# FARM CREDIT SYSTEM INSURANCE CORPORATION

*1998 Annual Report*

FCSIC

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FCSIC

# CHAIRMAN'S MESSAGE

**The Farm Credit System** achieved an important objective during 1998 when, for the first time, the Farm Credit Insurance Fund reached the secure base amount required by the Agricultural Credit Act of 1987. The System can be quite proud of this achievement and investors in Farm Credit System debt securities can view this as an important milestone as well.

Since the inception of the Insurance Fund in 1989, the Farm Credit System Insurance Corporation's Board of Directors (Board) has focused on building the amount in the Fund to 2 percent of insured debt outstanding as required by Congress. Reaching the secure base amount, however, is only one step because the Board has an ongoing statutory responsibility not only to achieve, but to maintain, the 2 percent level.

Early in 1998, the Board reduced insurance premium rates to a level that, when considering growth in insured debt outstanding projected by System banks, was designed to maintain the Insurance Fund at the secure base amount throughout the year. Actual growth in System insured debt (roughly 9 percent) during the year outstripped growth projected by System banks (about 3 to 4 percent). This caused the Insurance Fund to drop below the secure base amount at yearend. The Board is committed to maintaining the Insurance Fund at the secure base amount and will adjust premium rates as needed to achieve this objective.

The financial condition of the System remains strong, with solid profits, strong loan volume growth, high loan quality, and higher capital levels at most institutions. The Board recognizes, however, that there are considerable uncertainties on the horizon regarding lower commodity prices and weaker agricultural export markets that will affect farm income in 1999. As a result, the loan portfolios of System institutions may reflect more risk during the year. The Board will closely monitor changing conditions and factor these into future premium rate decisions.

I encourage everyone to closely review the accompanying audit report. In doing so, you will find the Corporation continues to effectively manage and control its operations and programs. Also noteworthy is that the Corporation's primary computer systems are Year 2000 compliant.

I wish to thank my colleagues on the Board for their service and the dedicated Corporation staff for their outstanding work.

Michael M. Reyna

Michael M. Reyna, Chairman
May 1999

# HIGHLIGHTS

During the first quarter of 1998, the Insurance Fund for the first time attained its secure base amount of 2 percent of adjusted insured debt outstanding.

The balance in the Farm Credit Insurance Fund at December 31, 1998, was $1.26 billion.

In accordance with targets established in the Strategic Plan, the Corporation has successfully completed Y2K testing of its computer systems. Each system is now Y2K compliant.

The Corporation held 1998 calendar year operating costs to $1.5 million, unchanged from 1997.

Investment income exceeded performance measures with the portfolio's average yield exceeding the interest yield at seven comparable private sector funds that invest in U.S. Treasury securities.

## Selected Financial Data

| *(Dollars in millions)* | 1998 | 1997 | 1996 |
|---|---|---|---|
| Financial Condition: | | | |
| Total Assets | $ 1,408 | $ 1,310 | $ 1,169 |
| Total Liabilities | $ 149 | $ 139 | $ 130 |
| Insurance Fund Balance | $ 1,259 | $ 1,171 | $ 1,039 |
| Operations: | | | |
| Revenues | $ 99.5 | $ 142.3 | $ 147.2 |
| Operating Expenses | $ 1.5 | $ 1.5 | $ 1.5 |
| Insurance Expense | $ 9.7 | $ 9.1 | $ 8.5 |
| Net Income | $ 88.3 | $ 131.7 | $ 137.2 |
| System Insured Debt Outstanding *(principal and interest in billions)* | $ 68.4 | $ 62.9 | $ 60.7 |
| Insurance Fund as a percentage of Adjusted Insured Debt | 1.94% | 1.97% | 1.82% |

# BOARD OF DIRECTORS

**The Farm Credit System Insurance Corporation is managed by a three-member board of directors composed of the members of the Farm Credit Administration (FCA) Board. The Chairman of the Corporation's Board of Directors, however, must be an FCA Board Member other than the Chairman of the FCA Board.**

**Michael M. Reyna** became a member of the Corporation's Board in October 1998 and was elected by his colleagues as its Chairman in November 1998. Prior to joining the Board, he served as President Clinton's director of USDA Rural Development (formerly known as Farmers Home Administration) in California from November 1993 to October 1998. In this capacity, Mr. Reyna was responsible for growing and managing a diversified portfolio of housing, business, and infrastructure loans totaling more than $2.6 billion. He implemented a number of significant initiatives in California on behalf of the Clinton-Gore Administration, including the Northwest Economic Adjustment Initiative, the Rural Empowerment Zone-Enterprise Community program, the AmeriCorps program, and several Reinventing Government Initiatives. Previously, Mr. Reyna served as a principal advisor to the California State Legislature for 11 years, working on financial service industry regulation, and a wide range of issues including housing, economic development, local government finance and political reform. While serving as a private consultant to the Texas 2000 Project, an initiative of the Governor's Office of Budget and Planning, he developed and implemented a computer-based simulation model of the Texas economy, which estimated employment and population trends through the year 2000. He was an appointed member of several local commissions, including the Sacramento City Planning Commission, of which he served as Chairman in 1993. Mr. Reyna holds a bachelor's degree in business administration from the University of Texas at Austin and a master's degree in public policy and administration from the LBJ School of Public Affairs at the University of Texas.

**Marsha Pyle Martin,** a member of the Corporation's Board since October 1994, is also Chairman and Chief Executive Officer of the Farm Credit Administration. She brings to her position more than 35 years of experience in agriculture and agricultural finance. The Texas native, who holds a B.A. from Texas Woman's University and an M.S. from Texas A&M University, joined the Federal Intermediate Credit Bank of Texas in 1970 and in 1979 earned the distinction of being the first woman appointed to a senior officer position in the Farm Credit

System. During her career with the Farm Credit Bank of Texas she gained broad management experience, providing leadership and direction for the bank's corporate relations, legal, operations and supervision, management information, human resources, marketing, and public and legislative affairs departments. She has held leadership positions with various agricultural councils and advisory committees in the State of Texas. In 1995, she received the Academy of Honor in Agricultural Credit, awarded the Texan making the most significant contribution to agricultural credit. She holds the Texas Woman's University Distinguished Alumna Award for 1996 and was the 1990 recipient of the Cooperative Communicators Association's H.E. Klinefelter Award, the association's highest honor, in recognition of her distinguished contributions to cooperative communications.

**Ann Jorgensen** became a member of the Corporation's Board in May 1997. She brings to her position extensive experience in production agriculture and accounting. She started farming in partnership with her husband in 1963. Their farming enterprise now includes a cropping operation, Jorg-Anna Farms, and a hog operation, Timberland Hogs Ltd. She has worked as a tax accountant and as a licensed commodity broker. In 1981, she started Farm Home Offices, a mail order catalog company, which markets farm management products to help farmers improve their financial and production management systems. She served on a number of governing boards for the State of Iowa, including six years as a member of the Board of Regents. The Board of Regents is responsible for the state's three universities, including the University of Iowa Hospital, a world renowned teaching hospital, and its affiliated clinics. She is a co-author of a producer's guide entitled *The Farmer's Guide to Total Resource Management* and is the author of a book *Put Paperwork in its Place*. She was honored as the Outstanding Young Woman for the State of Iowa in 1976 and was inducted into the Iowa Volunteer Hall of Fame in 1989. She and her husband were recognized by *Farm Futures* magazine in 1983 as the owners of one of the Top 10 Best Managed Farms. In 1997, she was one of the national agricultural leaders named by Alpha Zeta, the national honorary agricultural fraternity, to its Centennial Honor Roll. A native of Iowa, she holds a B.A. from the University of Iowa.

# OVERVIEW

**The Farm Credit System Insurance Corporation** (Corporation) was established by the Agricultural Credit Act of 1987 (1987 Act) as an independent U.S. Government-controlled corporation. The Corporation's primary purpose is to ensure the timely payment of principal and interest on insured notes, bonds, and other obligations issued on behalf of Farm Credit System (System) banks. This report discusses the Corporation's operations for 1998, including management of the Insurance Fund, the level of insured debt outstanding, and risk management activities.

The System is a privately owned, nationwide financial cooperative that lends to agriculture and rural America. By ensuring the repayment of System debt securities to investors, the Corporation helps to maintain a dependable source of funds for the farmers, ranchers, and other borrowers of the System. The 1987 Act provided for all System banks to be insured. At yearend 1998, there were eight insured System banks.

During the first quarter of 1998, the Insurance Fund, for the first time, attained its secure base amount of 2 percent of adjusted insured debt outstanding. The 2 percent secure base amount is defined in statute and its achievement has been the principal goal of the Corporation since its inception in 1989 when it first began to manage the Insurance Fund. The Insurance Fund finished 1998 at $1.26 billion, slightly below the secure base amount as a result of 9 percent growth in insured debt during the course of the year.

The System, with $84 billion in assets on a combined basis, earned $1.2 billion in net income during 1998. Surplus as a percentage of total assets (excluding the Insurance Fund) increased from 10.8 percent at December 1997 to 11.1 percent at yearend. Asset quality remained good at most System institutions; however, some deterioration was experienced with non-performing assets increasing from 1.4 percent of total loans and other property owned in 1997 to 2.1 percent at yearend.

# MISSION

As an independent entity, the Farm Credit System Insurance Corporation shall:

- Protect investors in insured Farm Credit System obligations and taxpayers through sound administration of the Farm Credit Insurance Fund (Insurance Fund);

- Exercise its authorities to minimize loss to the Insurance Fund; and

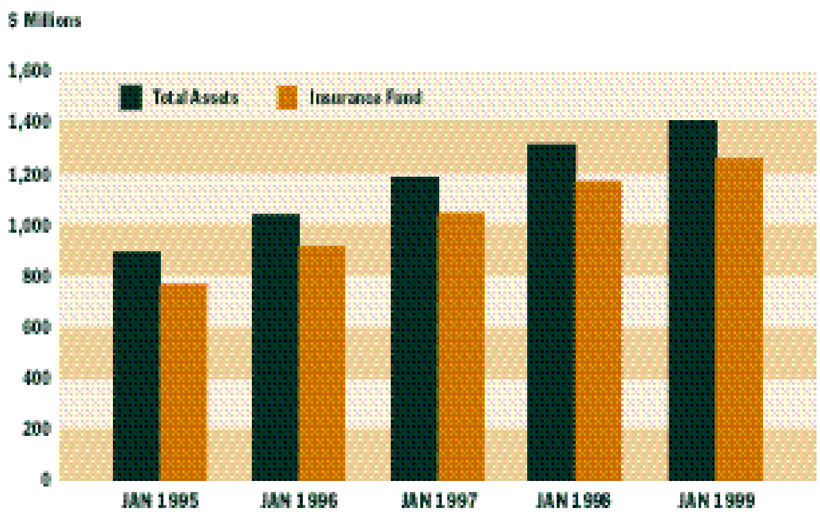
- Help ensure the future of a permanent system for delivery of credit to agricultural borrowers.

CORPORATE ACTIVITIES

# INSURANCE FUND MANAGEMENT

**Growth in the Insurance Fund** The Insurance Fund grew to $1.26 billion at yearend, an increase of 8 percent from 1997. The Insurance Fund represents the Corporation's equity, i.e., the difference between its total assets ($1.408 billion) and its total liabilities, including its insurance obligations ($149 million). The chart below shows growth in total Corporation assets and the Insurance Fund balance for the past five years.

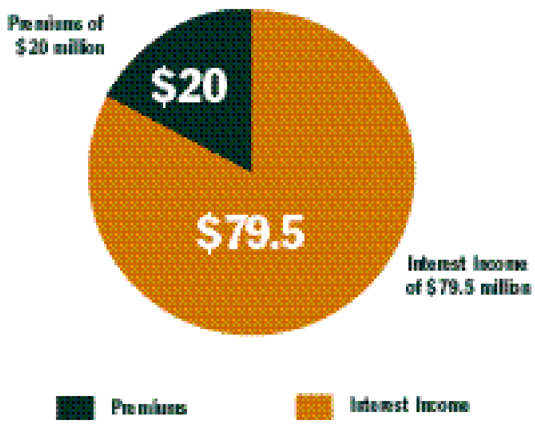
**GROWTH IN THE INSURANCE FUND**




**Revenues and Expenses** The Corporation's revenues are derived from two sources, premiums collected from insured System banks and interest income earned on the Corporation's investment portfolio. Total revenues for 1998 were $99 million. Revenues declined from $142 million in 1997 as a result of lower insurance premium rates in effect during the year. The decrease in insurance premium income was partially offset by an increase in interest income on the Corporation's investment portfolio. The Corporation's net income in 1998 was $88 million.

Corporation expenses totaled $11.3 million in 1998. Insurance expense was $9.7 million, consisting entirely of the annual provision for the liability to repay the Farm Credit System Financial Assistance Corporation (FAC) (see Note 5).

**1998 REVENUES**




The Corporation operates with a small core staff of 10 and utilizes contractors when necessary for specialized expertise. This organizational structure helps keep operating costs low while offering the flexibility to leverage capabilities by using external resources. For example, the FCA provides examination and certain administrative services to the Corporation on a reimbursable fee basis. The Corporation also uses contractual arrangements with the Federal Deposit Insurance Corporation and the General Services Administration for other specialized services.

Operating costs for 1998 of $1.5 million were unchanged from 1997. Of this amount, the Corporation's fixed costs for permanent staff, travel, rent, and miscellaneous expenses totaled $1.3 million. Contract services represented the balance of operating expenses of $0.2 million. These expenses include amounts reimbursed to the FCA for examination and other support and amounts paid to other contractors.

Operating costs represented 0.11 percent of average assets. This efficiency ratio has improved over the past five years, declining from 0.18 percent in 1994.

The Corporation's budget in 1999 for operating costs is $1.8 million.

## Premium Collection and Secure Base Amount

The Corporation assessed $20 million in premium revenue in 1998, a 72 percent decrease that reflects the effect of a reduction in insurance premium rates approved by the Corporation's Board in January 1998. Premiums are collected annually from all System banks based on the retail loan volume at each bank and its related associations. The Farm Credit Act of 1971, as amended, (the Act) provides for insurance premiums to be assessed on four classes of System loan assets:

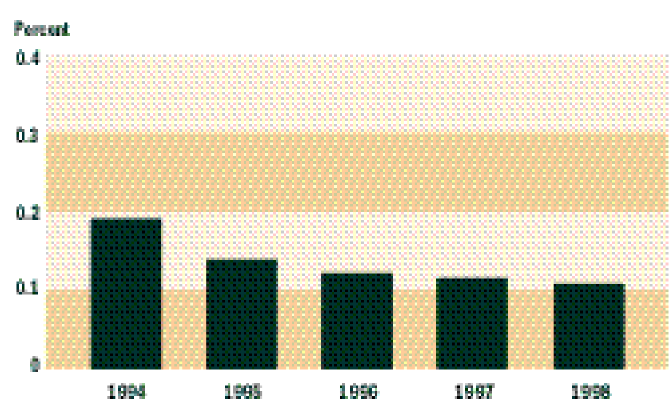
- Accrual loans (non-government guaranteed balance) – from zero to 15 basis points;
- Nonaccrual loans – from zero to 25 basis points;
- Portions of Federal Government-guaranteed accrual loans – from zero to 1.5 basis points; and
- Portions of state government-guaranteed accrual loans – from zero to 3 basis points.

(See Note 4 to the Corporation's financial statements.)

Premium revenue was accrued at December 31, 1998, representing the estimated premiums that were earned but not yet collected for calendar year 1998; these premiums were collected on January 28, 1999.

The Corporation's Board sets insurance premium rates in accordance with its Policy Statement on Adjustments to Insurance Premiums. The Policy Statement provides for a review to be conducted

**OPERATING EXPENSES AS A PERCENTAGE OF ASSETS**



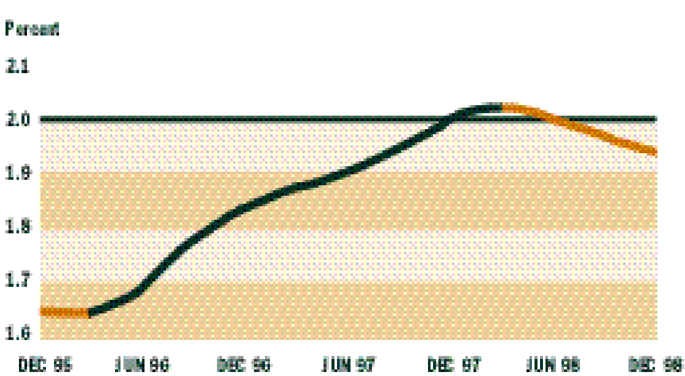
semiannually and sets out the following five factors the Board will consider in determining whether to adjust premiums:

- Level of the Insurance Fund relative to the secure base amount;
- Any projected losses to the Insurance Fund;
- Condition of the System;
- Health of the agricultural economy; and
- Risk in the financial environment.

In January 1998, the Board established insurance premium rates on accrual loans at 3 basis points, a 75 percent reduction from the rate assessed in 1997. This reduction reflected the strong financial condition of the System and the near attainment of the Insurance Fund's secure base amount. Insurance premium rates were maintained at 25 basis points on nonaccrual loans and zero basis points on government-guaranteed loans. These rates were affirmed by the Board at its mid-year review in August.

The Act establishes the secure base amount for the Insurance Fund as 2 percent of insured obligations issued and outstanding or such other percentage determined by the Corporation, in its sole discretion, to be actuarially sound. A reduction from insured obligations outstanding of a percentage of the guaranteed portions of principal outstanding on government-guaranteed loans in accrual status is required in determining the secure base amount. The chart below compares the growth in the Insurance Fund over the past three years with the secure base amount.

**INSURANCE FUND RELATIVE TO 2% SECURE BASE AMOUNT**




In the first quarter of 1998, the Insurance Fund attained the 2 percent secure base amount for the first time. Significant growth in insured debt outstanding during the balance of 1998 left the Insurance Fund at 1.94 percent at yearend. Because the secure base amount is a percentage of insured debt outstanding, it fluctuates depending upon System bank funding trends. The Corporation monitors insured debt issuance trends on a monthly basis.

After the secure base amount is reached and maintained, the Act provides for the Corporation to annually determine and segregate any excess Insurance Fund balances into allocated insurance reserve accounts (AIRAs). A separate account is established for each System bank (90 percent) and stockholders of the FAC (10 percent).

This annual allocation is determined by the amount by which the Insurance Fund exceeds the secure base amount calculated on an average daily balance basis, after adjustment for estimated operating and insurance expenses for the immediately succeeding calendar year. Excess Insurance Fund balances may be paid to System banks and FAC stockholders beginning no sooner than eight years after the aggregate Insurance Fund balance attains the secure base amount, but not before 2005.

The law provides for this authority to be exercised at the sole discretion of the Corporation's Board. Because the Insurance Fund was below the secure base amount at yearend 1998, there were no excess balances to allocate.

In October the Corporation's Board approved a proposed Policy Statement governing the operation of the AIRAs. The Policy Statement was published in the *Federal Register* for public comment in October 1998. The comment period closed in January 1999 and Corporation staff are reviewing the comments that have been received.

**Investment of Insurance Fund Assets** The Corporation had cash and investments totaling $1.36 billion at December 31, 1998, up 13 percent from yearend 1997. Funds are invested in U.S. Treasury securities in accordance with section 5.62 of the Act, 12 U.S.C. 2277a-11, and the Corporation's Investment Policy. The Policy provides that the Corporation will seek the maximum return consistent with its liquidity needs and a minimum exposure to loss of principal. The average portfolio yield for 1998 was 6.03 percent.

As a measure of investment management performance, the Corporation's average yield is compared with the interest yield of seven comparable U.S. Treasury securities investment funds available in the private sector. The comparison for the past five years is shown in the chart to the right.

The Corporation's average yield has exceeded the peer group over time, primarily as a result of the slightly longer weighted average portfolio maturity maintained by the Corporation. During periods of rising interest rates this differential narrows, while the opposite occurs during periods of falling interest rates.

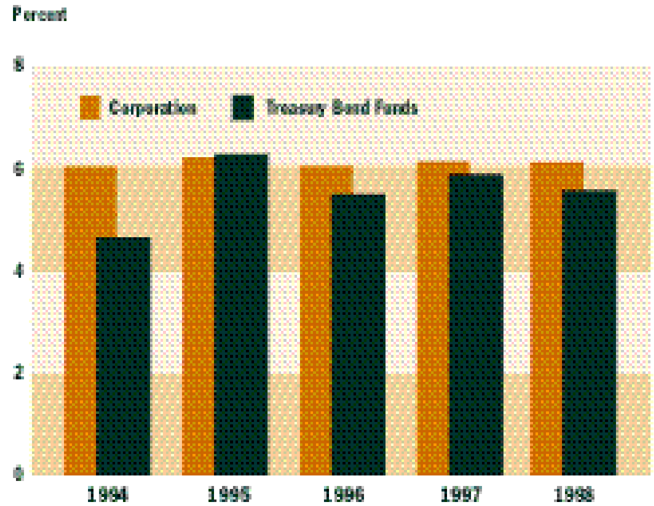
The Corporation maintains an investment strategy of purchasing a ladder of maturities and holding investments to maturity in accordance with its Investment Policy. The Policy provides for the portfolio to be divided into a liquidity pool and an investment pool.

The liquidity pool may only be invested in U.S. Treasury securities with maturities of one year or less and must be no less than 15 percent or more than 25 percent of total investments. The investment pool consists of the balance of the portfolio and may be invested in U.S. Treasury securities with maturities from one to 10 years, with the limit that no more than 25 percent of the investment pool may be invested longer than five years.

The table below shows the balances and maturities of the liquidity pool and investment pool at December 31, 1998. The weighted average portfolio maturity at yearend was 2.9 years. The liquidity pool component includes $61.9 million in cash equivalents.

**CORPORATION INTEREST YIELD**

*(Compared with Similar Bond Funds' Interest Yield)*




**INVESTMENT PORTFOLIO**

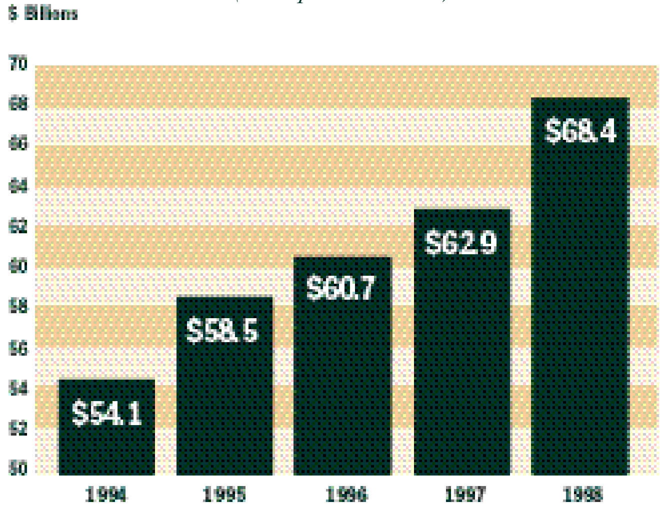
| | $ Millions | | % of Portfolio |
|---|---|---|---|
| Liquidity Pool | One Year or Less | $ 299 | 22% |
| Investment Pool | One Year to Five Years | $ 831 | 61% |
| | Five Years to Ten Years | $ 230 | 17% |
| Total | | $1,360 | 100% |

**Insured and Other Obligations** Obligations insured by the Corporation are statutorily defined as any note, bond, debenture, or other obligation issued on behalf of insured System banks under subsection (c) or (d) of section 4.2 of the Act, 12 U.S.C. 2153. Section 4.2(c) authorizes a System bank to join with any or all banks organized and operating under the same title of the Act to issue consolidated notes, bonds, debentures, or other obligations. Currently, there are no consolidated notes, bonds, or other obligations outstanding. Section 4.2(d) authorizes a System bank to join with the other banks of the System to issue Systemwide notes, bonds, debentures, or other obligations. Insured obligations are issued through the Federal Farm Credit Banks Funding Corporation on behalf of the System banks. The outstanding principal and accrued interest balances of insured obligations at December 31 for the past five years are shown below.

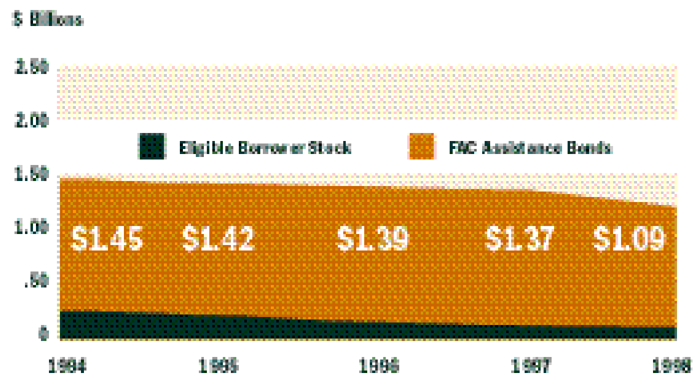
Insured obligations increased by 9 percent in 1998. This increase was used primarily to finance higher levels of System loan and investment assets.

INSURED OBLIGATIONS

*(Principal and Interest)*




OTHER OBLIGATIONS




The Corporation is also required by statute to use the Insurance Fund to satisfy System institution defaults on obligations related to FAC-issued bonds under section 6.26(d)(3) of the Act, 12 U.S.C 2278b-6, and ensure the retirement of eligible borrower stock. The above chart illustrates the outstanding balances of these obligations at December 31 for the past five years.

During 1998, other obligations declined as the FAC called and retired $240 million in high coupon assistance bonds in November. In addition, System banks have been providing funds to FAC for the repayment of other outstanding FAC assistance bonds. At December 31, 1998, the System had provided for the repayment of approximately $0.5 billion of the $1.0 billion of FAC assistance bonds still outstanding. Other obligations also declined as further retirement of outstanding eligible borrower stock occurred during the year. At yearend, eligible borrower stock outstanding at System institutions totaled $76 million.

The Corporation's principal liability for insurance obligations at December 31, 1998, was $149 million, which represents the liability to repay the FAC for financial assistance to the Federal Land Bank of Jackson in Receivership (see Note 5).

# RISK MANAGEMENT

The Corporation's program to identify and manage risk to the Insurance Fund minimizes the Fund's exposure to potential losses through early detection. Corporation staff use special examination procedures to evaluate the condition of weaker System institutions. FCA examination staff perform the majority of the fieldwork for these examinations on a reimbursable basis. In addition, the Corporation assesses risk exposure to the Insurance Fund through its ongoing review and analysis of the financial condition of System institutions, operation of analytical models, review of corporate actions approved by FCA for System institutions, Reports of Examination of System institutions, and by serving as a nonvoting participant on FCA's Regulatory Enforcement Committee. Corporation staff also monitor the development of legislative, judicial, regulatory, and economic trends that could affect the various risks to the Insurance Fund.

## Financial Assistance and Receivership

The Insurance Corporation is authorized to provide assistance to a System institution to prevent default, restore it to normal operations, or to facilitate a merger or consolidation. At the present time, no assistance agreements are outstanding.

The Corporation's program for managing receiverships and conservatorships relies on maintaining a capability to access specialized expertise, when needed, to handle resolutions of troubled institutions. This approach contains costs during periods of limited or no activity while providing the statutorily mandated capacity to deal effectively with potential receiverships or conservatorships.

Several developments occurred during the year which strengthened the Corporation's stand-by capabilities. Early in 1998, the Corporation executed a Memorandum of Understanding with the Federal Deposit Insurance Corporation that provides access to specialized contractor expertise available to the FDIC. Later in 1998, the General Services Administration awarded a Federal Government-wide contract for Financial Asset Services. This contract, which is available to the Corporation, establishes a pool of pre-qualified firms including real estate management companies, public accounting firms, investment and commercial banks, and a variety of other firms specializing in asset management and disposition. After discussions with GSA representatives, the Corporation determined that these resources could be utilized to meet most contingencies. These contracting arrangements provide a quick, streamlined approach to securing additional staff expertise and resources, enhancing the Corporation's capability to meet its statutory responsibilities.

PRICEWATERHOUSECOOPERS

## Report of Independent Accountants

To the Board of Directors of the Farm Credit
System Insurance Corporation

In our opinion, the accompanying statements of financial condition and the related statements of income and expenses and changes in insurance fund, and cash flows present fairly, in all material respects, the financial position of the Farm Credit System Insurance Corporation at December 31, 1998 and 1997, and the results of its operations and its cash flows for the years ended December 31, 1998 and 1997, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Corporation's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these financial statements in accordance with generally accepted auditing standards and generally accepted government auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

Washington, D.C.
January 29, 1999

PRICEWATERHOUSECOOPERS

**Report of Independent Accountants on**
**Compliance and on Internal Control Over Financial Reporting**
**Based on an Audit of Financial Statements**
**Performed in Accordance with Government Auditing Standards**

To the Board of Directors
Farm Credit System Insurance Corporation

We have audited the financial statements of the Farm Credit System Insurance Corporation as of and for the year ended December 31, 1998, and have issued our report thereon dated January 29, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended for the information of the Board of Directors and management of the Corporation. However, this report is a matter of public record and its distribution is not limited.

PricewaterhouseCoopers LLP

Washington, DC
January 29, 1999

FINANCIALS

# FINANCIAL STATEMENTS

***Statements of Financial Condition***
***as of December 31, 1998 and 1997***
*($ in thousands)*

| | 1998 | 1997 |
|---|---|---|
| **Assets** | | |
| Cash and Cash Equivalents | $ 61,959 | $ 1,748 |
| Investments in U.S. Treasury Obligations (Note 3) | 1,298,433 | 1,206,432 |
| Accrued Interest Receivable | 27,511 | 30,441 |
| Premiums Receivable (Note 4) | 19,966 | 71,242 |
| **Total Assets** | **1,407,869** | **1,309,863** |
| **Liabilities and Insurance Fund** | | |
| Accounts Payable and Accrued Expenses (Note 7) | 178 | 164 |
| Liability for Estimated Insurance Obligations (Note 5) | 148,921 | 139,178 |
| Farm Credit Insurance Fund | 1,258,770 | 1,170,521 |
| **Total Liabilities and Insurance Fund** | **$ 1,407,869** | **$ 1,309,863** |

*The accompanying notes are an integral part of these financial statements.*

# FINANCIAL STATEMENTS

***Statements of Income and Expenses and Changes in Insurance Fund for the Years Ended December 31, 1998 and 1997***
*($ in thousands)*

| | 1998 | 1997 |
|---|---|---|
| **Income** | | |
| Premiums (Note 4) | $ 19,972 | $ 71,242 |
| Interest Income | 79,545 | 71,088 |
| **Total Income** | **99,517** | **142,330** |
| **Expenses** | | |
| Administrative Operating Expenses (Note 7) | 1,525 | 1,511 |
| Provision for Estimated Insurance Obligations (Note 5) | 9,743 | 9,105 |
| **Net Income** | **88,249** | **131,714** |
| **Farm Credit Insurance Fund, Beginning of Year** | **1,170,521** | **1,038,807** |
| **Farm Credit Insurance Fund, End of Year** | **$ 1,258,770** | **$ 1,170,521** |

*The accompanying notes are an integral part of these financial statements.*

# FINANCIAL STATEMENTS

*Statements of Cash Flows*
*for the Years Ended December 31, 1998 and 1997*
*($ in thousands)*

| | 1998 | 1997 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net Income | $ 88,249 | $ 131,714 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Decrease (Increase) in Accrued Interest Receivable | 2,930 | 330 |
| Decrease (Increase) in Premiums Receivable | 51,276 | 14,474 |
| Net Amortization and Accretion of Investments | 10,991 | 12,511 |
| (Decrease) Increase in Accounts Payable and Accrued Expenses | 14 | (111) |
| Increase in Liability for Estimated Insurance Obligations | 9,743 | 9,105 |
| **Net Cash Provided by Operating Activities** | **163,203** | **168,023** |
| **Cash Flows from Investing Activities** | | |
| Payments for Purchase of U.S. Treasury Obligations | (336,871) | (403,332) |
| Proceeds from Redemption of U.S. Treasury Obligations | 233,879 | 236,098 |
| **Net Cash Used in Investing Activities** | **(102,992)** | **(167,234)** |
| **Net Change in Cash and Cash Equivalents** | 60,211 | 789 |
| **Cash and Cash Equivalents, Beginning of Year** | 1,748 | 959 |
| **Cash and Cash Equivalents, End of Year** | **$ 61,959** | **$ 1,748** |

*The accompanying notes are an integral part of these financial statements.*

NOTES

# NOTES TO THE FINANCIAL STATEMENTS

*As of December 31, 1998 and December 31, 1997*

## Note 1
## Insurance Fund: Statutory Framework

The Agricultural Credit Act of 1987 (1987 Act) established the Farm Credit System Insurance Corporation (Corporation) for the purpose of ensuring the timely payment of principal and interest on notes, bonds, debentures, and other obligations issued under subsection (c) or (d) of section 4.2 of the Farm Credit Act of 1971, as amended, (Act) (insured obligations). Each bank in the Farm Credit System (System) participating in insured obligations is an insured System bank. At December 31, 1998, there were eight insured System banks and 153 direct lender associations.

The Corporation is managed by a board of directors consisting of the same individuals as the Farm Credit Administration (FCA) Board except that the Chairman of the FCA Board may not serve as the Chairman of the Corporation's Board of Directors.

The Corporation has the responsibility to expend amounts to the extent necessary to:

1. Ensure the timely payment of interest and principal on insured obligations in the event of default by an insured System bank;
2. Satisfy, pursuant to section 6.26(d)(3) of the Act, defaults by System banks on obligations related to the issuance of U.S. Treasury-guaranteed bonds by the Farm Credit System Financial Assistance Corporation (FAC) (FAC bonds) (see Note 5); and
3. Ensure the retirement of eligible borrower stock at par value.

The Corporation, in its sole discretion, is authorized to expend amounts to provide financial assistance to certain insured institutions.

The balances outstanding at December 31, 1998, for each of the components of the Corporation's insurance responsibilities were $68.4 billion of insured obligations, $1.0 billion of FAC bonds (of which $0.5 billion in repayments have been provided for), and $76 million of eligible borrower stock.

If the Corporation does not have sufficient funds to ensure payment on insured obligations, System banks will be required to make payments under joint and several liability, as required by section 4.4 (2) of the Act.

Under section 5.63 of the Act, the Corporation is exempt from all Federal, state, and local taxes with the exception of real property taxes.

## Note 2
## Summary of Significant Accounting Policies

***Accounting Principles and Reporting Practices***—The accounting and reporting policies of the Corporation conform to generally accepted accounting principles and, as such, the financial statements have been prepared using the accrual basis of accounting. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Cash and Cash Equivalents***—Cash and cash equivalents include investments in U.S. Treasury obligations with original maturities of 90 days or less. At December 31, 1998, the Corporation held $61.9 million in overnight Treasury Certificates maturing on January 4, 1999, with an investment rate of 4.86 percent.

***Investments in U.S. Treasury Obligations***—Section 5.62 of the Act requires that funds of the Corporation, not otherwise employed, shall be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States. The Corporation has classified its investments as held to maturity in accordance with the Statement of Financial Accounting Standard (SFAS) No. 115 and carries them at cost. Premiums and discounts are amortized or accreted using the straight-line method, which approximates the interest method, over the terms of the respective issues.

***Liability for Estimated Insurance Obligations***—The liability for estimated insurance obligations is the present value of estimated probable insurance payments to be made in the future based on the Corporation's analysis of economic conditions of insured System banks. (Also see Note 5.)

The insured System banks' primary lending markets are borrowers engaged in farming, ranching, and producing or harvesting of aquatic products, and their cooperatives. Financial weaknesses in these market segments and the effect of general market conditions on the insured System banks' borrowers could adversely affect the banks' financial condition and profitability. Insured System banks also face risks from changing interest rate environments and the need to maintain ongoing access to financial markets. Adverse changes in the financial condition and profitability of insured System banks resulting from increased levels of credit, financial, or other risks could occur in the future which would have a material effect on the liability for estimated insurance obligations.

***Premiums***—Annual premiums are recorded as revenue during the period on which the premiums are based. All premiums are due on or before January 31 of the year subsequent to the year in which they are earned.

***Retirement Plan***—All permanent Corporation employees are covered by the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS).

The Corporation's contribution to the CSRS plan equals the 7 percent of base pay contributed by employees covered by that system. For those employees covered by FERS, the Corporation's contribution is 11.4 percent of base pay. In addition, for FERS-covered employees, the Corporation automatically contributes 1 percent of base pay to the employee's Thrift Savings Plan account, matches the first 3 percent contributed by the employee, and matches one-half of the next 2 percent contributed by the employee.

Retirement plan expenses amounted to $99,668 in 1998 and $94,103 in 1997.

## Note 3
## Investments

At December 31, 1998, and at December 31, 1997, investments in U.S. Treasury obligations consisted of the following:

*($ in thousands)*

| December 31, 1998 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|
| U.S. Treasury Notes | $1,298,433 | $43,360 | ($570) | $1,341,223 |
| **December 31, 1997** | | | | |
| U.S. Treasury Notes | $1,206,432 | $19,069 | ($843) | $1,224,658 |

The amortized cost and estimated market value of U.S. Treasury obligations at December 31, 1998, by contractual maturity, are shown below.

*($ in thousands)*

| | Amortized Cost | Estimated Market Value |
|---|---|---|
| Due in one year or less | $ 237,244 | $ 239,357 |
| Due after one year through five years | 831,170 | 859,940 |
| Due after five years through 10 years | 230,019 | 241,926 |
| | $ 1,298,433 | $ 1,341,223 |

## Note 4
## Premiums

Each System bank which issues insured obligations under subsection (c) or (d) of section 4.2 of the Act is an insured System bank and is required to pay premiums to the Corporation.

The Act establishes the range of insurance premium rates that the Corporation's Board may assess for any calendar year based on four classes of an insured bank's loan assets. The four classes of assets and the range that may be assessed for each are: (1) average annual accrual loans outstanding (other than the guaranteed portions of Government-guaranteed accrual loans) for the year may be from zero to 0.0015; (2) average annual non-accrual loans outstanding may be from zero to 0.0025; (3) average annual portions of Federal Government-guaranteed accrual loans may be from zero to 0.00015; and (4) average annual portions of state government-guaranteed accrual loans may be from zero to 0.0003.

In January 1998, the Board established insurance premium rates for 1998 at 0.0003 for accrual loans, 0.0025 for nonaccrual loans and zero for Government-guaranteed loans. In August 1998, the Corporation's Board approved continuing these rates for the second half of 1998.

The 1987 Act set a base amount for the Insurance Fund to achieve. The statutory secure base amount is equivalent to 2 percent of the aggregate outstanding insured obligations of all insured System banks (adjusted downward by a percentage of the guaranteed portions of principal outstanding on Government-guaranteed loans in accrual status) or such other percentage or amount determined by the Corporation, in its sole discretion, to be actuarially sound. When the amount of the Insurance Fund exceeds the secure base amount, the Corporation is required to reduce the premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount. In the first quarter of 1998, the Insurance Fund attained the secure base amount for the first time. At December 31, 1998, due to growth in insured debt outstanding during the second half of the year, the Insurance Fund dropped to 1.94 percent of adjusted insured obligations outstanding.

## Note 5
## Financial Assistance to System Banks and Estimated Insurance Obligations

The 1987 Act required that the FCA charter the Farm Credit System Assistance Board (Assistance Board) and the FAC (see Note 1) to carry out a program of financial assistance to the Farm Credit System. In order to raise funds to provide this assistance, the FAC had the authority to issue debt obligations with a maturity of 15 years. During 1988 to 1992, the FAC issued $1.26 billion in bonds. These funds were used to provide assistance to certain System banks experiencing financial difficulty and for other statutory authorized purposes.

### *Financial Assistance to Certain System Banks*

During the period from 1988 to 1992, assistance was provided to four open banks through the purchase by the FAC of $419 million in preferred stock issued by these institutions. Similar assistance totaling $374 million was provided to the Federal Land Bank of Jackson in Receivership to facilitate its closing and liquidation. Subject to Assistance Board approval, these assistance funds were used by the FAC to purchase preferred stock issued by an institution experiencing financial difficulty.

Prior to the maturity of the related 15-year debt obligations, each institution can redeem its preferred stock, pursuant to Section 6.26 of the Act, so as to allow the FAC to pay the principal of the maturing obligation. While an institution that issues preferred stock to the FAC is primarily responsible for providing funds for payment of the FAC bonds (through redemption of the preferred stock purchased with the proceeds of the FAC bonds), the institution may be prohibited from redeeming, or may elect not to redeem, the preferred stock pursuant to section 6.26 of the Act. If this occurs, then the FAC must use funds from its trust fund, to the extent available, to retire the debt. The FAC Trust Fund (Trust Fund) represents the funds received from System institutions' purchase of stock in the FAC. The Trust Fund totaled approximately $101 million and $94 million at December 31, 1998 and 1997, respectively. If the Trust Fund is not sufficient to retire the debt, then the

Corporation must purchase preferred stock from the FAC to provide funds to retire such debt. If the Corporation does not have sufficient funds, the U.S. Treasury must retire the debt. If this should occur, the Corporation is required to repay the U.S. Treasury as funds become available from the payment of premiums. At December 31, 1998, the only preferred stock held by the FAC was associated with the assistance provided to the Federal Land Bank of Jackson.

On May 20, 1988, the FCA placed the Federal Land Bank of Jackson and the Federal Land Bank Association of Jackson in receivership (collectively the FLBJR) and appointed a receiver to liquidate their assets. As of April 27, 1990, the FCA, the Receiver of the FLBJR, the FAC, the System banks, the Assistance Board, and the Corporation entered into an agreement which called for the FAC to issue 15-year U.S. Treasury-guaranteed bonds to purchase preferred stock in the FLBJR. Upon the maturity of the FAC bonds used to purchase preferred stock in the FLBJR in 2005, the Corporation will provide funds to repay the principal of these debt obligations, to the extent that the Trust Fund is not sufficient for such purpose. In January 1995, the FLBJR was terminated by the FCA and the receiver was discharged after transferring the remaining receivership assets to the FAC.

### *Estimated Insurance Obligation*

The Corporation estimated the present value of its liability to provide funds for payment of the $374 million non-callable 15-year maturing debt to be approximately $149 million and $139 million at December 31, 1998 and 1997, respectively. This liability is reflected in the accompanying statements of financial condition. The present value of this obligation is based on a discount rate of 7 percent to maturity, which was established at the time this liability was originally recorded. In accordance with SFAS No. 107, the fair value of this liability has been estimated by management using discount rates based upon U.S. Treasury securities of similar durations (4.8 percent for 1998 and 5.8 percent for 1997). The fair value was approximately $171 million and $151 million as of December 31, 1998 and 1997, respectively.

Provisions for changes in the Corporation's liability are reflected in the statements of income and expenses in the amount of $9.7 million and $9.1 million for the years ended December 31, 1998 and 1997, respectively.

The Corporation cannot predict the effects of future events upon System operations and upon the amount of the Trust Fund that will ultimately be available to reduce the Corporation's liability for FLBJR-related FAC bonds. The Corporation will annually reassess the likelihood of earlier use of the Trust Fund, changes in Trust Fund earnings, and other assumptions underlying its estimate of the liability for FLBJR-related FAC bonds.

### *Other Financial Assistance Provided to System Institutions by the FAC*

The Farm Credit Banks and Associations Safety and Soundness Act of 1992 (1992 Act) expanded the Corporation's responsibility to insure defaults by System institutions on payments related to other assistance funded by FAC bonds. These FAC bonds, aggregating $454 million, were issued to pay System Capital Preservation Agreement accruals, to retire eligible borrower stock of certain liquidating System institutions, and to pay operating expenses of the Assistance Board.

Previously, the Corporation had only been required: (1) to satisfy defaults on the repayment of Treasury-paid interest; and (2) to purchase the preferred stock of an assisted institution when the institution did not retire the stock at the maturity of the FAC bonds issued to purchase it. The 1992 Act made the Corporation responsible for defaults by System institutions on obligations related to the remaining $454 million of FAC bonds and related interest if such amounts cannot be recovered from defaulting institutions by the FAC or the Treasury, as the case may be, within 12 months.

The 1992 Act also expanded the potential uses of the Trust Fund to satisfy System institution defaults on the principal and interest of other FAC obligations and required System banks to make annual annuity payments to the FAC to provide funds for the retirement of the Capital Preservation Agreement-related FAC bonds aggregating $417 million and Treasury-paid interest at maturity. The Corporation is also required to satisfy defaults on the annual payments to the FAC to permit the repayment of Treasury-paid interest. During 1992 through 1998, all System banks made their annual annuity payments as scheduled. The Corporation is not aware of any events or circumstances which will prevent System banks from meeting their FAC obligations.

The Corporation actively monitors the creditworthiness and financial position of the insured System banks. One System bank that accounts for less than 5 percent of System insured debt experienced significant increases in its nonperforming loans during 1998. That bank is presently operating under a regulatory enforcement action and at yearend its regulatory core surplus ratio was below the level projected in its capital restoration plan. It has announced, subject to shareholder approval, its intent to merge with another System bank.

Other than obligations that have occurred as a result of resolving the FLBJR, as described above, management is not aware of any events or circumstances at this time which would require a liability for estimated insurance obligations to be recorded.

### *Early Redemption of Certain FAC Bonds*

In November 1998, System banks provided the necessary funds to allow the FAC to call and retire early $240 million of the $1.26 billion in FAC bonds issued during 1988 to 1992 (see paragraph 1, Note 5). Repayment of the remaining FAC bonds in accordance with the Act is being provided for by System banks and the Insurance Corporation.

## Note 6
## Operating Lease

On November 20, 1997, the Corporation executed a new six-year lease with the Farm Credit System Building Association for office space. The terms of the lease provide for an annual base rent for office space for the remaining term of $84,943 for 1999, $89,571 for 2000, $92,252 for 2001, $95,020 for 2002 and $98,134 for 2003. The Corporation recorded $85,859 and $66,851 for 1998 and 1997, respectively.

## Note 7
## Related Parties

The Corporation purchases services from the FCA under an Inter-Agency Agreement. These include examination and administrative support services. The Corporation had payables due to the FCA of $55,819 at December 31, 1998, and $22,093 at December 31, 1997. The Corporation purchased services for 1998 which totaled $152,185 compared with $160,141 for 1997.

# INCOME AND EXPENSES

***Farm Credit System Insurance Corporation By Year***

*($ in thousands)*

| | Income | | Expenses | |
|---|---|---|---|---|
| | Premiums | Investment | Provision for Insurance Obligations | Administrative and Operating Expenses |
| 1989 | $65,000 | $16,041 | — | $118 |
| 1990 | $72,000 | $25,705 | $140,000 | $243 |
| 1991 | $77,463 | $31,483 | $15,555 | $953 |
| 1992 | $73,902 | $37,198 | $12,062 | $1,200 |
| 1993 | $74,100 | $41,277 | ($39,444)[1] | $1,278 |
| 1994 | $76,526 | $46,389 | $8,890 | $1,482 |
| 1995 | $79,394 | $54,688 | ($14,329)[2] | $1,379 |
| 1996 | $85,736 | $61,471 | $8,509 | $1,469 |
| 1997 | $71,242 | $71,088 | $9,105 | $1,511 |
| 1998 | $19,972 | $79,545 | $9,743 | $1,525 |

[1]In 1993, the FAC Trust Fund was initially considered available to pay a portion of the Insurance Corporation's FAC obligation for assistance to the FLB of Jackson.

[2]In 1995, this provision was adjusted to reflect a change in the FAC Trust Fund's investment strategy and the termination of the FLB of Jackson receivership making available additional funds to reduce the Insurance Corporation's related FAC obligation.

# CORPORATE OFFICERS

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Chief Operating Officer

**Dennis M. Pittman**
Director of Risk Management

**Alan J. Glenn**
Chief Financial Officer

**Dorothy L. Nichols**
General Counsel

**C. Richard Pfitzinger**
Asset Assurance Manager

**Vivian L. Portis**
Secretary to the Board

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# REFERENCES

For additional information about the Farm Credit System, its financial condition and performance, and activities of the Farm Credit Administration, the following publications may be helpful.

Farm Credit System Annual Reports to Investors and Quarterly and Annual Information Statements for the current calendar year and the two preceding calendar years. These are available without charge from:

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

Annual Reports of the Farm Credit Administration (FCA) for the past five fiscal years and FCA's Report on the Financial Condition and Performance of the Farm Credit System for the past three calendar years. These are available without charge from:

**Office of Congressional and Public Affairs**
**Farm Credit Administration**
1501 Farm Credit Drive
McLean, VA 22102-5090
(703) 883-4056

Production of the 1998 Annual Report of the Farm Credit System Insurance Corporation coordinated by Anna Lacey with assistance from Michelle White and Christine Quinn.