

# QUARTERLY REPORT



June 30, 2019



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, 2019. This commentary should be read in conjunction with the accompanying unaudited consolidated financial statements and notes included in this report, as well as the 2018 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** 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, 2019. Net income was \$96.2 million for the six months ending June 30, 2019, an increase of \$5.4 million (5.9 percent) as compared with the same period in 2018. Our strong earnings primarily reflect higher net interest income offset by lower noninterest income and slightly higher operating expenses.

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

<b>For the six months ending June 30</b>	<b>2019</b>	<b>2018</b>
Net income	\$ 96.2	\$ 90.8
Net interest income	\$ 110.8	\$ 100.6
Net interest margin	3.17%	3.05%
Return on average assets	2.61%	2.62%
Return on average members equity	12.84%	13.09%

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>2019 versus 2018</b>	<b>2018 versus 2017</b>
Increase in net interest income	\$ 10.2	\$ 2.7
(Decrease) increase in noninterest income	(3.1)	6.4
Increase in noninterest expenses	(1.6)	(0.6)
(Increase) decrease in provision for income taxes	(0.1)	0.3
<b>Total increase in net income</b>	<b>\$ 5.4</b>	<b>\$ 8.8</b>

### **Net Interest Income**

Net interest income was \$110.8 million for the six months ending June 30, 2019, a \$10.2 million increase over the same period in 2018. 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:

<b>As of June 30</b>	<b>2019</b>	<b>2018</b>
Net interest income	\$ 110,807	\$ 100,623
Average balances:		
Average interest earning loans	\$ 7,040,076	\$ 6,648,989
Average interest bearing liabilities	\$ 5,768,628	\$ 5,451,265
Average yields and rates:		
Interest earning loan yield	5.51%	4.90%
Rate paid on interest bearing liabilities	2.81%	2.22%
Interest rate spread	2.70%	2.68%
Net interest margin (interest income as a percentage of average interest earning loans)	3.17%	3.05%

The Association's average loan rate was 5.51 percent as of June 30, 2019, up from 4.90 percent as of June 30, 2018. Average cost of debt funding also increased from 2.22 percent in 2018 to 2.81 percent in 2019. Interest income and cost of debt are both higher due to increases in publicized short term rates during 2018 which increases both Farm Credit East's and our customer's cost of borrowing. The average interest rate spread over cost of funding increased two basis points year over year from 2.68 percent to 2.70 percent.

### **Noninterest income**

Noninterest income was \$35.0 million for the six months ending June 30, 2019, a \$3.1 million decrease over the same period in 2018 mainly due to lower excess Insurance Fund premium refunds as well as lower patronage from CoBank. Included in noninterest income is \$1.6 million in refunds received for a portion of excess Insurance Fund premiums paid in prior years compared to \$5.1 million received in 2018, a decrease of \$3.5 million. These refunds are nonrecurring items and represents 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, 2019, CoBank patronage income totaled \$11.5 million, compared to \$12.3 million in 2018. The patronage rate paid by CoBank on the Association's note payable is 40 basis points in 2019 and was 45 basis points in 2018.

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, 2019 this revenue totaled \$4.9 million compared to \$4.5 million in 2018.

Noninterest income also includes fees for financial services, loan fees, compensation on participation loans and other noninterest income. These other noninterest income sources totaled \$17.0 million for the six months ending June 30, 2019, an increase of \$0.8 million compared to 2018. Financial services fee income is the largest component with \$14.4 million in revenue for the six months ended June 30, 2019 an increase of \$0.3 million compared to 2018.

### ***Noninterest expense***

Total noninterest expenses for the six month period ending June 30, 2019 increased \$1.6 million to \$49.0 million over the same period last year.

Salaries and employee benefits is the primary component of noninterest expense and totaled \$29.6 million, a decrease of \$0.3 million (1.1 percent) compared to 2018. The decrease is due to slightly lower staffing levels from open positions, normal retirements and slightly lower retirement plan expenses offset by normal merit increases.

Insurance Fund premiums were \$2.4 million for the six months ending June 30, 2019, a \$0.1 million increase 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 2019 and 2018. 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 \$0.7 million for the six months ending June 30, 2019 and \$0.5 million for the period ending June 30, 2018. 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, 2018, liabilities included a \$65.0 million patronage distribution payable to members, which has since been distributed in cash. Additionally in 2018, a special cash patronage dividend of \$15.0 million was paid in October. An anticipated patronage distribution payable to members of \$31.1 million was accrued during the first six months of 2019 which will be payable to members in cash early in 2020 provided the capital and earnings goals for the Association are achieved.

### ***Loan Portfolio***

Loans outstanding were \$7.2 billion at June 30, 2019 an increase of \$217.6 million, or 3.1 percent from the December 31, 2018 balance of \$7.0 billion. Compared to June 30, 2018 loan volume grew 7.0 percent. The combined period to period growth was driven by our branch based farm loan portfolio which grew \$177.8 million, or 3.8 percent, as strong demand for agricultural products benefited our producers. Our residential country living mortgage program grew \$79.8 million, or 10.8 percent, as reasonably strong demand continued in our Local Service Area (LSA) for this product and our capital markets group grew \$218.4 million, or 16.7 percent due to increased loan participation activity.

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 volume 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>2019</b>	<b>2018</b>
Purchased loans	\$ 1,308,688	\$ 1,121,657
Sold loans	\$ 1,004,798	\$ 765,111

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 loans outside our territory – which are included in other states in the following table.

<b>As of June 30</b>	<b>2019</b>	<b>2018</b>
New York	47%	49%
New Jersey	12	11
Maine	7	7
Massachusetts	6	6
Connecticut	5	5
Rhode Island, New Hampshire and other states	23	22
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>2019</b>	<b>2018</b>
Dairy	21.9%	23.1%
Timber	10.2	10.1
Processing & Marketing	10.2	8.4
Cash Field	9.6	10.4
Livestock	9.5	9.5
Fruit	8.7	8.6
Aquatic	4.4	4.5
Vegetables	3.8	3.5
Farm Services	3.6	3.8
Nursery	3.2	3.5
Greenhouse	2.9	3.3
Potato	2.7	2.7
All Other	9.3	8.6
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, 2019	December 31, 2018
Nonaccrual loans	\$ 50,123	\$ 45,771
Accruing loans 90 days or more past due	2,764	757
Accruing restructured loans	603	617
Total impaired loans	\$ 53,490	\$ 47,145
Other property owned	2,110	2,609
Total high risk assets	\$ 55,600	\$ 49,754
Impaired loans to total loans	0.74%	0.68%
High risk assets to total loans	0.77%	0.71%
Nonaccrual loans to total loans	0.70%	0.66%
Delinquencies as a % of total performing loans	0.30%	0.40%

In general, the Association is adequately secured on much of the \$50.1 million in nonaccrual loan volume at June 30, 2019. However, the Association has established specific loan loss allowances of \$4.9 million in relation to \$13.9 million of the nonaccrual portfolio.

Other property owned is comprised of real or personal property that has been acquired through collections or deed in lieu of foreclosure. Other property owned totaled \$2.1 million at June 30, 2019, a \$0.5 million decrease from December 31, 2018. During the first six months, the Association acquired two properties and sold two properties. 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	2019	2018
Acceptable	91.47%	92.40%
Special mention	4.70	3.85
Substandard/doubtful	3.83	3.75
Total	100.00%	100.00%

Over the last twelve months, loans classified Acceptable decreased by 0.9 percent of total loans while loans classified as Special Mention increased by 0.8 percent of total loans, primarily due to continuing low milk prices and other challenges impacting a small number of loans to dairy, cranberries, cash grains and some logging customers. The level of adversely classified loans (“Substandard”, “Doubtful” and “Loss”) as a percent of total loans and related accrued interest remained relatively unchanged from 3.8 percent a year ago. While overall loan quality measures remain strong at June 30, 2019, we do expect some further deterioration during 2019 due to low commodity prices and other factors impacting our 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, 2019 has guarantees totaling \$269.6 million. In addition, the Association has loan guarantees with State agencies totaling \$14.9 million. The Association also participates in the Farmer Mac Long Term Standby Commitment to Purchase Program and as of June 30, 2019, commitments totaling \$15.6 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, 2019 and 2018.

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>2019</b>	<b>2018</b>
Components:		
Allowance for loan losses	\$ 79,171	\$ 76,924
Reserve for unfunded commitments	9,684	9,940
<b>Allowance for credit losses (ACL)</b>	<b>\$ 88,855</b>	<b>\$ 86,864</b>
ACL as a percentage of:		
Total loans	1.24%	1.29%
Nonaccrual loans	177.27%	190.94%
Impaired loans	166.12%	176.69%

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, 2019 the Association's note payable to CoBank totaled \$5.8 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 \$1.5 billion at June 30, 2019 and consisted of capital stock and participation certificates of \$15.2 million, additional paid in capital of \$229.2 million, unallocated retained earnings of \$1.3 billion, and accumulated other comprehensive loss of (\$30.1) 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.

<b>As of June 30</b>	<b>2019</b>	<b>2018</b>	<b>FCA Minimum with Buffer</b>
Common Equity Tier 1 Capital Ratio (CET1)	17.60%	17.46%	7.00%
Tier 1 Capital Ratio	17.60%	17.46%	8.50%
Total Regulatory Capital Ratio (TRC)	18.78%	18.69%	10.50%
Tier 1 Leverage Ratio	18.48%	18.29%	5.00%
UREE Leverage Ratio	20.31%	20.10%	1.50%
Permanent Capital	17.79%	17.65%	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, 2019	December 31, 2018
<b>ASSETS</b>		
Loans	\$ 7,181,914	\$ 6,964,353
Less: Allowance for loan losses	79,171	78,370
Net loans	7,102,743	6,885,983
Cash	30,422	23,395
Accrued interest receivable	33,105	28,760
Investment in CoBank, ACB	236,743	235,769
Premises and equipment, net	27,673	27,245
Other property owned	2,110	2,609
Other assets	57,029	60,759
<b>Total Assets</b>	<b>\$ 7,489,825</b>	<b>\$ 7,264,520</b>
<b>LIABILITIES</b>		
Notes payable to CoBank, ACB	\$ 5,846,411	\$ 5,657,199
Patronage distributions payable	31,114	65,000
Accrued interest payable	13,569	13,305
Reserve for unfunded commitments	9,684	10,483
Other liabilities	55,196	64,592
<b>Total Liabilities</b>	<b>5,955,974</b>	<b>5,810,579</b>
<b>MEMBERS' EQUITY</b>		
Capital stock and participation certificates	15,220	15,079
Additional paid-in capital	229,198	229,198
Unallocated retained earnings	1,319,523	1,255,417
Accumulated other comprehensive loss	(30,090)	(45,753)
<b>Total Members' Equity</b>	<b>1,533,851</b>	<b>1,453,941</b>
<b>Total Liabilities and Members' Equity</b>	<b>\$ 7,489,825</b>	<b>\$ 7,264,520</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,	
	2019	2018	2019	2018
<b>INTEREST INCOME</b>				
Loans	\$ 98,321	\$ 84,465	\$ 194,012	\$ 163,442
Other	137	96	312	234
Total interest income	98,458	84,561	194,324	163,676
<b>INTEREST EXPENSE</b>				
Notes payable to CoBank, ACB	42,135	33,434	83,510	63,049
Other	5	2	7	4
Total interest expense	42,140	33,436	83,517	63,053
Net interest income	56,318	51,125	110,807	100,623
Provision for loan losses	-	-	-	-
Net interest income after provision for loan losses	56,318	51,125	110,807	100,623
<b>NONINTEREST INCOME</b>				
Patronage income	7,623	7,746	16,404	16,785
Financially related services income	8,107	7,595	14,367	14,097
Compensation on participation loans, net	904	425	1,579	1,075
Loan fees	699	533	1,039	1,067
Other income	5	2	1,650	5,070
Total noninterest income	17,338	16,301	35,039	38,094
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	14,559	14,453	29,568	29,905
Occupancy and equipment	1,013	861	2,103	1,907
Insurance Fund premiums	1,219	1,152	2,397	2,264
Information technology services	3,183	2,835	6,543	5,907
Other operating expenses	4,238	3,601	8,413	7,424
Total noninterest expenses	24,212	22,902	49,024	47,407
Income before income taxes	49,444	44,524	96,822	91,310
Provision for income taxes	328	236	658	467
<b>Net Income</b>	49,116	44,288	96,164	90,843
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>				
Net change in cash flow hedge	9,030	(352)	14,714	(4,453)
Net change in retirement plan liabilities	-	-	5	-
Other Comprehensive Income (loss)	9,030	(352)	14,719	(4,453)
<b>Comprehensive Income</b>	\$ 58,146	\$ 43,936	\$ 110,883	\$ 86,390

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, 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
<b>Balance at December 31, 2018</b>	\$ 15,079	\$ 229,198	\$ 1,255,417	\$ (45,753)	\$ 1,453,941
Cumulative effect of adjustment from change in accounting principle	-	-	(944)	944	-
<b>Balance at December 31, 2018, as adjusted</b>	\$ 15,079	\$ 229,198	\$ 1,254,473	\$ (44,809)	\$ 1,453,941
Comprehensive income (loss)	-	-	96,164	14,719	110,883
Capital stock and participation certificates issued	666	-	-	-	666
Capital stock and participation certificates retired	(525)	-	-	-	(525)
Patronage Distribution	-	-	(31,114)	-	(31,114)
<b>Balance at June 30, 2019</b>	\$ 15,220	\$ 229,198	\$ 1,319,523	\$ (30,090)	\$ 1,533,851

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, 2018, are contained in the 2018 Annual Report to Stockholders. These unaudited second quarter 2019 financial statements should be read in conjunction with the 2018 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 statements and should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2018 as contained in the 2018 Annual Report to Stockholders.

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, 2019. Descriptions of the significant accounting policies are included in the 2018 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 2018, the Financial Accounting Standards Board (FASB) issued guidance entitled “Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Cost.” The guidance aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by this guidance. This guidance becomes effective for interim and annual periods beginning after December 15, 2019. The guidance also requires an entity (customer) to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement. It further specifies where to present expense and payments in the financial statements. Early adoption is permitted. The guidance is to be applied on a retrospective or prospective basis to all implementation costs incurred after the date of adoption. The Association is evaluating the impact of adoption on the Association’s financial condition and its results of operations.

In August 2018, the FASB issued guidance entitled “Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans.” The guidance modifies the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. This guidance becomes effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The guidance is to be applied on a retrospective basis for all periods. The adoption of this guidance will not impact the Association’s financial condition or its results of operations, but will impact the employee benefit plan disclosures.

In August 2018, the FASB issued guidance entitled “Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement.” The guidance modifies the requirements on fair value measurements by removing, modifying or adding to the disclosures. This guidance becomes effective for interim and annual periods beginning after December 15, 2019. Early adoption is permitted and an entity is permitted to early adopt any removal or modified disclosures and delay adoption of the additional disclosures until their effective date. The Association early adopted the removal and modified disclosures during the fourth quarter of 2018.

In August 2017, the FASB issued guidance entitled “Targeted Improvements to Accounting for Hedging Activities.” The guidance better aligns an entity’s risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments in this guidance require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This guidance also addresses the timing of effectiveness testing, qualitative and quantitative effectiveness testing and components that can be excluded from effectiveness testing. The Association adopted the new standard on January 1, 2019 and recorded a cumulative-effect adjustment to retained earnings of \$0.9 million with the offsetting amount to accumulated other comprehensive income (loss) to reflect the removal of previously recorded hedge ineffectiveness on the cash flow hedges.

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 became effective for interim and annual periods beginning after December 15, 2018. The Association adopted this guidance on January 1, 2019 with no impact on the Association’s financial condition, results of operations or its lease disclosures.

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

### Loans Outstanding

Loans outstanding by loan type are shown below.

<b>As of</b>	<b>June 30, 2019</b>		<b>December 31, 2018</b>	
Real estate mortgage	\$ 3,242,345	45.1%	\$ 3,189,961	45.8%
Production and intermediate term	2,548,987	35.5	2,533,160	36.4
Agribusiness	1,149,704	16.0	1,056,980	15.2
Rural infrastructure	162,106	2.3	105,330	1.5
Rural residential real estate	55,705	0.8	56,090	0.8
Other	23,067	0.3	22,832	0.3
<b>Total Loans</b>	<b>\$ 7,181,914</b>	<b>100.0%</b>	<b>\$ 6,964,353</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 \$15.6 million at June 30, 2019 and \$16.9 million at December 31, 2018. Fees paid to Farmer Mac for such commitments totaled \$35 thousand for the six months ended June 30, 2019 and \$41 thousand at June 30, 2018. These amounts are classified as noninterest expense. In addition to Farmer Mac, the Association has credit enhancements with federal and state government agencies totaling \$284.4 million at June 30, 2019 and \$267.4 million at December 31, 2018.

### 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, 2019</b>	<b>Acceptable</b>	<b>OAEM</b>	<b>Substandard/ Doubtful</b>	<b>Total</b>
Real estate mortgage	40.9%	2.3%	2.0%	45.2%
Production and Intermediate term	32.0	2.1	1.4	35.5
Agribusiness	15.4	0.3	0.4	16.1
Rural infrastructure	2.2	-	-	2.2
Rural residential real estate	0.7	-	-	0.7
Other	0.3	-	-	0.3
Total	91.5%	4.7%	3.8%	100.0%

<b>December 31, 2018</b>	<b>Acceptable</b>	<b>OAEM</b>	<b>Substandard/ Doubtful</b>	<b>Total</b>
Real estate mortgage	41.8%	2.3%	1.8%	45.9%
Production and Intermediate term	33.2	1.9	1.3	36.4
Agribusiness	14.6	0.1	0.4	15.1
Rural infrastructure	1.5	-	-	1.5
Rural residential real estate	0.8	-	-	0.8
Other	0.3	-	-	0.3
Total	92.2%	4.3%	3.5%	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 2018 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.

As of	June 30, 2019	December 31, 2018
Nonaccrual loans	\$ 50,123	\$ 45,771
Accruing loans 90 days or more past due	2,764	757
Accruing restructured loans	603	617
Total impaired loans	\$ 53,490	\$ 47,145

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

As of	June 30, 2019	December 31, 2018
Impaired loans with related allowance	\$ 13,860	\$ 12,355
Impaired loans with no related allowance	39,630	34,790
Total impaired loans	\$ 53,490	\$ 47,145
Total specific allowance	\$ 4,864	\$ 3,208

For the six months ending June 30,	2019	2018
Average impaired loans	\$ 52,250	\$ 38,103
Interest income recognized on impaired loans	\$ 440	\$ 523

### Commitments on Impaired loans

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at June 30, 2019.

### Loan Delinquencies

The following tables present an aging of past due loans.

As of June 30, 2019	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	\$ 13,943	\$ 12,100	\$ 26,043	\$3,216,302	\$ 3,242,345	\$ 1,410
Production and intermediate term	8,958	13,317	22,275	2,526,712	2,548,987	1,354
Agribusiness	948	268	1,216	1,148,488	1,149,704	-
Rural infrastructure	-	-	-	162,106	162,106	-
Rural residential real estate	112	46	158	55,547	55,705	-
Other	-	-	-	23,067	23,067	-
Total Loans	\$ 23,961	\$ 25,731	\$ 49,692	\$ 7,132,222	\$ 7,181,914	\$ 2,764

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, 2018	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	\$ 19,727	\$ 9,686	\$ 29,413	\$ 3,160,548	\$ 3,189,961	\$ 757
Production and intermediate term	12,812	13,257	26,069	2,507,091	2,533,160	-
Agribusiness	1,296	531	1,827	1,055,153	1,056,980	-
Rural infrastructure	-	-	-	105,330	105,330	-
Rural residential real estate	165	47	212	55,877	56,090	-
Other	-	-	-	22,832	22,832	-
Total Loans	\$ 34,000	\$ 23,521	\$ 57,521	\$ 6,906,832	\$ 6,964,353	\$ 757

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, 2019 and June 30, 2018. 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, 2019	December 31, 2018	June 30, 2019	December 31, 2018
Real estate mortgage	\$ 611	\$ 638	\$ 67	\$ 79
Production and intermediate term	80	238	21	176
<b>Total</b>	<b>\$ 691</b>	<b>\$ 876</b>	<b>\$ 88</b>	<b>\$ 255</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,	2019	2018
<b>Allowance for Loan Losses</b>		
Beginning balance at January 1	\$ 78,370	\$ 75,751
Charge-offs	(144)	(663)
Recoveries	146	732
Transfers from (to) Reserve for Unfunded Commitments	799	1,104
Ending balance at June 30,	<b>\$ 79,171</b>	<b>\$ 76,924</b>
<b>Reserve for Unfunded Commitments</b>		
Beginning balance at January 1	\$ 10,483	\$ 11,044
Transfers (to) from Allowance for Loan Losses	(799)	(1,104)
Ending balance at June 30,	<b>\$ 9,684</b>	<b>\$ 9,940</b>
<b>Allowance for Credit Losses</b>	<b>\$ 88,855</b>	<b>\$ 87,226</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.

### 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 (FCA) sets minimum regulatory capital requirements for Banks and Associations.

Effective January 1, 2017, Farm Credit East implemented new regulatory capital requirements as required by the FCA. At June 30, 2019, the Association's capital and leverage ratios exceeded regulatory minimums as shown in the following table.

Ratio	Primary Components of Numerator	Denominator	Minimum Requirement	Minimum with Buffer*	Ratios as of June 30, 2019
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%	17.60%
Tier 1 Capital	CET1 Capital, non-cumulative perpetual preferred stock	Risk-adjusted assets	6.0%	8.5%	17.60%
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%	18.78%
Tier 1 Leverage**	Tier 1 Capital	Total assets	4.0%	5.0%	18.48%
Unallocated Retained Earnings and URE Equivalents (UREE) Leverage	URE and URE Equivalents	Total assets	1.5%	-	20.31%
Permanent Capital	Retained earnings, common stock, non-cumulative perpetual preferred stock and subordinated debt, subject to certain limits	Risk-adjusted assets	7.0%	-	17.79%

\* 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 2018, the Board of Directors approved a patronage resolution. This resolution will allow the Association to pay a patronage refund on 2019 income provided the capital goals and earnings for the Association are achieved. The patronage program is described more fully in the 2018 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 (\$39.4) million at June 30, 2019 and at December 31, 2018. Also included in accumulated other comprehensive income/loss is the unrealized holding gain or loss on cash flow derivatives of \$9.3 million and (\$6.3) million at June 30, 2019 and December 31, 2018, 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 2018 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, 2019</b>				
Derivative assets	\$ -	\$ 10,578	\$ -	\$ 10,578
Assets held in trust	\$ 12,456	\$ -	\$ -	\$ 12,456
<b>December 31, 2018</b>				
Derivative assets	\$ -	\$ 1,809	\$ -	\$ 1,809
Assets held in trust	\$ 12,082	\$ -	\$ -	\$ 12,082
<b>Liabilities:</b>				
<b>June 30, 2019</b>				
Derivative liabilities	\$ -	\$ 1,226	\$ -	\$ 1,226
<b>December 31, 2018</b>				
Derivative liabilities	\$ -	\$ 7,171	\$ -	\$ 7,171

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, 2019</b>				
Impaired loans	\$ -	\$ -	\$ 48,626	\$ 48,626
Other Property Owned	\$ -	\$ -	\$ 2,297	\$ 2,297
Rural Investments, LLC	\$ -	\$ -	\$ 35	\$ 35
<b>December 31, 2018</b>				
Impaired loans	\$ -	\$ -	\$ 43,936	\$ 43,936
Other Property Owned	\$ -	\$ -	\$ 2,844	\$ 2,844
Rural Investments, LLC	\$ -	\$ -	\$ 250	\$ 250

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, 2019			December 31, 2018		
	Carrying Amount	Fair Value	Fair Value Hierarchy	Carrying Amount	Fair Value	Fair Value Hierarchy
<b>Financial assets:</b>						
Loans, net	\$ 7,102,743	\$ 7,199,330	Level 3	\$ 6,885,983	\$ 6,917,614	Level 3
Cash	\$ 30,422	\$ 30,422	Level 1	\$ 23,395	\$ 23,395	Level 1
<b>Financial liabilities:</b>						
Notes payable to ACB	\$ 5,846,411	\$ 5,877,986	Level 3	\$ 5,657,199	\$ 5,589,455	Level 3

### Valuation Techniques

As more fully discussed in Note 2 to the 2018 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 adopted Accounting Standards Update "Derivatives and Hedging" on January 1, 2019 as discussed in Note 1. Upon adoption, the Association recorded a cumulative-effect adjustment to retained earnings of \$0.9 million with the offsetting amount to accumulated other comprehensive income (loss) to reflect the removal of the previously recorded hedge ineffectiveness on cash flow hedges.

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, 2019, the Association has executed interest rate swap contracts with CoBank, ACB having a notional amount of \$1.1 billion. The fair value of the swap contracts at June 30, 2019 is \$9.3 million. The carrying value of the hedged assets were \$10.6 million and the carrying value of the hedged liabilities were \$1.3 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, 2019 which is the date the financial statements were issued or available to be issued. No subsequent event items met the criteria for disclosure.

## Management's Report on Internal Control over Financial Reporting

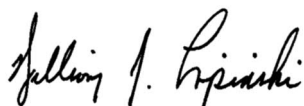
The Association maintains a system of internal control over financial reporting. For purposes of this report, "internal control over financial reporting" is defined as a process designed by, or under the supervision of the Association's principal executives and principal financial officers, or persons 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, 2019 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, 2019

**Senior Officers**

William J. Lipinski ..... Chief Executive Officer  
 Paul S. Bajgier ..... Executive Vice President Accounting and Branch Operations and Treasurer  
 William S. Bathel ..... Executive Vice President and Chief Risk Officer  
 Briana S. Beebe ..... Senior Vice President and Human Resources Director  
 Janice P. Bitter ..... Executive Vice President and Regional Manager  
 John P. Caltabiano ..... Executive Vice President and Innovation Leader  
 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  
 David H. Pugh ..... Executive Vice President and Regional Manager  
 Michael J. Reynolds ..... Executive Vice President and Chief Business Officer

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Matthew W. Beaton ..... Chair  
 Laurie K. Griffen ..... Vice Chair  
 Kurt W. Alstede ..... Director  
 Michael N. Brooks ..... Director  
 Peter R. Call ..... Director  
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 Peter H. Triandafillou ..... Appointed Director  
 Terry R. Zittel ..... Director





# FARM CREDIT EAST

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