan portfolio.

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

As of June 30	2018	2017
Net interest income	\$ 100,623	\$ 97,972
Average balances:		
Average interest earning loans	\$ 6,648,989	\$ 6,331,552
Average interest bearing liabilities	\$ 5,454,667	\$ 5,249,076
Average yields and rates:		
Interest earning loan yield	4.90%	4.30%
Rate paid on interest bearing liabilities	2.22%	1.60%
Interest rate spread	2.68%	2.70%
Net interest margin (interest income as a percentage of average earning loans)	3.05%	3.12%

The Association's average loan rate was 4.90 percent as of June 30, 2018, up from 4.30 percent as of June 30, 2017. Average cost of debt funding also increased from 1.60 percent in 2017 to 2.22 percent in 2018. Interest income and cost of debt are both higher due to increases in publicized short term rates in 2018 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 2.70 percent to 2.68 percent. The decrease in yields from 2017 was due to slightly lower average yield on variable rate loans, reflective of spread compression from increased competition for the business of our customers. Additionally, the Association's borrowing cost to fund loans to customers has decreased slightly in the first two quarters due to slightly lower liquidity requirements as a condition of our lending agreement with CoBank. The combined impact of these items resulted in a slightly lower spread as of June 30, 2018.

**Noninterest income**

Noninterest income was \$38.1 million for the six months ending June 30, 2018, a \$6.4 million increase over the same period in 2017. Included in noninterest income is \$5.1 million in refunds received for a portion of excess Insurance Fund premiums paid in prior years. These refunds represent the Association's portion of the excess in the System-wide Insurance Fund above the required minimum secure base amount.

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, 2018, CoBank patronage income totaled \$12.3 million, compared to \$11.8 million in 2017. The patronage rate paid by CoBank on the Association's note payable was 45 basis points in 2018 and 2017.

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, 2018 this revenue totaled \$4.5 million compared to \$3.9 million in 2017.

Noninterest income also includes fees for financial services, loan fees, compensation on participation loans and other noninterest income. These other noninterest income sources totaled \$16.2 million for the six months ending June 30, 2018, an increase of \$0.3 million compared to 2017. Financial services fee income is the largest component with \$14.1 million in revenue for the six months ended June 30, 2018 an increase of \$0.6 million compared to 2017.

**Noninterest expense**

Total noninterest expenses for the six month period ending June 30, 2018 increased \$0.6 million to \$47.4 million over the same period last year.

Salaries and employee benefits is the primary component of noninterest expense and totaled \$29.9 million, an increase of \$0.8 million (2.7 percent) compared to 2017. The increase is primarily due to annual merit increases offset by slightly lower retirement plan expenses.

Insurance Fund premiums were \$2.3 million for the six months ending June 30, 2018, a \$1.4 million decrease compared to the same period a year ago. Insurance Fund premium rates are set by the Farm Credit System Insurance Corporation and were 9 basis points of adjusted insured debt obligations for the first six months of 2018 compared to 15 basis points in 2017. Noninterest expenses also include fees paid to our technology service provider, occupancy and equipment expense and other operating expenses.

**Provision for Income Taxes**

The provision for income taxes totaled \$0.5 million for the six months ending June 30, 2018 and \$0.8 million for the period ending June 30, 2017. The decrease is a result of the Tax Cuts and Jobs Act of 2017 enacted late 2017 which among other things lowered the federal corporate tax rate from 35 percent to 21 percent. 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, 2017, liabilities included a \$60.0 million patronage distribution payable to members, which has since been distributed in cash. An anticipated patronage distribution payable to members of \$25.5 million was accrued during the first six months of 2018 which will be payable to members in cash early in 2019 provided the capital and earnings goals for the Association are achieved.

**Loan Portfolio**

Loans outstanding were \$6.7 billion at June 30, 2018 an increase of \$107.7 million, or 1.6 percent from the December 31, 2017 balance of \$6.6 billion. Compared to June 30, 2017 loan volume grew 5.8 percent. The combined period to period growth was driven primarily by our branch based farm loan portfolio which grew \$263.7 million, or 6.0 percent, as strong demand for agricultural products benefited our producers. Our residential country living mortgage program grew \$77.0 million, or 11.6 percent, as reasonably strong demand continued in our Local Service Area (LSA) for this product and our capital markets group grew \$30.4 million, or 2.4 percent.

While we make loans and provide financially related services to qualified borrowers in agricultural and rural sectors and to certain related entities, our loan portfolio is diversified by loan participations purchased and sold, geographic locations served, commodities financed and loan size.

The Association purchases loan participations from other System and non-System entities to generate additional earnings and diversify risk related to existing commodities financed and our geographic area served. In addition we sell a portion of certain large loans to other System and non-System entities to reduce risk and comply with lending limits we have established. Our volume of participations purchased and sold as of June 30 are reflected in the following table.

<b>As of June 30</b>	<b>2018</b>	<b>2017</b>
Purchased participations	\$ 1,121,657	\$ 1,037,384
Sold participations	\$ 765,111	\$ 866,641

Loans are originated and serviced within the LSA in New York, New Jersey, Maine and throughout Southern New England. The geographic distribution of loans follows. As previously mentioned, we purchase loan participations outside our territory – which are included in other states in the following table.

<b>As of June 30</b>	<b>2018</b>	<b>2017</b>
New York	49%	48%
New Jersey	11	12
Maine	7	7
Massachusetts	6	7
Connecticut	5	5
Rhode Island, New Hampshire and other states	22	21
Total	100%	100%

The following table shows the primary agricultural commodities produced by our borrowers based on the Standard Industrial Classification System (SIC) published by the federal government. This system is used to assign commodity or industry categories based on the primary business of the customer. A primary business category is assigned when the commodity or industry accounts for 50 percent or more of the total value of sales for a business; however, a large percentage of agricultural operations typically includes more than one commodity.

<b>As of June 30</b>	<b>2018</b>	<b>2017</b>
Dairy	23.1%	22.3%
Cash Field	10.4	10.5
Timber	10.1	10.6
Livestock	9.5	9.4
Fruit	8.6	8.6
Processing & Marketing	8.4	8.4
Aquatic	4.5	4.6
Farm Services	3.8	3.8
Nursery	3.5	3.9
Vegetables	3.5	3.4
Greenhouse	3.3	3.5
Potato	2.7	3.1
All Other	8.6	7.9
Total	100.0%	100.0%

**High Risk Assets**

Nonperforming loan volume is comprised of nonaccrual loans, accruing restructured loans, and loans 90 days past due still accruing interest and are referred to as impaired loans. Nonaccrual loans represent all loans where there is a reasonable doubt as to collection of principal and/or interest. High Risk assets consist of impaired loans and other property owned. The following table summarizes high risk assets and delinquency information:

As of	June 30, 2018	December 31, 2017
Nonaccrual loans	\$ 45,494	\$ 35,600
Accruing loans 90 days or more past due	2,218	1,821
Accruing restructured loans	628	643
Total Impaired Loans	\$ 48,340	\$ 38,064
Other Property Owned	353	1,447
Total High Risk Assets	\$ 48,693	\$ 39,511
Impaired Loans to Total Loans	0.72%	0.58%
High Risk Assets to Total Loans	0.73%	0.60%
Nonaccrual Loans to Total Loans	0.68%	0.54%
Delinquencies as a % of total performing loans	0.55%	0.21%

In general, the Association is adequately secured on much of the \$45.5 million in nonaccrual loan volume at June 30, 2018. However, the Association has established specific loan loss allowances of \$2.9 million in relation to \$12.6 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 \$0.4 million at June 30, 2018, a \$1.1 million decrease from December 31, 2017. During the first six months, the Association acquired two owned properties and sold five. The Association is actively marketing all other property owned assets and intends to dispose of all properties in an orderly and timely fashion.

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

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

We review the credit quality of the loan portfolio on an on-going basis as part of our risk management practices. Each loan is classified according to the Uniform Classification System (UCS) which is used by all System institutions. The following table presents statistics based on UCS classified as a percent of total loans and related accrued interest.

As of June 30	2018	2017
Acceptable	92.40%	92.90%
Special mention	3.85	4.12
Substandard/doubtful	3.75	2.98
Total	100.00%	100.00%

The overall credit quality measures remain strong at June 30, 2018. Adversely classified loans (‘Substandard’ and ‘Doubtful’) increased to 3.8 percent of total loans at June 30, 2018 from 3.0 percent at June 30, 2017. ‘Special Mention’ loans decreased to 3.8 percent of loans from 4.1 percent a year ago. Although credit quality in our loan portfolio is generally favorable, there was some deterioration as a result of continuing low milk prices and other challenges impacting a small number of customers.

### ***Credit Risk Management***

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 each 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 credit risk by establishing limits for single borrower hold positions and industry concentrations based on underlying risks. The geographic and commodity diversity in the loan portfolio, coupled with disciplined underwriting reduces the potential for significant credit losses.

To further manage portfolio risk, the Association is a Preferred Lender under the USDA’s Farm Service Agency guarantee program and as of June 30, 2018 has guarantees totaling \$238.1 million. In addition, the Association has loan guarantees with State agencies totaling \$17.8 million. The Association also participates in the Farmer Mac Long Term Standby Commitment to Purchase Program and as of June 30, 2018, commitments totaling \$18.9 million were in this program.

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

We monitor our loan portfolio on a regular basis to determine if any increase through provision for loan losses or decrease through a loan loss reversal in our allowance for loan losses is warranted based on our assessment of the probable and estimable losses inherent in our loan portfolio. The allowance for loan losses covers the funded portion of loans outstanding, while the reserve for unfunded commitments covers losses on unfunded lending commitments.

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, 2018 and 2017.

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

<b>As of June 30</b>	<b>2018</b>	<b>2017</b>
Components:		
Allowance for loan losses	\$ 76,924	\$ 73,741
Reserve for unfunded commitments	9,940	13,362
<b>Allowance for Credit Losses (ACL)</b>	<b>\$ 86,864</b>	<b>\$ 87,103</b>
ACL as a percentage of:		
Total loans	1.29%	1.37%
Nonaccrual loans	190.94%	210.45%
Impaired loans	176.69%	200.10%

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, 2018 the Association’s note payable to CoBank totaled \$5.5 billion.

The line of credit available to the Association is formula-driven based on Association loan volume and credit quality. Because of the funding relationship with CoBank, the Association does not maintain large balances in cash or other liquid investments. Substantially all of the Association’s assets are pledged as security to CoBank. 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 \$1.4 billion at June 30, 2018 and consisted of capital stock and participation certificates of \$15.0 million, additional paid in capital of \$229.2 million, unallocated retained earnings of \$1.2 billion, and accumulated other comprehensive loss of (\$56.4) million.

### Capital Plan and Regulatory Requirements

The Board of Directors establishes a formal capital adequacy plan that addresses capital goals in relation to risks. The capital adequacy plan assesses the capital level necessary for financial viability and to provide for growth. Our plan is updated annually and approved as part of the Association’s annual Business Plan.

As shown in the following table, our capital and leverage ratios exceeded regulatory minimums. If these capital standards are not met, the FCA can impose restrictions, including limiting our ability to pay patronage distributions and retire equities.

As of June 30	2018	2017	FCA Minimum with Buffer
Common Equity Tier 1 Capital Ratio (CET1)	17.46%	16.74%	7.00%
Tier 1 Capital Ratio	17.46%	16.74%	8.50%
Total Regulatory Capital Ratio (TRC)	18.69%	17.99%	10.50%
Tier 1 Leverage Ratio	18.29%	17.74%	5.00%
UREE Leverage Ratio	20.10%	19.54%	1.50%
Permanent Capital	17.65%	16.92%	7.00%

For additional information on the New Capital Regulations, see Note 3 to these consolidated financial statements “Members Equity”.

### 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.

**CONSOLIDATED BALANCE SHEETS**  
*(unaudited and dollars in thousands)*

	June 30, 2018	December 31, 2017
<b>ASSETS</b>		
Loans	\$ 6,712,878	\$ 6,605,200
Less: Allowance for loan losses	76,924	75,751
Net loans	6,635,954	6,529,449
Cash	24,130	48,736
Accrued interest receivable	26,084	23,266
Investment in CoBank, ACB	225,594	224,509
Premises and equipment, net	27,604	25,479
Other property owned	353	1,447
Other assets	46,122	58,092
<b>Total Assets</b>	<b>\$ 6,985,841</b>	<b>\$ 6,910,978</b>
<b>LIABILITIES</b>		
Notes payable to CoBank, ACB	\$ 5,463,500	\$ 5,414,435
Patronage distributions payable	25,474	60,000
Accrued interest payable	11,040	9,185
Reserve for unfunded commitments	9,940	11,044
Other liabilities	65,291	66,780
<b>Total Liabilities</b>	<b>5,575,245</b>	<b>5,561,444</b>
<b>MEMBERS' EQUITY</b>		
Capital stock and participation certificates	14,954	14,808
Additional paid-in capital	229,198	229,198
Unallocated retained earnings	1,222,865	1,157,496
Accumulated other comprehensive loss	(56,421)	(51,968)
<b>Total Members' Equity</b>	<b>1,410,596</b>	<b>1,349,534</b>
<b>Total Liabilities and Members' Equity</b>	<b>\$ 6,985,841</b>	<b>\$ 6,910,978</b>

The accompanying notes are an integral part of these statements.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(unaudited and dollars in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
<b>INTEREST INCOME</b>				
Loans	\$ 84,465	\$ 70,264	\$ 163,442	\$136,802
Other	96	100	234	369
Total interest income	84,561	70,364	163,676	137,171
<b>INTEREST EXPENSE</b>				
Notes payable to CoBank, ACB	33,434	20,337	63,049	39,196
Other	2	2	4	3
Total interest expense	33,436	20,339	63,053	39,199
Net interest income	51,125	50,025	100,623	97,972
Provision for loan losses	-	-	-	-
Net interest income after provision for loan losses	51,125	50,025	100,623	97,972
<b>NONINTEREST INCOME</b>				
Patronage income	7,746	7,129	16,785	15,722
Financially related services income	7,595	7,312	14,097	13,545
Compensation on participation loans, net	425	520	1,075	1,178
Loan fees	533	630	1,067	1,153
Other income	2	26	5,070	27
Total noninterest income	16,301	15,617	38,094	31,625
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	14,453	14,035	29,905	29,129
Occupancy and equipment	861	800	1,907	1,739
Insurance Fund premiums	1,152	1,839	2,264	3,633
Information technology services	2,835	2,669	5,907	5,209
Other operating expenses	3,601	3,616	7,424	7,076
Total noninterest expenses	22,902	22,959	47,407	46,786
Income before income taxes	44,524	42,683	91,310	82,811
Provision for income taxes	236	396	467	792
<b>Net Income</b>	44,288	42,287	90,843	82,019
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>				
Net change in cash flow hedge	(352)	(574)	(4,453)	(1,133)
Other Comprehensive (Loss) Income	(352)	(574)	(4,453)	(1,133)
		\$		\$
<b>Comprehensive Income</b>	\$ 43,936	41,713	\$ 86,390	80,886

The accompanying notes are an integral part of these statements.

**CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY**  
*(unaudited and dollars in thousands)*

	Capital Stock and Participation Certificates	Additional Paid-in- Capital	Unallocated Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Members' Equity
<b>Balance at December 31, 2016</b>	\$ 14,338	\$ 229,198	\$ 1,057,428	\$ (54,362)	\$ 1,246,602
Comprehensive Income (Loss)			82,019	(1,133)	80,886
Capital stock and participation certificates issued	690				690
Capital stock and participation certificates retired	(467)				(467)
Patronage Distribution			(25,351)		(25,351)
<b>Balance at June 30, 2017</b>	\$ 14,561	\$ 229,198	\$ 1,114,096	\$ (55,495)	\$ 1,302,360
<b>Balance at December 31, 2017</b>	\$ 14,808	\$ 229,198	\$ 1,157,496	\$ (51,968)	\$ 1,349,534
Comprehensive Income (Loss)			90,843	(4,453)	86,390
Capital stock and participation certificates issued	669				669
Capital stock and participation certificates retired	(523)				(523)
Patronage Distribution			(25,474)		(25,474)
<b>Balance at June 30, 2018</b>	\$ 14,954	\$ 229,198	\$ 1,222,865	\$ (56,421)	\$ 1,410,596

The accompanying notes are an integral part of these statements.

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

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

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

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

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

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. The guidance sets forth the requirement for new and enhanced disclosures. The Association adopted the new standard effective January 1, 2018, using the modified retrospective approach. As the majority of the Association’s revenues are not subject to the new guidance, the adoption of the guidance did not have a material impact on the financial position, results of operations, equity or cash flows.

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

### Loans Outstanding

Loans outstanding by loan type are shown below.

As of	June 30, 2018		December 31, 2017	
Real estate mortgage	\$ 3,088,413	46.0%	\$ 3,056,162	46.3%
Production and intermediate term	2,430,379	36.2	2,432,909	36.8
Agribusiness	992,377	14.8	951,001	14.4
Rural infrastructure	116,961	1.7	85,653	1.3
Rural residential real estate	56,703	0.9	56,596	0.9
Other	28,045	0.4	22,879	0.3
<b>Total Loans</b>	<b>\$ 6,712,878</b>	<b>100.0%</b>	<b>\$ 6,605,200</b>	<b>100.0%</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 real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent 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.

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 \$18.9 million at June 30, 2018 and \$20.2 at December 31, 2017. Fees paid to Farmer Mac for such commitments totaled \$41 thousand for the six months ended June 30, 2018 and \$76 thousand at June 30, 2017. These amounts are classified as noninterest expense. In addition to Farmer Mac, the Association has credit enhancements with federal and state government agencies totaling \$255.9 million at June 30, 2018 and \$254.3 million at December 31, 2017.

### 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, 2018</b>	<b>Acceptable</b>	<b>OAEM</b>	<b>Substandard/ Doubtful</b>	<b>Total</b>
Real estate mortgage	42.2%	2.0%	1.8%	46.0%
Production and Intermediate term	33.0	1.7	1.5	36.2
Agribusiness	14.2	0.1	0.5	14.8
Rural infrastructure	1.8	-	-	1.8
Rural residential real estate	0.8	-	-	0.8
Other	0.4	-	-	0.4
Total	92.4%	3.8%	3.8%	100.0%

<b>December 31, 2017</b>	<b>Acceptable</b>	<b>OAEM</b>	<b>Substandard/ Doubtful</b>	<b>Total</b>
Real estate mortgage	43.1%	1.6%	1.6%	46.3%
Production and Intermediate term	34.3	1.1	1.5	36.9
Agribusiness	13.7	0.1	0.6	14.4
Rural infrastructure	1.3	-	-	1.3
Rural residential real estate	0.8	-	-	0.8
Other	0.3	-	-	0.3
Total	93.5%	2.8%	3.7%	100.0%

### 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 2017 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, 2018</b>	<b>December 31, 2017</b>
Nonaccrual loans	\$ 45,494	\$ 35,600
Accruing loans 90 days or more past due	2,218	1,821
Accruing restructured loans	628	643
<b>Total impaired loans</b>	<b>\$ 48,340</b>	<b>\$ 38,064</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, 2018</b>	<b>December 31, 2017</b>
Impaired loans with related allowance	\$ 12,578	\$ 12,229
Impaired loans with no related allowance	35,762	25,835
<b>Total impaired loans</b>	<b>\$ 48,340</b>	<b>\$ 38,064</b>
<b>Total specific allowance</b>	<b>\$ 2,915</b>	<b>\$ 2,490</b>

<b>For the six months ending June 30,</b>	<b>2018</b>	<b>2017</b>
Average impaired loans	\$ 38,103	\$ 54,644
Interest income recognized on impaired loans	\$ 523	\$ 758

### Commitments on Impaired loans

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at June 30, 2018.

### Loan Delinquencies

The following tables present an aging of past due loans.

<b>As of June 30, 2018</b>	<b>30-89 Days Past Due</b>	<b>90 Days or More Past Due</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Total Loans</b>	<b>Accruing Loans 90 Days or More Past Due</b>
Real estate mortgage	\$ 19,195	\$ 14,318	\$ 33,513	\$3,054,900	\$3,088,413	\$ 2,092
Production and intermediate term	16,966	12,968	29,934	2,400,445	2,430,379	126
Agribusiness	132	741	873	991,504	992,377	-
Rural infrastructure	-	-	-	116,961	116,961	-
Rural residential real estate	115	197	312	56,391	56,703	-
Other	-	-	-	28,045	28,045	-
<b>Total Loans</b>	<b>\$ 36,408</b>	<b>\$ 28,224</b>	<b>\$ 64,632</b>	<b>\$ 6,648,246</b>	<b>\$6,712,878</b>	<b>\$ 2,218</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.

December 31, 2017	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	\$ 8,796	\$ 16,234	\$ 25,030	\$ 3,031,132	\$3,056,162	\$ 1,550
Production and intermediate term	3,636	13,477	17,113	2,415,796	2,432,909	271
Agribusiness	62	1,243	1,305	949,696	951,001	-
Rural infrastructure	-	-	-	85,653	85,653	-
Rural residential real estate	160	265	425	56,171	56,596	-
Other	-	-	-	22,879	22,879	-
<b>Total Loans</b>	<b>\$ 12,654</b>	<b>\$ 31,219</b>	<b>\$ 43,873</b>	<b>\$ 6,561,327</b>	<b>\$6,605,200</b>	<b>\$ 1,821</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 no TDR's that occurred during the six months ended June 30, 2018. There were two TDR's totaling \$0.4 million that occurred during the six months ended June 30, 2017. 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, 2018	December 31, 2017	June 30, 2018	December 31, 2017
Real estate mortgage	\$ 653	\$ 678	\$ 89	\$ 97
Production and intermediate term	253	269	189	207
<b>Total</b>	<b>\$ 906</b>	<b>\$ 947</b>	<b>\$ 278</b>	<b>\$ 304</b>

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

### 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.

For the six months ended June 30,	2018	2017
<b>Allowance for Loan Losses</b>		
Beginning balance at January 1	\$ 75,751	\$ 77,583
Charge-offs	(663)	(7)
Recoveries	732	271
Transfers from (to) Reserve for Unfunded Commitments	1,104	(2,353)
<b>Ending balance at June 30,</b>	<b>\$ 76,924</b>	<b>\$ 75,494</b>
<b>Reserve for Unfunded Commitments</b>		
Beginning balance at January 1	\$ 11,044	\$ 8,932
Transfers (to) from Allowance for Loan Losses	(1,104)	2,353
<b>Ending balance at June 30,</b>	<b>\$ 9,940</b>	<b>\$ 11,285</b>
<b>Allowance for Credit Losses</b>	<b>\$ 87,226</b>	<b>\$ 86,779</b>

### **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 percent of the amount of the loan, and not more than 10 percent 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 percent 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 sets minimum regulatory capital requirements for Banks and Associations. Effective January 1, 2017, new regulatory capital requirements for Banks and Associations were adopted. These new requirements replaced the core surplus and total surplus requirements with Common Equity Tier 1, Tier 1 Capital and Total Capital risk-based capital ratio requirements. The new requirements also replaced the existing net collateral ratio for System Banks with a Tier 1 Leverage ratio and an Unallocated Retained Earnings (URE) and URE Equivalents Leverage ratio that are applicable to both the Banks and

Associations. The Permanent Capital Ratio continues to remain in effect; however, the risk-adjusted assets are calculated differently than in the past.

The following sets forth the regulatory capital ratio requirements and ratios at June 30, 2018:

Ratio	Primary Components of Numerator	Denominator	Minimum Requirement	Minimum with Buffer*	Ratios as of June 30, 2018
Common Equity Tier 1 (CET1) Capital	Unallocated retained earnings (URE), common cooperative equities (qualifying capital stock and allocated equity) <sup>1</sup>	Risk-adjusted assets	4.5%	7.0%	17.46%
Tier 1 Capital	CET1 Capital, non-cumulative perpetual preferred stock	Risk-adjusted assets	6.0%	8.5%	17.46%
Total Capital	Tier 1 Capital, allowance for loan losses <sup>2</sup> , common cooperative equities <sup>3</sup> , and term preferred stock and subordinated debt <sup>4</sup>	Risk-adjusted assets	8.0%	10.5%	18.69%
Tier 1 Leverage**	Tier 1 Capital	Total assets	4.0%	5.0%	18.29%
Unallocated Retained Earnings and URE Equivalents (UREE) Leverage	URE and URE Equivalents	Total assets	1.5%	1.5%	20.10%
Permanent Capital	Retained earnings, common stock, non-cumulative perpetual preferred stock and subordinated debt, subject to certain limits	Risk-adjusted assets	7.0%	7.0%	17.65%

\* The new capital requirements have a three-year phase-in of the capital conservation buffer applied to the risk-adjusted capital ratios. There is no phase-in of the leverage buffer. Amounts shown reflect the full capital conservation buffer.

\*\* Must include the regulatory minimum requirement for the URE and UREE Leverage ratio.

<sup>1</sup> Equities outstanding 7 or more years

<sup>2</sup> Capped at 1.25 percent of risk-adjusted assets

<sup>3</sup> Outstanding 5 or more years, but less than 7 years

<sup>4</sup> Outstanding 5 or more years

### Patronage Distribution

In December 2017, the Board of Directors approved a patronage resolution. This resolution will allow the Association to pay a patronage refund on 2018 income provided the capital goals and earnings for the Association are achieved. The patronage program is described more fully in the 2017 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 (\$44.0) million at June 30, 2018 and at December 31, 2017. Also included in accumulated other comprehensive income/loss is the unrealized holding gain or loss

on cash flow derivatives of (\$12.4) million and (\$7.9) million at June 30, 2018 and December 31, 2017, 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 14 to the 2017 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:

	Fair Value Measurement Using			Total Fair Value
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
<b>June 30, 2018</b>				
Derivative assets	\$ -	\$ -	\$ -	\$ -
Assets held in trust	\$ 11,557	\$ -	\$ -	\$ 11,557
<b>December 31, 2017</b>				
Assets held in trust	\$ 11,294	\$ -	\$ -	\$ 11,294
<b>Liabilities:</b>				
<b>June 30, 2018</b>				
Derivative liabilities	\$ -	\$ 12,369	\$ -	\$ 12,369
<b>December 31, 2017</b>				
Derivative liabilities	\$ -	\$ 6,967	\$ -	\$ 6,967

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

	Fair Value Measurement Using			Total Fair Value
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
<b>June 30, 2018</b>				
Impaired loans	\$ -	\$ -	\$ 45,425	\$ 45,425
Other Property Owned	\$ -	\$ -	\$ 380	\$ 380
Rural Investments, LLC	\$ -	\$ -	\$ 250	\$ 250
<b>December 31, 2017</b>				
Impaired loans	\$ -	\$ -	\$ 35,575	\$ 35,575
Other Property Owned	\$ -	\$ -	\$ 1,582	\$ 1,582
Rural Investments, LLC	\$ -	\$ -	\$ 465	\$ 465

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:

	June 30, 2018			December 31, 2017		
	Carrying Amount	Fair Value	Fair Value Hierarchy	Carrying Amount	Fair Value	Fair Value Hierarchy
<b>Financial assets:</b>						
Loans, net	\$ 6,635,954	\$ 6,658,586	Level 3	\$ 6,529,449	\$ 6,544,083	Level 3
Cash	\$ 24,130	\$ 24,130	Level 1	\$ 48,736	\$ 48,736	Level 1
<b>Financial liabilities:</b>						
Notes payable to ACB	\$ 5,463,500	\$ 5,386,339	Level 3	\$ 5,414,435	\$ 5,405,361	Level 3

### Valuation Techniques

As more fully discussed in Note 2 to the 2017 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.

### 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.

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 and are collateralized through loan agreements. Notwithstanding collateral and netting provisions, our derivative assets and liabilities are not offset in the accompanying consolidated balance sheets. The Association's derivative activities are monitored by senior management and the Board of Directors.

#### **Cash flow hedges**

The Association uses "receive fixed/pay variable" 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, 2018, the Association has executed interest rate swap contracts with CoBank, ACB having a notional amount of \$990.0 million. The fair value of the swap contracts at June 30, 2018 is (\$12.4) million of which (\$12.4) million is reflected in accumulated other comprehensive income due to the highly effective nature of the hedge transaction and \$17 thousand of income is recorded in interest expense due to the ineffectiveness of the hedge transactions. The carrying value of the hedged assets were \$0.0 million and the carrying value of the hedged liabilities were \$12.4 million. 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 – Subsequent Events**

The Association has evaluated subsequent events through August 7, 2018 which is the date the financial statements were issued or available to be issued. No subsequent event items met the criteria for disclosure.

## Report of 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, 2018 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 7, 2018

**Senior Officers**

William J. Lipinski .....Chief Executive Officer  
 Paul S. Bajgier ..... Senior Vice President and Treasurer  
 William S. Bathel ..... Executive Vice President and Chief Risk Officer  
 Briana S. Beebe ..... Senior Vice President and Human Resources Director  
 Gary R. Bradley ..... Executive Vice President and Regional Manager  
 John P. Caltabiano ..... Executive Vice President and Regional Manager  
 Thomas W. Cosgrove .....Senior Vice President of Knowledge Exchange, Public Relations and Marketing  
 Alena C. Gfeller ..... Executive Vice President, Managing Counsel and Corporate Secretary  
 Andrew N. Grant .....Executive Vice President and Chief Financial Officer  
 Brian K. Monckton ..... Executive Vice President and Regional Manager  
 Frederick H. Morton..... Executive Vice President and Regional Manager  
 Roger E. Murray .....Executive Vice President and Business Unit Manager  
 Raymond J. Nowak ..... Consultant  
 Michael J. Reynolds ..... Executive Vice President and Chief Business Officer

**Board of Directors**

Matthew W. Beaton..... Chair  
 Laurie K. Griffen ..... Vice Chair  
 Michael N. Brooks .....Director  
 Peter R. Call .....Director  
 Tim C. Chan ..... Outside Director  
 Daniel J. Corey .....Director  
 David E. Hardie ..... Director  
 Henry L. Huntington ..... Director  
 Philip J. Jones .....Director  
 LouAnne F. King ..... Director  
 John P. Knopf .....Director  
 Lisa P. Sellew ..... Director  
 Douglas W. Shelmidine..... Director  
 Diane D. Souza..... Outside Director  
 Peter H. Triandafillou.....Appointed Director  
 Terry R. Zittell..... Director



# FARM CREDIT EAST

## MAIN OFFICE

240 South Road  
Enfield, CT 06082  
800.562.2235  
860.741.4380

## 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  
800.929.1350  
585.815.1900

**Bedford, NH**  
David Bishop, Manager  
2 Constitution Drive  
Bedford, NH 03110  
800.825.3252  
603.472.3554

**Bridgeton, NJ**  
Scott Andersen, Manager  
29 Landis Avenue  
Bridgeton, NJ 08302  
800.219.9179  
856.451.0933

**Burrville, NY**  
Kathryn Canzonier,  
Manager  
25417 NYS Route 12  
Watertown, NY 13601  
800.626.3276  
315.782.6050

**Claverack, NY**  
Timothy Slavin, Manager  
190 State Route 9H  
Hudson, NY 12534  
800.362.4404  
518.851.3313

**Cooperstown, NY**  
Robert Yurkewecz,  
Manager  
7397 State Highway 80  
Cooperstown, NY 13326  
800.762.3276  
607.282.3002

**Cortland, NY**  
Janice Bitter, Manager  
One Technology Place,  
Suite 2  
Homer, NY 13077  
800.392.3276  
607.749.7177

**Country Living**  
David Pugh, Director  
7397 State Highway 80  
Cooperstown, NY 13326  
800.762.3276  
607.282.3002

**Dayville, CT**  
Lynn Weaver, Manager  
785 Hartford Pike  
Dayville, CT 06241  
800.327.6785  
860.774.0717

**Enfield, CT**  
Keith Stechsulte,  
Manager  
240 South Road  
Enfield, CT 06082  
800.562.2235  
860.741.4380

**Flemington, NJ**  
Stephen Makarevich,  
Manager  
9 County Road 618  
Lebanon, NJ 08833  
800.787.3276  
908.782.5215

**Geneva, NY**  
Stephen Tudhope,  
Manager  
1450 Route 14  
Phelps, NY 14532  
800.929.7102  
315.781.7100

**Greenwich, NY**  
Christopher Truso,  
Manager  
394 State Route 29  
Greenwich, NY 12834  
800.234.0269  
518.692.0269

**Hornell, NY**  
David Van Lieshout,  
Manager  
1155 Airport Road  
Hornell, NY 14843  
800.929.2025  
607.324.2020

**Mayville, NY**  
Jenny Montalbano,  
Manager  
28 E. Chautauqua  
Mayville, NY 14757  
800.929.2144  
716.753.2144

**Middleboro, MA**  
Cynthia Stiglitz, Manager  
67 Bedford Street,  
PO Box 720  
Middleboro, MA 02346  
800.946.0506  
508.946.4455

**Middletown, NY**  
Blane Allen, Manager  
669 East Main Street  
Middletown, NY 10940  
888.792.3276  
845.343.1802

**Potsdam, NY**  
Michael Haycock,  
Manager  
One Pioneer Drive  
Potsdam, NY 13676  
800.295.8431  
315.265.8452

**Presque Isle, ME**  
Peter Hallowell, Manager  
26 Rice Street  
Presque Isle, ME 04769  
800.831.4640  
207.764.6431

**Riverhead, NY**  
Keith Stechsulte,  
Manager  
1281 Route 58  
Riverhead, NY 11901  
800.890.3028  
631.727.2188

