



**2008 ANNUAL REPORT**

*December 31, 2008*



Part of the Farm Credit System

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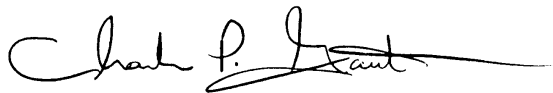
## REPORT OF MANAGEMENT

The consolidated financial statements of Texas Land Bank, ACA (Association) are prepared by management, who is responsible for the statements' integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America appropriate in the circumstances. Other financial information included in the annual report is consistent with that in the consolidated financial statements.

To meet its responsibility for reliable financial information, management depends on the Farm Credit Bank of Texas' and the Association's accounting and internal control systems, which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. The systems have been designed to recognize that the cost of controls must be related to the benefits derived. The consolidated financial statements are audited by PricewaterhouseCoopers LLP, independent accountants, who conduct a review of internal controls solely for the purpose of establishing a basis for reliance thereon in determining the nature, extent and timing of audit tests applied in the audit of the consolidated financial statements in accordance with auditing standards generally accepted in the United States of America. The Association is also examined by the Farm Credit Administration.

The Audit Committee of the board of directors has overall responsibility for the Association's systems of internal control and financial reporting. The Audit Committee consults regularly with management and reviews the results of the audits and examinations referred to previously.

The undersigned certify that this annual report has been reviewed and 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 his or her knowledge or belief.



Charles P. Gant  
Chief Executive Officer/President  
March 2, 2009



Barnett L. Baker  
Chairman, Board of Directors  
March 2, 2009



Sharla K. Chambers  
Chief Financial Officer  
March 2, 2009

## REPORT OF AUDIT COMMITTEE

The Audit Committee (Committee) is composed of directors David W. Conrad, Barnett L. Baker, John C. Courtney, and Gary R. Murphy. In 2008, seven Committee meetings were held. The Committee oversees the scope of Texas Land Bank, ACA's (Association) system of internal controls and procedures, and the adequacy of management's action with respect to recommendations arising from those auditing activities. The Committee's approved responsibilities are described more fully in the Audit Committee Charter, which is available upon request. The Committee approved the appointment of PricewaterhouseCoopers LLP for 2008.

Management is responsible for Texas Land Bank, ACA's internal controls and the preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements are prepared under the oversight of the Committee. PricewaterhouseCoopers LLP is responsible for performing an independent audit of Texas Land Bank, ACA's consolidated financial statements in accordance with auditing standards generally accepted in the United States of America and to issue a report thereon. The Committee's responsibilities include monitoring and overseeing the processes.

In this context, the Committee reviewed and discussed the Association's audited consolidated financial statements for the year ended December 31, 2008 (audited consolidated financial statements) with management and PricewaterhouseCoopers LLP. The Committee also reviews with PricewaterhouseCoopers LLP the matters required to be discussed by Statement on Auditing Standards No. 114 (The Auditor's Communication With Those Charged With Governance) and both PricewaterhouseCoopers LLP's and Texas Land Bank, ACA's internal auditors directly provide reports on significant matters to the Committee.

The Committee discussed with PricewaterhouseCoopers LLP its independence from the Association. The Committee also reviewed the non-audit services provided by PricewaterhouseCoopers LLP and concluded that these services were not incompatible with maintaining the independent accountant's independence. The Committee has discussed with management and PricewaterhouseCoopers LLP such other matters and received such assurances from them as the Committee deemed appropriate.

Based on the foregoing review and discussions and relying thereon, the Committee recommended that the board of directors include the audited consolidated financial statements in the Association's Annual Report to Stockholders for the year ended December 31, 2008.

### Audit Committee Members

David W. Conrad, Chairman  
Barnett L. Baker, Member  
John C. Courtney, Member  
Gary R. Murphy, Member

*March 2, 2009*

**TEXAS LAND BANK, ACA**

**FIVE-YEAR SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA**  
(unaudited)  
(dollars in thousands)

	December 31,				
	2008	2007	2006	2005	2004
<b>Balance Sheet Data</b>					
<u>Assets</u>					
Cash	\$ 60	\$ 62	\$ 67	\$ 61	\$ 56
Loans	408,271	385,664	349,504	302,790	282,597
Less: allowance for loan losses	369	83	113	31	26
Net loans	407,902	385,581	349,391	302,759	282,571
Investment in and receivable from the Bank	6,606	6,124	5,107	4,539	4,449
Other property owned, net	-	-	32	-	-
Other assets	5,412	5,847	5,573	4,682	3,689
Total assets	<u>\$ 419,980</u>	<u>\$ 397,614</u>	<u>\$ 360,170</u>	<u>\$ 312,041</u>	<u>\$ 290,765</u>
<u>Liabilities</u>					
Obligations with maturities of one year or less	\$ 5,170	\$ 4,889	\$ 5,128	\$ 4,466	\$ 4,657
Obligations with maturities greater than one year	335,096	317,046	284,377	241,920	224,990
Total liabilities	<u>340,266</u>	<u>321,935</u>	<u>289,505</u>	<u>246,386</u>	<u>229,647</u>
<u>Members' Equity</u>					
Capital stock and participation certificates	2,621	2,661	2,632	2,622	2,567
Allocated retained earnings	12,765	8,645	4,144	-	-
Unallocated retained earnings	64,072	64,089	63,889	63,033	58,551
Accumulated other comprehensive income	256	284	-	-	-
Total members' equity	<u>79,714</u>	<u>75,679</u>	<u>70,665</u>	<u>65,655</u>	<u>61,118</u>
Total liabilities and members' equity	<u>\$ 419,980</u>	<u>\$ 397,614</u>	<u>\$ 360,170</u>	<u>\$ 312,041</u>	<u>\$ 290,765</u>
Year Ended December 31,					
<b>Statement of Income Data</b>					
Net interest income	\$ 11,891	\$ 11,245	\$ 10,382	\$ 9,399	\$ 8,592
(Provision for loan losses) or loan loss reversal	(2,089)	(615)	(82)	(4)	6,721
Income from the Bank	1,287	1,203	1,012	862	568
Other noninterest income	1,189	898	896	806	817
Noninterest expense	(5,409)	(5,029)	(4,445)	(3,780)	(4,544)
Net income (loss)	<u>\$ 6,869</u>	<u>\$ 7,702</u>	<u>\$ 7,763</u>	<u>\$ 7,283</u>	<u>\$ 12,154</u>
<b>Key Financial Ratios for the Year</b>					
Return on average assets	1.7%	2.0%	2.3%	2.5%	4.4%
Return on average members' equity	8.6%	10.5%	11.3%	11.3%	22.5%
Net interest income as a percentage of average earning assets	3.0%	3.0%	3.2%	3.3%	3.1%
Net charge-offs as a percentage of average loans	0.40%	0.01%	0.00%	0.00%	0.00%

**TEXAS LAND BANK, ACA**

**FIVE-YEAR SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA**  
**(unaudited)**  
**(dollars in thousands)**

	December 31,				
	2008	2007	2006	2005	2004
<b><u>Key Financial Ratios at Year End</u></b>					
Members' equity as a percentage of total assets	<b>19.1%</b>	19.0%	19.6%	21.0%	21.0%
Debt as a percentage of members' equity	<b>426.9%</b>	425.4%	409.7%	375.3%	375.7%
Allowance for loan losses as a percentage of loans	<b>0.1%</b>	0.02%	0.03%	0.01%	0.01%
Permanent capital ratio	<b>18.0%</b>	18.0%	18.7%	21.0%	18.9%
Core surplus ratio	<b>17.3%</b>	17.3%	17.9%	20.1%	18.0%
Total surplus ratio	<b>17.3%</b>	17.3%	17.9%	20.1%	18.0%
<b><u>Net Income Distribution/Allocation</u></b>					
Cash patronage paid	\$ <b>3,007</b>	\$ 2,763	\$ 2,800	\$ 2,200	\$ 1,300
Nonqualified notices of allocation	<b>4,127</b>	4,501	4,144	-	-

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following commentary explains management's assessment of the principal aspects of the consolidated financial condition and results of operations of Texas Land Bank, ACA, including its wholly-owned subsidiaries, Texas PCA (PCA) and Texas Land Bank, FLCA (FLCA) for the years ended December 31, 2008, 2007 and 2006, and should be read in conjunction with the accompanying consolidated financial statements. The accompanying financial statements were prepared under the oversight of the Association's Audit Committee.

### **Forward-Looking Information:**

This annual information statement 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 "anticipates," "believes," "could," "estimates," "may," "should," "will," or other variations of these terms are intended to identify the forward-looking statements. These statements are based on assumptions and analyses made in light of experience and other 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:

- political, legal, regulatory and economic conditions and developments in the United States and abroad;
- economic fluctuations in the agricultural, rural utility, international and farm-related business sectors;
- weather-related, disease, and other adverse climatic or biological conditions that periodically occur that impact agricultural productivity and income;
- changes in United States government support of the agricultural industry; and
- actions taken by the Federal Reserve System in implementing monetary policy.

### **Significant Events:**

The Association's 16-county trade area is located in the I-35 Corridor between the major metropolitan areas of Dallas-Fort Worth and Austin. This central sunbelt location has relatively low business and housing costs and, in recent years, a steady immigration of new residents, which has favored economic growth in the area. NAFTA-related commerce has created numerous opportunities for the area. Although the national economy has entered into a cycle that some economists, business and government leaders have classified as the worst business environment, liquidity problems and recession since the Great Depression, the economy for the areas serviced by the Association continued to be stable through the third quarter of 2008. By the fourth quarter of 2008, the overall economy in the area began to show signs of slowing down. While economists are projecting negative to flat growth in the major key economic indicators in the U.S. economy as a whole during 2009, it has been projected that the same indicators for the Texas economy will show slightly positive growth in 2009 and that the Texas economy will outpace the U.S. economy. It is uncertain at this time to what extent the local economy will be affected and the impact that it will have on the Association, but the Association is in a strong financial position to be able to continue to weather the current financial crisis that is impacting the nation and globe and provide financing for the rural and agricultural needs of Central Texas now and into the future.

In response to the uncertain economic conditions impacting local, national, and global economies and upon study of its loan portfolio and operating environment, the Association's management and members of the Audit Committee deemed it prudent to increase the allowance for loan loss for 2008 above levels that have been typical since 2004. While this negatively impacted Association earnings for 2008, management and the Audit Committee determined that this provided a more accurate picture of the loan portfolio.

In December 2008, the Association received a direct loan patronage of \$996,221 from the Bank, representing 30 basis points on the average daily balance of the Association's direct loan with the Bank. During 2008, the Association received \$290,373 in interest credit patronage payments from the Bank, based on the Association's stock investment in the Bank.

On October 1, 2006, pursuant to a restructuring plan approved by the Farm Credit Administration (FCA) and the Association's shareholders, the Association reorganized to form an Agricultural Credit Association (ACA). Pursuant to the restructuring plan, a

Production Credit Association (PCA) was formed, Texas PCA (PCA), which, together with Texas Land Bank, FLCA (FLCA), became wholly-owned subsidiaries of the Association. The formation of the ACA and creation of the PCA enable the Association to make short- and intermediate-term loans for agricultural production or operating purposes through the PCA while maintaining the tax-exempt status of long-term mortgage interest for loans generated by the FLCA.

In addition to the restructuring of the Association into an ACA in 2006, a revised patronage plan was created. Patronage distributions may be paid to patrons of the Association, as the board of directors may determine by resolution subject to capitalization requirements as defined by the Farm Credit Administration (FCA) and the Association's Capital Plan. During 2006, the Association declared \$2,762,523 in cash patronage to its members and allocated \$4,143,784 in nonqualified patronage for a total of \$6,906,307. During 2007, the board of directors approved a patronage of \$7,502,635 with \$3,001,054 to be paid in cash and \$4,501,340 to be paid in nonqualified notices of allocation. In keeping with the patronage program that was established the previous two years, the board approved a patronage for the 2008 year in the amount of \$6,877,605. Of that amount, \$2,751,042 will be paid in cash in April 2009 and the remainder will be paid in nonqualified notices of allocation.

For over 91 years, the Association has consistently continued to provide its members with quality financial services. The board of directors and management remain committed to maintaining the financial integrity of the Association while offering competitive loan products that meet the financial needs of agricultural producers and rural property owners.

### **Loan Portfolio:**

The Association makes and services loans to farmers, ranchers, rural homeowners and certain farm-related businesses. The Association's loan volume consists of long-term farm mortgage loans, production and intermediate-term loans, farm-related business loans, and rural home loans. These loan products are available to eligible borrowers with competitive fixed, adjustable and index-based interest rates. Loan maturities range from one to 30 years, with annual operating loans comprising the majority of the commercial loans and 15- to 30-year maturities comprising the majority of the mortgage loans, with an average loan portfolio maturity of less than 20 years. Loans serviced by the Association offer several installment payment cycles, the timing of which usually coincides with the seasonal cash-flow capabilities of the borrower. However, it should be noted that a significant number of borrowers have monthly installment payment cycles that coincide with their nonfarm income and are not as vulnerable to seasonal fluctuations.

Cattle prices have been pressured due to declining pasture conditions caused by lack of rainfall in addition to higher feed costs and slower export sales. However, ongoing demand for meat protein and supply management in meat production have continued to provide support for meat prices. As the United States continues to seek expansion of export sales, markets will likely find ongoing support internationally. This, however, will depend on the state of the international economy going forward.

Fuel and fertilizer costs, which are impacted by changes in fuel oil and natural gas prices, continue to be a major consideration in producers' planning processes. While fuel oil and natural gas prices have decreased from their recent highs, market volatility could continue to put upward pressure on these prices. Cotton and grain prices have also come under pressure due to weaker export markets. The prices in the commodity markets in general have trended lower during the overall softening in the financial markets. Lack of rainfall during the critical portion of the growing season in some areas has also adversely impacted crop yields.

Demand for production loans continued as some producers have become concerned about the stability of the commitment to agricultural lending of lenders outside the Farm Credit System. The demand for properties by borrowers with significant nonfarm income has decreased as a result of the economic slowdown noted previously. As a result, overall demand for new loans decreased thus reducing the growth in loan volume from previous years.

Though slightly reduced, the overall credit quality of the loan portfolio remained strong through the end of 2008. The composition of the Association's loan portfolio, including principal less funds held of \$408,270,608, \$385,663,911 and \$349,504,055 as of December 31, 2008, 2007 and 2006, respectively, is described more fully in detailed tables in Note 3 to the financial statements, "Loans and Allowance for Loan Losses," included in this annual report.

### **Purchase and Sales of Loans:**

During 2008, 2007 and 2006, the Association was participating in loans with other lenders. As of December 31, 2008, 2007 and 2006, these participations totaled \$61,118,208, \$55,026,024 and \$46,214,352, or 15.0 percent, 14.3 percent and 13.2 percent of loans, respectively. None of the loans was purchased from entities outside the District in 2008, 2007 or 2006. The Association has also sold participations of \$5,233,393, \$9,543,497 and \$8,414,050 as of December 31, 2008, 2007 and 2006, respectively.

## Risk Exposure:

High-risk assets include nonaccrual loans, loans which are past due 90 days or more and still accruing interest, formally restructured loans and other property owned, net. The following table illustrates the Association's components and trends of high-risk assets serviced for the prior three years as of December 31:

	2008		2007		2006	
	Amount	%	Amount	%	Amount	%
Nonaccrual	\$ 4,210,523	100.0%	\$ 301,743	80.7%	\$ 93,448.00	74.5%
90 days past due and still accruing interest	-	0.0%	72,037	19.3%	-	0.0%
Other property owned, net	-	0.0%	-	0.0%	32,000	25.5%
Total	\$ 4,210,523	100.0%	\$ 373,780	100.0%	\$ 125,448	100.0%

At December 31, 2008, 2007 and 2006, loans that were considered impaired were \$4,210,523, \$373,780 and \$93,448, representing 1.0 percent, 0.1 percent and 0.0 percent of loan volume, respectively. Impaired loans consist of all high-risk assets except other property owned, net. The primary drivers of the increase in impaired loans were three participation loans to three borrowers totaling \$3,782,492 that were deemed to be nonaccrual by the end of 2008. Based on information provided to the Association as of December 31, 2008, a specific allowance in the amount of \$86,000 was recorded on one of the loans due to future losses that are expected. It is anticipated, although not certain, that all three of these loans will be removed from impaired status with no additional losses during 2009 through resolution of bankruptcy or liquidation of assets.

The Association has significant monthly payment loan volume and loans to borrowers that are not dependent solely upon farm income for repayments. Thus, the Association does not experience large fluctuations due to seasonal characteristics. The factors affecting the operations of the Association are the same factors that would affect any agricultural real estate lender.

## Allowance for Loan Losses:

The following table provides relevant information regarding the allowance for loan losses as of, or for the year ended, December 31:

	2008	2007	2006
Allowance for loan losses	\$ 368,663	\$ 82,663	\$ 112,673
Provision for loan losses	2,089,010	615,482	82,160
Loans charged off	(1,803,010)	(2,519,408)	-
Recoveries	-	1,873,916	-
Allowance for loan losses to total loans	0.1%	0.02%	0.03%
Allowance for loan losses to nonaccrual loans	8.8%	27.4%	120.6%
Allowance for loan losses to impaired loans	8.8%	22.1%	120.6%

The allowance for loan losses is maintained based upon estimates that consider the general financial strength of the agricultural economy, loan portfolio composition, credit administration and the portfolio's prior loan loss experience. Based upon ongoing risk assessment and the allowance for loan losses procedures outlined above, the allowance for loan losses of \$368,663, \$82,663 and \$112,673 at December 31, 2008, 2007 and 2006, respectively, is considered adequate by management to compensate for inherent losses in the loan portfolio at such dates.

The provision for loan losses for 2008 was \$2,089,010, reflecting an increase of \$1,473,528 from the \$615,482 provision recorded in 2007. The increase is primarily attributable to the Association's participation in a loan that was deemed nonaccrual due to a credit default and undercollateralized position in the fourth quarter of 2008 which ultimately resulted in a charge-off in the amount of \$1,803,010. Although there was a charge-off of a loan in the amount of \$2,519,408 in 2007, there was a subsequent recovery on the same loan in the amount of \$1,873,916. These two items contributed to a provision for loan loss in 2007 in the amount of \$615,482. There were no recoveries of charge-offs in 2008. In addition, the Association also maintained another participation loan in its portfolio that was in bankruptcy at the end of 2008 and deemed to be undercollateralized. As a result, the Association recorded a specific allowance on that loan in the amount of \$86,000.

Allowance for loan losses as a percentage of nonaccrual loans decreased to 8.8 percent at the end of 2008 from 27.4 percent at the same time in 2007. Although the allowance for loan loss increased, the volume of nonaccrual loans increased at a proportionally higher level due to the loan as discussed above that was moved to nonaccrual status due to its declaration of bankruptcy in the fourth quarter of 2008. Due to the fact that this loan was considered to be well collateralized and the borrower

expected to reorganize and continue operations after bankruptcy, it was determined that no specific provisions for loan loss or charge-offs of this loan were necessary. As a result, the allowance for loan loss did not increase, but the total nonaccrual loans did increase, causing a reduction in the ratio of allowance for loan loss to nonaccrual loans.

### Results of Operations:

The Association's net income for the year ended December 31, 2008, was \$6,869,438 as compared to \$7,702,124 for the year ended December 31, 2007, reflecting a decrease of \$832,686, or 10.8 percent. The decrease in net income experienced by the Association in 2008 as compared to 2007 was primarily the result of a \$1.8 million charge-off of a loan previously discussed offset by net interest income and noninterest income that were \$646,074 and \$375,045 higher in 2008 than 2007. The Association's net income for the year ended December 31, 2006 was \$7,762,515. Net income decreased \$60,391, or 0.8 percent, in 2007 versus 2006, which was primarily the result of an increase in the provision for loan loss in 2007 caused by a loan that was deemed to be nonaccrual due to a credit default and significant undercollateralized position. This loan was liquidated in 2007.

Net interest income for 2008, 2007 and 2006 was \$11,891,402, \$11,245,328 and \$10,381,715, reflecting increases of \$646,074, or 5.7 percent, for 2008 versus 2007 and \$863,613, or 8.3 percent, for 2007 versus 2006. Net interest income is the principal source of earnings for the Association and both wholly-owned subsidiaries and is impacted by volume, yields on assets and cost of debt. The effects of changes in average volume and interest rates on net interest income over the past three years are presented in the following tables:

	2008		2007		2006	
	Average Balance	Interest	Average Balance	Interest	Average Balance	Interest
Loans	\$ 402,504,068	\$ 27,677,866	\$ 374,209,394	\$ 28,066,686	\$ 321,200,040	\$ 23,813,812
Interest-bearing liabilities	332,100,648	15,786,464	308,218,767	16,821,358	259,270,750	13,432,097
Impact of capital	\$ 70,403,420		\$ 65,990,627		\$ 61,929,290	
Net interest income		\$ 11,891,402		\$ 11,245,328		\$ 10,381,715

	Average Yield	Average Yield	Average Yield
Yield on loans	6.87%	7.50%	7.41%
Cost of interest-bearing liabilities	4.75%	5.46%	5.18%
Interest rate spread	2.12%	2.04%	2.23%

	2008 vs. 2007			2007 vs. 2006		
	Increase (decrease) due to			Increase (decrease) due to		
	Volume	Rate	Total	Volume	Rate	Total
Interest income	\$ 2,122,185	\$ (2,511,005)	\$ (388,820)	\$ 3,876,804	\$ 376,070	\$ 4,252,874
Interest expense	1,303,378	(2,338,272)	(1,034,894)	2,535,850	853,411	3,389,261
Net interest income	\$ 818,807	\$ (172,733)	\$ 646,074	\$ 1,340,954	\$ (477,341)	\$ 863,613

Interest income decreased by \$388,820, or 1.4 percent, compared to 2007, primarily due to a decrease in the market interest rates charged to borrowers. Interest expense for 2008 decreased by \$1,034,894, or 6.2 percent, compared to 2007 due to a decrease in the cost of funds to the Association. The ultimate effect of interest expense decreasing by a larger percentage than interest income is the increase of the interest rate spread by 8 basis points to 2.12 percent in 2008 from 2.04 percent in 2007. The interest rate spread decreased by 19 basis points to 2.04 percent in 2007 from 2.23 percent in 2006, primarily as a result of increased competition in the marketplace during that timeframe that caused compressed interest rate spreads.

The Association offers a variety of loan interest rate products including indexed interest rate loans and fixed rate loans with varied terms of maturities and repricing intervals. Interest rate risk inherent in the Association's loan portfolio is substantially mitigated through the funding relationship with the Bank. Periodic review of interest rate margins by the Association's Asset and Liability Committee (ALCO) allows for adjustments of product rate margins as needed for repricings and new loan offerings in order to remain market competitive and to meet business plan goals.

Noninterest income for 2008 increased by \$375,045, or 17.8 percent, compared to 2007, due primarily to an increase of \$278,493 in fees collected on loan origination and servicing fees by the Association as well as an increase of \$83,276 in patronage income

from the Bank for both the FLCA and PCA subsidiaries. Noninterest income for 2007 increased by \$192,968, or 10.1 percent, compared to 2006, due primarily to the increase in patronage income from the Bank in 2007.

Operating expenses consist primarily of salaries, employee benefits, purchased services and Farm Credit System Insurance Corporation (FCSIC) insurance premiums. Expenses for purchased services may include administrative services, marketing, information systems, accounting and loan processing, among others. Noninterest expenses for 2008, 2007 and 2006 respectively were \$5,409,161, \$5,028,884 and \$4,445,234. The increase was attributable to increases in FCSIC insurance premiums of \$18,155 from 2007 to 2008 and \$110,918 from 2006 to 2007; an increase in advertising expenses of \$30,228 in 2008 from 2007 and \$60,291 in 2007 from 2006; as well as an increase in salary and benefits of \$332,281 from 2007 to 2008 and an increase of \$442,358 from 2006 to 2007. The increases in salary and benefits were primarily the result of increased costs to fund the defined benefit retirement plan in addition to staff additions and merit pay raises.

For the year ended December 31, 2008, the Association's return on average assets was 1.7 percent, as compared to 2.0 percent and 2.3 percent for the years ended December 31, 2007 and 2006, respectively. For the year ended December 31, 2008, the Association's return on average members' equity was 8.6 percent, as compared to 10.5 percent and 11.3 percent for the years ended December 31, 2007 and 2006, respectively. The decreases in these measures of performance from 2006 through 2008 were the result of the decreases in net income as discussed above, primarily impacted by charge-offs and additional provision for loan losses experienced in the loan portfolio during 2007 and 2008.

Because the Association depends on the Bank for funding, any significant positive or negative factors affecting the operations of the Bank would have a similar effect on the operations of the Association.

#### **Liquidity and Funding Sources:**

The interest rate risk inherent in the Association's loan portfolio is substantially mitigated through the funding relationship with the Bank. The Bank manages interest rate risk through its direct loan pricing and asset/liability management process.

The primary source of liquidity and funding for the Association is a direct loan from the Bank. The outstanding balance of \$333,802,614, \$315,621,025 and \$283,097,264 as of December 31, 2008, 2007 and 2006, respectively, is recorded as a liability on the Association's balance sheet. The note carried a weighted average interest rate of 4.36 percent, 5.37 percent and 5.20 percent at December 31, 2008, 2007 and 2006, respectively. The indebtedness is collateralized by a pledge of substantially all of the Association's assets to the Bank and is governed by a general financing agreement. The increase in note payable to the Bank and related accrued interest payable since December 31, 2007, is due to an increase in the average debt volume that is the result of an increased volume of loans to borrowers. The Association's own funds, which represent the amount of the Association's loan portfolio funded by the Association's equity, were \$73,452,598, \$70,060,939 and \$65,810,979 at December 31, 2008, 2007 and 2006, respectively. The maximum amount the Association may borrow from the Bank as of December 31, 2008, was \$409,657,601 as defined by the general financing agreement.

The liquidity policy of the Association is to manage cash balances to maximize debt reduction and to increase accrual loan volume. This policy will continue to be pursued during 2009. As borrower payments are received, they are applied to the Association's note payable to the Bank. The Association has reclassified cash receipts of \$1,371,706 at December 31, 2008, to the direct note.

The Association will continue to fund its operations through direct borrowings from the Bank, capital surplus from prior years and borrower stock, although the borrower stock is a minor funding source. It is management's opinion that funds available to the Association are sufficient to fund its operations for the coming year.

#### **Capital Resources:**

The Association's capital position remains strong with total members' equity of \$79,714,498, \$75,678,598 and \$70,665,132 at December 31, 2008, 2007 and 2006, respectively. Under regulations governing minimum permanent capital adequacy and other capitalization issues, the Association is required to maintain a minimum adjusted permanent capital of 7.0 percent of risk-adjusted assets as defined by the FCA. The permanent capital ratio measures available at-risk capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the institution's financial capacity to absorb potential losses beyond that provided in the allowance for loss accounts. The Association's permanent capital ratio at December 31, 2008, 2007 and 2006 was 18.0 percent, 18.0 percent and 18.7 percent, respectively.

The core surplus ratio measures available core surplus capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the quality of capital that exists to maintain stable earnings and financial strength. The Association's

core surplus ratio at December 31, 2008, 2007 and 2006 was 17.3 percent, 17.3 percent and 17.9 percent, respectively, which is in compliance with the FCA's minimum ratio requirement of 3.5 percent.

The total surplus ratio measures available surplus capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the reserves existing to protect borrowers' investment in the Association. The Association's total surplus ratio at December 31, 2008, 2007 and 2006 was 17.3 percent, 17.3 percent and 17.9 percent, respectively, which is in compliance with the FCA's minimum ratio requirement of 7.0 percent.

In 2008, 2007 and 2006, the Association paid patronage distributions of \$3,007,297, \$2,762,764 and \$2,800,000, respectively. For the year ended December 31, 2008, the board of directors approved a \$2,751,042 patronage distribution to be paid in April 2009. See Note 6 to the consolidated financial statements, "Members' Equity," included in this annual report, for further information.

#### **Relationship With the Bank:**

The Association's statutory obligation to borrow only from the Bank is discussed in Note 5 to the consolidated financial statements, "Note Payable to the Bank," included in this annual report.

The Bank's ability to access capital of the Association is discussed in Note 2 to the consolidated financial statements, "Summary of Significant Accounting Policies," included in this annual report, within the section "Capital Stock Investment in the Bank."

The Bank's role in mitigating the Association's exposure to interest rate risk is described in the section "Liquidity and Funding Sources" of Management's Discussion and Analysis and in Note 5 to the consolidated financial statements, "Note Payable to the Bank," included in this annual report.

The Bank provides computer systems to support the critical operations of all district associations. In addition, each association has operating systems and facility-based systems that are not supported by the Bank. As disclosed in Note 9 to the consolidated financial statements, "Related Party Transactions," included in this annual report, the Bank provides many services that the Association can utilize, such as administrative, marketing, information systems, and accounting services. Additionally, the Bank allocates district expenses to the associations, such as the Farm Credit System Insurance Corporation insurance premiums.

#### **Summary:**

Over the past 91 years, regardless of the state of the agricultural economy, your Association's board of directors and management, as well as the board of directors and management of the Bank, have been committed to offering their borrowers a ready source of financing at a competitive price. Your continued support will be critical to the success of this Association.

**REPORT OF INDEPENDENT AUDITORS**

To the Board of Directors and Stockholders  
of the Texas Land Bank, ACA

In our opinion, the accompanying consolidated balance sheets and related consolidated statements of income, of changes in members' equity and of cash flows present fairly, in all material respects, the financial position of Texas Land Bank, ACA and subsidiaries (Association) at December 31, 2008, 2007 and 2006, and the results their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These consolidated financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 our opinion.

*PricewaterhouseCoopers LLP*

Austin, Texas  
March 2, 2009

**TEXAS LAND BANK, ACA**  
**CONSOLIDATED BALANCE SHEET**

	December 31,		
	2008	2007	2006
<b>Assets</b>			
Cash	\$ 60,000	\$ 61,792	\$ 66,924
Loans	408,270,608	385,663,911	349,504,055
Less: allowance for loan losses	368,663	82,663	112,673
Net loans	407,901,945	385,581,248	349,391,382
Accrued interest receivable	3,928,186	4,272,113	3,946,697
Investment in and receivable from the Bank:			
Capital stock	6,605,955	6,107,250	5,107,135
Other	380	16,612	-
Other property owned, net	-	-	32,000
Premises and equipment	1,364,663	1,475,982	1,541,232
Other assets	118,987	99,044	84,411
Total assets	<b>\$ 419,980,116</b>	<b>\$ 397,614,041</b>	<b>\$ 360,169,781</b>
<b>Liabilities</b>			
Note payable to the Bank	\$ 333,802,614	\$ 315,621,025	\$ 283,097,264
Advance conditional payments	305	9,526	-
Accrued interest payable	1,293,137	1,425,402	1,280,153
Drafts outstanding	666,896	166,514	495,925
Patronage distributions payable	2,751,042	3,001,054	2,762,523
Other liabilities	1,751,624	1,711,922	1,868,784
Total liabilities	<b>340,265,618</b>	<b>321,935,443</b>	<b>289,504,649</b>
<b>Members' Equity</b>			
Capital stock and participation certificates	2,620,855	2,660,520	2,631,975
Allocated retained earnings	12,765,444	8,645,124	4,143,784
Unallocated retained earnings	64,072,029	64,088,861	63,889,373
Accumulated other comprehensive income	256,170	284,093	-
Total members' equity	<b>79,714,498</b>	<b>75,678,598</b>	<b>70,665,132</b>
Total liabilities and members' equity	<b>\$ 419,980,116</b>	<b>\$ 397,614,041</b>	<b>\$ 360,169,781</b>

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

TEXAS LAND BANK, ACA

CONSOLIDATED STATEMENT OF INCOME

	Year Ended December 31,		
	2008	2007	2006
<b><u>Interest Income</u></b>			
Loans	\$ 27,677,866	\$ 28,066,686	\$ 23,813,812
<b><u>Interest Expense</u></b>			
Note payable to the Bank	15,785,974	16,821,121	13,432,097
Advance conditional payments	490	237	-
Total interest expense	15,786,464	16,821,358	13,432,097
Net interest income	11,891,402	11,245,328	10,381,715
<b><u>Provision for Losses</u></b>			
Provision for loan losses	2,089,010	615,482	82,160
Net interest income after provision for loan losses	9,802,392	10,629,846	10,299,555
<b><u>Noninterest Income</u></b>			
Patronage income from the Bank	1,286,594	1,203,318	1,012,052
Loan fees	1,126,270	847,777	850,747
Financially related services income	18,723	16,958	15,245
Provision for acquired property losses	-	8,000	-
Other noninterest income	44,620	25,109	30,150
Total noninterest income	2,476,207	2,101,162	1,908,194
<b><u>Noninterest Expenses</u></b>			
Salaries and employee benefits	2,922,115	2,589,834	2,147,476
Directors' expense	221,631	211,672	168,157
Purchased services	512,493	504,297	564,784
Travel	127,175	134,192	126,584
Occupancy and equipment	259,527	258,332	243,958
Communications	74,045	80,447	73,576
Advertising	313,559	283,331	223,040
Public and member relations	97,591	92,001	124,563
Supervisory and exam expense	138,978	130,015	126,957
Insurance Fund premiums	606,016	587,861	476,943
(Loss) on sale of premises and equipment, net	3,914	4,588	1,053
(Loss) on other property owned, net	-	734	-
Other noninterest expense	132,117	151,580	168,143
Total noninterest expenses	5,409,161	5,028,884	4,445,234
Income before income taxes	6,869,438	7,702,124	7,762,515
Income taxes	-	-	-
Net income	\$ 6,869,438	\$ 7,702,124	\$ 7,762,515

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

TEXAS LAND BANK, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

	Capital Stock/ Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
		Allocated	Unallocated		
Balance at December 31, 2005	\$ 2,621,695	\$ -	\$ 63,033,165	\$ -	\$ 65,654,860
Net income	-	-	7,762,515	-	7,762,515
Capital stock/participation certificates issued	341,315	-	-	-	341,315
Capital stock/participation certificates and allocated retained earnings retired	(331,035)	-	-	-	(331,035)
Patronage refunds:					
Cash	-	-	(2,762,523)	-	(2,762,523)
Capital stock/participation certificates and allocated retained earnings	-	4,143,784	(4,143,784)	-	-
Balance at December 31, 2006	2,631,975	4,143,784	63,889,373	-	70,665,132
Net income	-	-	7,702,124	-	7,702,124
Adjustment to initially apply FAS No. 158	-	-	-	284,093	284,093
Capital stock/participation certificates issued	340,160	-	-	-	340,160
Capital stock/participation certificates and allocated retained earnings retired	(311,615)	-	-	-	(311,615)
Patronage refunds:					
Cash	-	-	(3,001,054)	-	(3,001,054)
Capital stock/participation certificates and allocated retained earnings	-	4,501,340	(4,501,340)	-	-
Change in estimated patronage declared in 2006 and paid in 2007	-	-	(242)	-	(242)
Balance at December 31, 2007	2,660,520	8,645,124	64,088,861	284,093	75,678,598
Adjustment to beginning balance due to FAS No. 158 accounting change	-	-	(8,665)	-	(8,665)
Balance at January 1, 2008	2,660,520	8,645,124	64,080,196	284,093	75,669,933
Comprehensive income					
Net income	-	-	6,869,438	-	6,869,438
Change in pension and postretirement benefit plans	-	-	-	(27,923)	(27,923)
Total comprehensive income	-	-	6,869,438	(27,923)	6,841,515
Capital stock/participation certificates issued	312,960	-	-	-	312,960
Capital stock/participation certificates and allocated retained earnings retired	(352,625)	-	-	-	(352,625)
Patronage refunds:					
Cash	-	-	(2,751,042)	-	(2,751,042)
Capital stock/participation certificates and allocated retained earnings	-	4,126,563	(4,126,563)	-	-
Change in estimated patronage declared in 2007 and paid in 2008	-	(6,243)	-	-	(6,243)
<b>Balance at December 31, 2008</b>	<b>\$ 2,620,855</b>	<b>\$ 12,765,444</b>	<b>\$ 64,072,029</b>	<b>\$ 256,170</b>	<b>\$ 79,714,498</b>

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

**TEXAS LAND BANK, ACA**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

	Year Ended December 31,		
	2008	2007	2006
<b>Cash flows from operating activities:</b>			
Net income	\$ 6,869,438	\$ 7,702,124	\$ 7,762,515
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	2,089,010	615,482	82,160
Gain on other property owned, net	-	(8,000)	-
Depreciation	133,359	161,450	163,271
Loss on sale of premises and equipment, net	3,914	4,588	1,053
Decrease (increase) in accrued interest receivable	343,927	(325,416)	(966,943)
Decrease (increase) in other receivable from the bank	16,232	(16,612)	-
Increase in other assets	(19,943)	(14,633)	(7,649)
(Decrease) increase in accrued interest payable	(132,266)	145,248	350,641
Increase in other liabilities	3,114	127,231	369,883
Net cash provided by operating activities	<u>9,306,785</u>	<u>8,391,462</u>	<u>7,754,931</u>
<b>Cash flows from investing activities:</b>			
Increase in loans, net	(24,409,707)	(38,671,265)	(46,745,875)
Cash recoveries of loans previously charged off	-	1,873,917	-
Purchase of investment in the Bank	(498,705)	(1,000,115)	(567,650)
Purchases of premises and equipment	(26,053)	(101,291)	(81,949)
Proceeds from sales of premises and equipment	100	503	384
Proceeds from sales of other property owned	-	32,000	-
Net cash used in investing activities	<u>(24,934,365)</u>	<u>(37,866,251)</u>	<u>(47,395,090)</u>

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

**TEXAS LAND BANK, ACA**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

	Year Ended December 31,		
	2008	2007	2006
<b>Cash flows from financing activities:</b>			
Net draws on note payable to the Bank	18,181,590	32,523,761	42,106,718
Increase (decrease) in drafts outstanding	500,381	(329,411)	328,990
(Decrease) increase in advance conditional payments	(9,221)	9,526	-
Issuance of capital stock and participation certificates	312,960	340,720	341,315
Retirement of capital stock and participation certificates	(352,625)	(312,175)	(331,035)
Patronage distributions paid	(3,007,297)	(2,762,764)	(2,800,000)
Net cash provided by financing activities	15,625,788	29,469,657	39,645,988
Net (decrease) increase in cash	(1,792)	(5,132)	5,829
Cash at the beginning of the year	61,792	66,924	61,095
Cash at the end of the year	\$ 60,000	\$ 61,792	\$ 66,924

**Supplemental schedule of noncash investing and financing activities:**

Loans charged off	1,803,010	2,519,408	-
Patronage distributions declared	2,751,042	3,001,054	2,762,523

**Supplemental cash information:**

Cash paid during the year for:			
Interest	\$ 15,918,245	\$ 16,675,872	\$ 13,081,456

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

**TEXAS LAND BANK, ACA**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 — ORGANIZATION, RESTRUCTURING, AND OPERATIONS:**

- A. Organization: Texas Land Bank, ACA, including its wholly-owned subsidiaries, Texas PCA and Texas Land Bank, FLCA (collectively called “the Association”), is a member-owned cooperative which provides credit and credit-related services to, or for the benefit of, eligible borrowers/stockholders for qualified agricultural purposes in the counties of Bell, Bosque, Burnet, Coryell, Dallas, Ellis, Falls, Freestone, Hamilton, Hill, Lampasas, Limestone, McLennan, Milam, Navarro and Williamson in the state of Texas.

The Association is a lending institution of the Farm Credit System (System), a nationwide system of cooperatively owned banks and associations that was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (Act). The most recent significant amendment to the Act was the Agricultural Credit Act of 1987 (1987 Act). At December 31, 2008, the System consisted of four Farm Credit Banks and their affiliated associations, one Agricultural Credit Bank and its affiliated associations, the Federal Farm Credit Banks Funding Corporation (Funding Corporation) and various service and other organizations.

The Farm Credit Bank of Texas (Bank) and its related associations are collectively referred to as the “District.” The Bank provides funding to all associations within the District and is responsible for supervising certain activities of the district associations. At December 31, 2008, the District consisted of the Bank, 6 FLCAs and 13 ACA parent companies, which have two wholly-owned subsidiaries, an FLCA and a PCA, operating in or servicing the states of Alabama, Louisiana, Mississippi, New Mexico and Texas.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System banks and associations. The FCA examines the activities of the associations, and certain actions by the associations are subject to the prior approval of the FCA and the supervising bank.

The Act established the Farm Credit System Insurance Corporation (FCSIC) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used (1) to ensure the timely payment of principal and interest on Systemwide debt obligations, (2) to ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for the discretionary uses by the FCSIC of providing assistance to certain troubled System institutions and to cover the operating expenses of the FCSIC. Each System bank has been required to pay premiums, which may be passed on to the associations into the Insurance Fund, based on its annual average loan principal outstanding, until the monies in the Insurance Fund reach the “secure base amount,” which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (Systemwide debt obligations) or other such percentage of the aggregate obligations as the Insurance Corporation in its sole discretion determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, the FCSIC is required to reduce 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 June 2008, with the passage of the Food, Conservation, and Energy Act of 2008 (Farm Bill), the basis for assessing premiums was changed, beginning with the second half of 2008, to reflect each Bank’s pro rata share of outstanding insured debt. The Farm Bill imposes premiums of 20 basis points on adjusted insured debt obligations, with the Insurance Corporation Board having the ability to reduce the amount, and a risk surcharge of 10 basis points on nonaccrual loans and other-than-temporarily impaired investments.

FCA regulations require borrower information to be held in strict confidence by Farm Credit institutions, their directors, officers and employees. Directors and employees of the Farm Credit institutions are prohibited, except under specified circumstances, from disclosing nonpublic personal information about members.

- B. Restructuring: On October 1, 2006, pursuant to a restructuring plan approved by the FCA and the Association’s shareholders, the Association reorganized to form an ACA as permitted by the 1987 Act. Pursuant to the restructuring plan, a Production Credit Association (PCA) formed, Texas PCA, which, together with Texas Land Bank, FLCA (FLCA), became wholly-owned subsidiaries of the Association. The formation of the ACA and creation of the PCA enable the Association to make short- and intermediate-term loans for agricultural production or operating purposes through the PCA as well as continue to benefit from the tax-exempt status of long-term mortgage interest for loans generated by the FLCA.
- C. Operations: The Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services that can be offered by the Association. The Association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers,

producers or harvesters of aquatic products, rural residents and farm-related businesses. The Association makes and services short- and intermediate-term loans for agricultural production or operating purposes, and secured long-term real estate mortgage loans, with funding from the Bank.

The Association also serves as an intermediary in offering credit life insurance.

The Association's financial condition may be affected by factors that affect the Bank. The financial condition and results of operations of the Bank may materially affect stockholders' investment in the Association. Upon request, stockholders of the Association will be provided with the Tenth Farm Credit District's Annual Report to Stockholders, which includes the combined financial statements of the Bank and all of the district associations. The District's annual report discusses the material aspects of the financial condition, changes in financial condition, and results of operations for the Bank and the District. In addition, the District's annual report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Fund.

The lending and financial services offered by the Bank are described in Note 1 of the District's annual report to stockholders.

## **NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

The accounting and reporting policies of the Association conform to accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results could differ from those estimates. Certain amounts in prior years' consolidated financial statements have been reclassified to conform to current financial statement presentation. The consolidated financial statements include the accounts of Texas PCA and Texas Land Bank, FLCA. All significant intercompany transactions have been eliminated in consolidation.

- A. Cash and Cash Equivalents: Cash and cash equivalents, as included in the statement of cash flows, represent cash on hand and on deposit at local banks.
- B. Loans and Allowance for Loan Losses: Long-term real estate mortgage loans generally have original maturities ranging from five to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less.

Loans are carried at their principal amount outstanding adjusted for charge-offs and deferred loan fees or costs.

Statement of Financial Accounting Standards (SFAS) No. 91, "Accounting for Nonrefundable Fees and Costs Associated With Originating and Acquiring Loans and Initial Direct Costs of Leases," requires loan origination fees and direct loan origination costs, if material, to be capitalized and the net fee or cost to be amortized over the life of the related loan as an adjustment to yield. SFAS No. 91 has not been implemented because the effects were not material to the financial position or results of operations for any year presented.

Impaired loans are loans that are nonperforming and for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan. Impaired loans include nonaccrual loans, restructured loans and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest and penalty interest incurred as a result of past-due status, is collected or otherwise discharged in full.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years).

Payments received on nonaccrual loans are generally applied to the recorded investment in the loan asset. If collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it, the interest portion of payments is recognized as current interest income. Nonaccrual loans may be transferred to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected, and the loan is not classified as "doubtful" or "loss." If

previously unrecognized interest income exists upon transfer of a nonaccrual loan to accrual status, interest income will be recognized as cash payments are received.

In cases where a borrower experiences financial difficulties and, should the Association make certain monetary concessions to the borrower through modifications to the contractual terms of the loan, the loan is classified as a restructured loan. If the borrower's ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

Loans are charged off, wholly or partially, as appropriate, at the time they are determined to be uncollectible.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

- C. **Capital Stock Investment in the Bank:** The Association's investment in the Bank is in the form of Class A voting capital stock and allocated retained earnings. This investment is adjusted periodically based on the Association's proportional utilization of the Bank compared to other district associations. The Bank requires a minimum stock investment of 2 percent of the Association's average borrowing from the Bank. This investment is carried at cost plus allocated equities in the accompanying consolidated balance sheet.

If needed to meet regulatory capital adequacy requirements, the board of directors of the Bank may increase the percentage of stock held by an association from 2 percent of the average outstanding balance of borrowings from the Bank to a maximum of 5 percent of the average outstanding balance of borrowings from the Bank.

- D. **Other Property Owned, Net:** Other property owned, net, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned, net.
- E. **Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation is provided on the straight-line method using estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense, and improvements are capitalized.
- F. **Advance Conditional Payments:** The Association is authorized under the Act to accept advance payments from borrowers. To the extent that the borrower's access to such funds is restricted, the advance conditional payments are netted against the borrower's related loan balance. Amounts in excess of the related loan balance and amounts to which the borrower has unrestricted access are presented as liabilities in the accompanying consolidated balance sheet. Advance conditional payments are not insured. Interest is generally paid by the Association on such accounts at rates established by the board of directors.
- G. **Employee Benefit Plans:** Employees of the Association participate in either the defined benefit retirement plan (DB Plan) or the defined contribution plan (DC Plan) and are eligible to participate in the Farm Credit Benefits Alliance 401(k) Plan. The DB Plan is closed to new participants. Participants generally include employees hired prior to January 1, 1996. The DB Plan is noncontributory and provides benefits based on salary and years of service. The "Projected Unit Credit" actuarial method is used for financial reporting and funding purposes for the DB Plan.

Participants in the DC Plan generally include employees who elected to transfer from the DB Plan prior to January 1, 1996, and employees hired on or after January 1, 1996. Participants in the DC Plan direct the placement of their employers' contributions, 5.0 percent of salaries for the year ended December 31, 2008, made on their behalf into various investment alternatives.

The structure of the District's DB plan is characterized as multi-employer, since neither the assets, liabilities nor costs of any plan are segregated or separately accounted for by the associations. No portion of any surplus assets is available to the associations, nor are the associations required to pay for plan liabilities upon withdrawal from the plans. As a result, the associations recognize as pension cost the required contribution to the plans for the year. Contributions due and unpaid are

recognized as a liability. The Association recognized pension costs for the DC Plan of \$51,656, \$45,075 and \$25,203 for the years ended December 31, 2008, 2007 and 2006, respectively. For the DB Plan, the Association recognized pension costs of \$443,984, \$173,192 and \$176,068 for the years ended December 31, 2008, 2007 and 2006, respectively.

The Association also participates in the Farm Credit Benefits Alliance 401(k) Plan which requires the associations to match 100 percent of employee contributions up to 3.0 percent of base salary and to match 50 percent of employee contributions for the next 2.0 percent of employee contributions, up to a maximum employer contribution of 4.0 percent of base salary. Association 401(k) plan costs are expensed as incurred. The Association's contributions to the 401(k) plan were \$73,310, \$74,291 and \$58,009 for the years ended December 31, 2008, 2007 and 2006, respectively.

In addition to pension benefits, the Association provides certain health care and life insurance benefits to qualifying employees and retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities. In 2004, the District discontinued its multi-employer health and welfare plan, which provided substantially all employees with health care, life insurance and postretirement benefits during their working lives and after retirement if they reached normal retirement age and met the years of service criteria while working for the Association. At that time, the Association adopted a new plan to provide the same benefits to its retirees and employees. Under the new plan, the Association no longer participates in the joint and several liability with any other entities, which was intrinsic to the multi-employer plan. For employers providing these benefits outside of a multi-employer plan, SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" (SFAS 106), requires the liability for the contractual obligation of these benefits to be recognized as employees render the services necessary to earn the benefits. Accordingly, in December 2004, the Association recognized as an expense the unfunded liability for these postretirement benefits. Since that time, the net periodic expense for these benefits has been accrued in accordance with SFAS 106.

- H. **Income Taxes:** The ACA holding company conducts its business activities through two wholly-owned subsidiaries. Long-term mortgage lending activities are operated through the wholly-owned FLCA subsidiary which is exempt from federal and state income tax. Short- and intermediate-term lending activities are operated through the wholly-owned PCA subsidiary. Operating expenses are allocated to each subsidiary based on estimated relative service. All significant transactions between the subsidiaries and the parent company have been eliminated in consolidation. The ACA, along with the PCA subsidiary, is subject to income tax. The Association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated retained earnings. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. The Association distributes patronage on the basis of book income. Deferred taxes are recorded on the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (over 50 percent probability), based on management's estimate, that they will not be realized. The consideration of valuation allowances involves various estimates and assumptions as to future taxable earnings, including the effects of our expected patronage program, which reduces taxable earnings. The Association intends to distribute all of its taxable income in the form of patronage in future years. As a result, the financial statements for the Association do not reflect a tax expense or deferred tax asset.
- I. **Patronage Refunds From the Farm Credit Bank of Texas:** The Association records patronage refunds from the Bank upon receipt of the patronage.
- J. **Fair Value Measurement:** Effective January 1, 2008, the System adopted SFAS No. 157, "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It describes three levels of inputs that may be used to measure fair value:

Level 1 — Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 asset and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 — Observable inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly. Level 2 inputs include the following: (a) quoted prices for similar assets or liabilities in active markets; (b) quoted prices for identical or similar assets or liabilities in markets that are not active so that they are traded less frequently than exchange-traded instruments, the prices are not current or principal market

information is not released publicly; (c) inputs other than quoted prices that are observable such as interest rates and yield curves, prepayment speeds, credit risks and default rates; and (d) inputs derived principally from or corroborated by observable market data by correlation or other means. This category generally includes certain U.S. Government and agency mortgage-backed debt securities, corporate debt securities, and derivative contracts.

Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities are considered Level 3. These unobservable inputs reflect the reporting entity's own assumptions about assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, asset-backed securities, and highly structured or long-term derivative contracts.

The fair value disclosures have been expanded in accordance with SFAS No. 157, as disclosed in Note 11.

Recently Issued Accounting Pronouncements: In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 161, "Disclosures about Derivative Instruments and Hedging Activities," which amends and expands the disclosure requirements for derivative instruments and for hedging activities previously required by SFAS No. 133. It states that an entity with derivative instruments shall disclose information to enable users of the financial statements to understand: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under this Statement and related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Association does not expect adoption of SFAS No. 161 to have any impact on its financial statement disclosures.

### NOTE 3 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans as of December 31 follows:

Loan Type	2008		2007		2006	
	Amount	%	Amount	%	Amount	%
Real estate mortgage	\$ 348,550,244	85.3%	\$ 338,215,635	87.8%	\$ 320,611,147	91.7%
Production & intermediate term	17,539,944	4.3%	14,309,108	3.7%	-	0.0%
Processing and marketing	12,498,826	3.1%	8,966,500	2.3%	5,790,490	1.7%
Energy	9,810,895	2.4%	8,366,998	2.2%	6,872,945	2.0%
Rural residential real estate	9,605,301	2.4%	7,505,317	1.9%	6,788,758	1.9%
Communication	7,709,882	1.9%	5,472,327	1.4%	8,294,246	2.4%
Farm-related business	2,555,516	0.6%	2,828,026	0.7%	1,146,469	0.3%
Total	<u>\$ 408,270,608</u>	<u>100.0%</u>	<u>\$ 385,663,911</u>	<u>100.0%</u>	<u>\$ 349,504,055</u>	<u>100.0%</u>

Geographic Distribution:

County	2008	2007	2006
Bosque	7.5%	7.2%	8.0%
Bell	6.2%	5.9%	6.5%
Navarro	6.1%	6.3%	7.0%
Williamson	6.1%	6.3%	6.9%
Hill	6.0%	6.5%	6.0%
McLennan	6.0%	5.7%	6.3%
Lampasas	5.4%	5.7%	5.7%
Falls	5.3%	4.7%	4.5%
Hamilton	5.3%	5.2%	5.5%
Burnet	3.8%	4.0%	4.6%
Limestone	3.6%	3.4%	2.7%

Coryell	3.6%	3.9%	3.6%
Ellis	3.5%	3.3%	4.0%
Freestone	2.7%	3.1%	3.4%
Milam	2.6%	3.1%	3.5%
Other States	13.3%	12.6%	10.9%
Other Counties	13.0%	13.1%	10.9%
Totals	100.0%	100.0%	100.0%

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

Operation/Commodity	2008		2007		2006	
	Amount	%	Amount	%	Amount	%
Livestock, except dairy and poultry	\$ 277,238,872	67.9%	\$ 264,742,068	68.6%	\$ 239,669,320	68.6%
Cash grains	46,998,937	11.5%	45,874,013	11.9%	38,155,111	10.9%
Timber	14,573,240	3.6%	15,934,285	4.1%	15,811,623	4.5%
Electric services	9,802,276	2.4%	6,788,051	1.8%	5,293,998	1.5%
Rural home loans	8,405,017	2.1%	6,014,333	1.6%	6,793,078	1.9%
Communications	7,709,882	1.9%	5,472,327	1.4%	8,294,246	2.4%
Hunting, trapping and game propagation	6,688,331	1.6%	6,261,537	1.6%	5,042,700	1.4%
Paper and allied products	4,923,761	1.2%	3,659,167	0.9%	3,029,261	0.9%
Poultry and eggs	3,726,025	0.9%	2,998,983	0.8%	782,592	0.2%
Field crops except cash grains	3,598,539	0.9%	3,695,168	1.0%	10,543,908	3.0%
General farms, primarily livestock	3,261,174	0.8%	2,284,873	0.6%	925,719	0.3%
Agricultural services	1,802,688	0.4%	1,158,253	0.3%	1,532,473	0.4%
Horticultural specialties	1,721,489	0.4%	1,941,913	0.5%	757,211	0.2%
Fruit and tree nuts	1,514,547	0.4%	1,594,896	0.4%	571,447	0.2%
Dairy farms	1,241,395	0.3%	1,478,606	0.4%	678,121	0.2%
Farm and garden machinery equipment	649,477	0.2%	707,296	0.2%	260,553	0.1%
Landlords	435,019	0.1%	677,201	0.2%	178,188	0.1%
Other	13,979,939	3.4%	14,380,941	3.7%	11,184,506	3.2%
Total	\$ 408,270,608	100.0%	\$ 385,663,911	100.0%	\$ 349,504,055	100.0%

The amount of collateral obtained 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 (or 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.

#### Asset Quality:

The following table reflects the credit quality of the Association's loan volume as of December 31:

	2008	2007	2006
Acceptable	97.0%	99.3%	97.0%
Special mention	1.8%	0.3%	2.7%
Substandard	1.2%	0.4%	0.3%
Total	100.0%	100.0%	100.0%

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms. The following presents information relating to impaired loans as of December 31:

	2008		2007		2006	
	Amount	%	Amount	%	Amount	%
Nonaccrual loans						
Current as to principal and interest	\$ 4,062,582	96.5%	\$ 301,743	80.7%	\$ 61,675	66.0%
Past due	147,941	3.5%	-	0.0%	31,773	34.0%
Total nonaccrual loans	<u>4,210,523</u>	<u>100.0%</u>	<u>301,743</u>	<u>80.7%</u>	<u>93,448</u>	<u>100.0%</u>
Accrual loans						
90 days or more past due	-	0.0%	72,037	19.3%	-	0.0%
Formally restructured	-	0.0%	-	0.0%	-	0.0%
Total impaired accrual loans	<u>-</u>	<u>0.0%</u>	<u>72,037</u>	<u>19.3%</u>	<u>-</u>	<u>0.0%</u>
Total impaired loans	<u>\$ 4,210,523</u>	<u>100.0%</u>	<u>\$ 373,780</u>	<u>100.0%</u>	<u>\$ 93,448</u>	<u>100.0%</u>

The Association loan portfolio contained \$4,210,523 in loans classified as impaired at December 31, 2008. This represented an increase of \$3,836,743 from the same period in 2007. All of the impaired loans at December 31, 2008, were classified as nonaccrual, with 96.5 percent current as to principal and interest payments. Nonaccrual loan volume was primarily being driven by three participation loans. While all three were current on payments of principal and interest, the debtors had filed bankruptcy, forcing the Association to classify the loans into nonaccrual status. Based on the data provided to the Association, while there was enough concern regarding the viability of one of the borrowers going forward to prevent the loan from being moved to cash basis, the loan was well secured and did not warrant a specific allowance as of December 31, 2008. Another loan was classified as nonaccrual cash basis with no specific allowance as of December 31, 2008, due to expectations that the borrower could continue to generate positive cash flow after bankruptcy restructuring as well as an adequately collateralized position. The third and smallest loan was deemed to be undercollateralized, and a specific loan loss allowance in the amount of \$86,000 was associated with it as of December 31, 2008.

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2008.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2, "Summary of Significant Accounting Policies." The following table presents interest income recognized on impaired loans.

	2008	2007	2006
Interest income recognized on nonaccrual loans	\$ 7,054	\$ 5,928	\$ 4,992
Interest income recognized on impaired accrual loans	-	8,052	-
Interest income recognized on impaired loans	<u>\$ 7,054</u>	<u>\$ 13,980</u>	<u>\$ 4,992</u>

A summary of the allowance for loan losses as of December 31 follows:

	2008	2007	2006
Beginning balance	\$ 82,663	\$ 112,673	\$ 30,513
Provision for loan losses	2,089,010	615,482	82,160
Loans charged off	(1,803,010)	(2,519,408)	-
Recoveries	-	1,873,916	-
Allowance for loan losses	<u>\$ 368,663</u>	<u>\$ 82,663</u>	<u>\$ 112,673</u>

The increase in the provision for loan losses and loans charged off is related to two participation loans. During 2008, one borrower with a loan in the amount of \$1.8 million declared bankruptcy, and the loan was deemed to be nonaccrual due to its credit default and undercollateralized position. The assets related to this loan are in the process of being liquidated through bankruptcy proceedings, but due to information received by the Association regarding the collateral values and bids received for the assets, it is the opinion of the Association that there will be minimal recovery. Therefore, the loan was completely charged off as of December 31, 2008. The second loan attributable to the increase in provision is also in bankruptcy and deemed to be

undercollateralized. The borrower is working on a plan of restructuring through the bankruptcy court, but due to the undercollateralized position, the Association recorded a specific allowance for loan loss.

The following table presents information concerning impaired loans as of December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Impaired loans with related allowance	\$ 191,897	\$ -	\$ -
Impaired loans with no related allowance	4,018,626	373,780	93,448
Total impaired loans	<u>\$ 4,210,523</u>	<u>\$ 373,780</u>	<u>\$ 93,448</u>
Allowance on impaired loans	<u>\$ 86,000</u>	<u>\$ -</u>	<u>\$ -</u>

The following table summarizes impaired loan information for the years ended December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Average impaired loans	<u>\$ 1,013,107</u>	<u>\$ 239,379</u>	<u>\$ 44,095</u>

Interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans at December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Interest income which would have been recognized under the original terms	\$ 148,977	\$ 372,567	\$ 15,054
Less: interest income recognized	(7,054)	(13,980)	(4,992)
Foregone interest income	<u>\$ 141,923</u>	<u>\$ 358,587</u>	<u>\$ 10,062</u>

#### NOTE 4 — PREMISES AND EQUIPMENT:

Premises and equipment consisted of the following at December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Land and improvements	\$ 191,766	\$ 191,766	\$ 191,766
Building and improvements	1,707,536	1,706,487	1,688,988
Furniture and equipment	164,222	158,448	158,114
Computer equipment and software	99,176	102,782	94,600
Automobiles	220,186	224,531	213,046
	<u>2,382,886</u>	<u>2,384,014</u>	<u>2,346,514</u>
Accumulated depreciation	(1,018,223)	(908,032)	(805,282)
Total	<u>\$ 1,364,663</u>	<u>\$ 1,475,982</u>	<u>\$ 1,541,232</u>

The Association leases office space in Dallas, Georgetown and Marble Falls, and it leases office equipment for the offices in Waco, Lampasas, Temple, Corsicana and Hillsboro. Combined office equipment lease expense was \$39,175, \$23,906 and \$23,906 for the years ended December 31, 2008, 2007 and 2006 respectively. The lease extends through December 4, 2010. Minimum annual lease payments for the next two years are as follows:

	<u>Operating</u>
2009	\$ 30,139
2010	29,249
Total	<u>\$ 59,388</u>

#### NOTE 5 — NOTE PAYABLE TO THE BANK:

The interest rate risk inherent in the Association's loan portfolio is substantially mitigated through the funding relationship with the Bank. The Bank manages interest rate risk through its direct loan pricing and asset/liability management process. The Association's indebtedness to the Bank represents borrowings by the Association to fund the majority of its loan portfolio. The indebtedness is collateralized by a pledge of substantially all of the Association's assets, and is governed by a general financing

agreement. The interest rate on the direct loan is based upon the Bank's cost of funding the loans the Association has outstanding to its borrowers.

The total amount and the weighted average interest rate of the Association's direct loan from the Bank at December 31, 2008, 2007 and 2006, was \$333,802,614 at 4.41 percent, \$315,621,025 at 5.38 percent and \$283,097,264 at 5.20 percent, respectively.

Under the Act, the Association is obligated to borrow only from the Bank unless the Bank approves borrowing from other funding sources. The Bank and FCA regulations have established limitations on the Association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2008, 2007 and 2006, the Association's note payable was within the specified limitations. The maximum amount the Association may borrow from the Bank as of December 31, 2008, was \$409,657,601, as defined by the general financing agreement.

In addition to borrowing limits, the financing agreement establishes certain covenants including limits on leases, investments, other debt, and dividend and patronage distributions; minimum standards for return on assets and for liquidity; and provisions for conducting business, maintaining records, reporting financial information, and establishing policies and procedures. Remedies specified in the financing agreement associated with the covenants include additional reporting requirements, development of action plans, increases in interest rates on indebtedness, reduction of lending limits or repayment of indebtedness. As of and for the years ended December 31, 2008, 2007 and 2006, the Association was not subject to remedies associated with the covenants in the financing agreement.

#### **NOTE 6 — MEMBERS' EQUITY:**

Protection of certain borrower equity is provided under the Act that requires the Association, when retiring protected borrower equity, to retire such equity at par or stated value regardless of its book value. Protected borrower equity includes capital stock, participation certificates and allocated equities that were outstanding as of January 6, 1988, or were issued or allocated prior to October 6, 1988. If an association is unable to retire protected borrower equity at par value or stated value, amounts required to retire this equity would be obtained from the Insurance Fund.

In accordance with the Act and Association's capitalization bylaws, each borrower is required to invest in the Association as a condition of borrowing. The investment in Class A capital stock (for farm loans) or participation certificates (for rural home and farm-related business loans) is equal to 2 percent of the loan amount, up to a maximum amount of \$1,000. The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, usually by adding the aggregate par value of the capital stock or participation certificates to the principal amount of the related loan obligation. The capital stock or participation certificates are subject to a first lien by the Association. Such stock and participation certificates may be transferred to persons who assume liability for the transferor's loan. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding capital stock or participation certificates.

If needed to meet regulatory capital adequacy requirements, the board of directors of the Association may increase the percentage of stock requirement for each borrower up to a maximum of 10 percent of the loan amount.

Each owner of Class A capital stock is entitled to a single vote, while participation certificates provide no voting rights to their owners.

Within two years of repayment of a loan, the Association capital bylaws require the conversion of any borrower's outstanding Class A to Class C stock. Class C stock has no voting rights except in a case where a new issuance of preferred stock has been submitted to stockholders affected by the preference. Redemption of Class C shares is made solely at the discretion of the Association's board of directors. At December 31, 2008, 2007 and 2006, the Association did not have Class C stock.

All borrower stock is at-risk. As such, losses that result in impairment of capital stock or participation certificates shall be borne on a pro rata basis by all holders of Class A capital stock and participation certificates. In the event of liquidation of the Association, capital stock and participation certificates would be utilized as necessary to satisfy any remaining obligations in excess of the amounts realized on the sale or liquidation of assets. Any excess of the amounts realized on the sale or liquidation of assets over the Association's obligations to external parties and to the Bank would be distributed to the holders of common stock and participation certificates, pro rata, in proportion to the number of shares or units of participation certificates then outstanding until an amount equal to the aggregate par value or unit value of all shares of such stock and participation certificates issued and outstanding has been distributed to such holders.

Dividends and patronage distributions may be paid on the capital stock and participation certificates of the Association, as the board of directors may determine by resolution subject to capitalization requirements as defined by the FCA. Amounts not distributed are retained as unallocated retained earnings. The following dividends and patronage distributions were declared and paid in 2008, 2007 and 2006, respectively:

<u>Date Declared</u>	<u>Date Paid or Payable</u>	<u>Patronage</u>
<b>December 2008</b>	<b>April 2009</b>	<b>\$2,751,042</b>
December 2007	April 2008	3,001,054
December 2006	April 2007	2,762,523

The FCA's capital adequacy regulations require the Association to achieve permanent capital and total surplus of at least 7.0 percent and core surplus of at least 3.5 percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the ratio requirements can initiate certain mandatory and possibly additional discretionary actions by the FCA that, if undertaken, could have a direct material effect on the Association's financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to stockholders unless prescribed capital standards are met. The Association's permanent capital ratio, core surplus ratio and total surplus ratio at December 31, 2008, were 18.0 percent, 17.3 percent and 17.3 percent, respectively.

The Association's board of directors has established a Capital Adequacy Plan (Plan) that includes the capital targets that are necessary to achieve the institution's capital adequacy goals as well as the minimum permanent capital standards. The Plan monitors projected dividends, patronage distributions, equity retirements and other actions that may decrease the Association's permanent capital. In addition to factors that must be considered in meeting the minimum standards, the board of directors also monitors the following factors: capability of management; quality of operating policies, procedures, and internal controls; quality and quantity of earnings; asset quality and the adequacy of the allowance for losses to absorb potential loss within the loan and lease portfolios; sufficiency of liquid funds; needs of an institution's customer base; and any other risk-oriented activities such as funding and interest rate risk, potential obligations under joint and several liability, contingent and off-balance sheet liabilities or other conditions warranting additional capital. At least quarterly, management reviews the Association's goals and objectives with the board.

The Association is required to purchase stock in the Bank. The level of stock required is calculated annually based on the average borrowings of the Association from the Bank. The required level is currently 2 percent of the average borrowing from the previous 12-month period ending November 30, 2008. The stock investment in the Bank reduces the amount of Association capital available for inclusion in the Association's capital adequacy calculations.

An FCA regulation empowers the FCA to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

At December 31, the Association had the following shares of Class A capital stock and participation certificates outstanding at a par value of \$5 per share:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Class A stock	<u>496,344</u>	<u>506,775</u>	<u>502,109</u>
Participation certificates	<u>27,827</u>	<u>25,329</u>	<u>24,286</u>
Total	<u><u>524,171</u></u>	<u><u>532,104</u></u>	<u><u>526,395</u></u>

#### **NOTE 7 — INCOME TAXES:**

The provision for income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows for the years ended December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Federal tax at statutory rate	\$ 2,335,609	\$ 2,618,722	\$ 2,639,255
Income not subject to federal tax	(2,327,452)	(2,592,374)	(2,639,255)
Patronage distributions	(10,934)	(26,680)	-
Other	2,777	332	-
Provision for income taxes	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Deferred tax assets and liabilities in accordance with SFAS No. 109, "Accounting for Income Taxes," are comprised of the following at December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<u>Deferred Tax Assets</u>			
Allowance for loan losses	\$ 2,053	\$ 828	\$ 237
Gross deferred tax assets	<u>2,053</u>	<u>828</u>	<u>237</u>
Valuation allowance	<u>(2,053)</u>	<u>(828)</u>	<u>(237)</u>
Net deferred tax asset	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The calculation of tax assets and liabilities involves various management estimates and assumptions as to the future taxable earnings.

The Association recorded valuation allowances of \$2,053, \$828 and \$237 during 2008, 2007 and 2006, respectively. The Association will continue to evaluate the realizability of the deferred tax assets and adjust the valuation allowance accordingly.

Upon adoption of FIN 48 on January 1, 2007, the Association did not need to recognize a tax liability for any uncertain tax positions and at December 31, 2008, did not recognize a tax liability for any uncertain tax position.

#### **NOTE 8 — EMPLOYEE BENEFIT PLANS:**

**Employee Retirement Plans:** Employees of the Association participate in either the defined benefit retirement plan (DB Plan) or the defined contribution plan (DC Plan) and are eligible to participate in the Farm Credit Benefits Alliance 401(k) Plan. These plans are described more fully in section G of Note 2, "Summary of Significant Accounting Policies."

**Other Postretirement Benefits:** In addition to pension benefits, the Association provides certain health care and life insurance benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities. Until December 2004, the Association participated in the District's multi-employer health and welfare plan, which provided substantially all employees with postretirement health care and life insurance benefits. Neither the assets, liabilities nor cost of the multi-employer plan were segregated or separately accounted for by participating associations. Costs were recognized only to the extent of the contributions to the plan. In December 2004, the District discontinued its multi-employer health and welfare plan, and the Association adopted a new plan to provide the same benefits to its retirees and employees. Under the new plan, the Association will no longer be joint and severally liable with any other employers.

In September 2006, the FASB issued SFAS No. 158, which required the recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. The balance sheet recognition provisions of SFAS 158 were adopted at December 31, 2007. SFAS 158 also requires that employers measure the benefit obligation and plan assets as of the fiscal year end for fiscal years ending after December 15, 2008. In fiscal 2007 and earlier, the System used a September 30 measurement date for pension and other postretirement benefit plans. The Standard provides two approaches for an employer to transition to a fiscal year-end measurement date. The System has applied the second approach, which allows for the use of the measurements determined for the prior year end.

Under this alternative, pension and postretirement benefit income measured for the three-month period October 1, 2007 to December 31, 2007 (determined using the September 2007 measurement date) was recorded as an adjustment to beginning 2008 retained earnings. As a result, the Association decreased retained earnings \$8,665, net of taxes and increased the pension and other postretirement benefit liabilities by \$8,665.

The following table reflects the benefit obligation, cost and actuarial assumptions for the Association's other postretirement benefits:

<b>Disclosure Information Under FASB Statement 132</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
<b>Change in Accumulated Postretirement Benefit Obligation</b>			
Accumulated Postretirement Benefit Obligation, Beginning of Year	\$ 936,923	\$ 962,204	\$ 1,026,338
Service cost	31,828	24,120	33,648
Interest cost	75,255	56,989	53,273
Plan participants' contributions	9,348	1,104	1,458
Plan amendments	-	-	(11,739)
Special termination benefits	-	-	-
Actuarial gain	(35,840)	(85,986)	(121,250)
Benefits paid	(39,463)	(21,508)	(19,524)
Accumulated Postretirement Benefit Obligation, End of Year	\$ 978,051	\$ 936,923	\$ 962,204
<b>Change in Plan Assets</b>			
Plan assets at fair value, beginning of year	\$ -	\$ -	\$ -
Actual return on plan assets	-	-	-
Company contributions	30,115	20,404	18,066
Plan participants' contributions	9,348	1,104	1,458
Benefits paid	(39,463)	(21,508)	(19,524)
Plan assets at fair value, end of year	\$ -	\$ -	\$ -
Funded status of the plan	\$ (978,051)	\$ (936,923)	\$ (962,204)
<b>Amounts Recognized in Statement of Financial Position</b>			
Noncurrent assets	\$ -	\$ -	\$ -
Current liabilities	(29,465)	-	-
Noncurrent liabilities	(948,586)	-	-
Total	\$ (978,051)	\$ -	\$ -
<b>Amounts Recognized in Accumulated Other Comprehensive Income</b>			
Net actuarial loss	\$ 114,598	\$ 151,456	\$ -
Prior service credit	(370,768)	(435,549)	-
Net transition obligation	-	-	-
Total	\$ (256,170)	\$ (284,093)	\$ -
<b>Additional Information</b>			
Increase in minimum liability included in other comprehensive income	\$ 27,923	\$ -	\$ -
<b>Weighted-Average Assumptions Used to Determine Obligations at Year-End</b>			
Measurement date	12/31/2008	9/30/2007	9/30/2006
Discount rate	6.30%	6.50%	6.00%
Health care cost trend rate assumed for next year (pre-/post-65) - medical	8.5%/6.5%	8.5%/6.5%	9.0%/6.75%
Health care cost trend rate assumed for next year - Rx	12.00%	12.00%	13.00%
Ultimate health care cost trend rate	5.00%	4.75%	4.75%
Year that the rate reaches the ultimate trend rate	2015	2016	2016

Service cost	\$ 25,462	\$ 24,120	\$ 33,648
Interest cost	60,204	56,989	53,273
Expected return on plan assets	-	-	-
Amortization of:			
Unrecognized net transition obligation	-	-	-
Unrecognized prior service cost	(51,825)	(55,728)	(54,919)
Unrecognized net loss	814	2,901	15,085
Net postretirement benefit cost	34,655	28,282	47,087
Adjustment to retained earnings for 2008 due to change in measurement date	\$ 8,665	\$ -	\$ -

**Other Changes in Plan Assets and Projected Benefit Obligation Recognized in Other Comprehensive Income**

Net actuarial gain	\$ (35,840)	\$ -	\$ -
Amortization of net actuarial gain	(1,018)	-	-
FAS88 recognition of gain	-	-	-
Prior service cost	-	-	-
Amortization of prior service cost	64,781	-	-
FAS88 recognition of prior service cost	-	-	-
Amortization of transition liability	-	-	-
Total recognized in other comprehensive income	\$ 27,923	\$ -	\$ -

**AOCI Amounts Expected to be Amortized into Expense in 2009**

Unrecognized net transition obligation	\$ -	\$ -	\$ -
Unrecognized prior service cost	(51,173)	(51,825)	-
Unrecognized net loss	1,651	814	-
Total	\$ (49,522)	\$ (51,011)	\$ -

**Weighted-Average Assumptions Used to Determine Benefit Cost**

Measurement date	9/30/2007	9/30/2006	9/30/2005
Discount rate	6.50%	6.00%	5.25%
Health care cost trend rate assumed for next year (pre-/post-65) - medical	9.0%/6.75%	9.0%/6.75%	9.5%/7.0%
Health care cost trend rate assumed for next year - rx	13.00%	13.00%	13.50%
Ultimate health care cost trend rate	4.75%	4.75%	4.75%
Year that the rate reaches the ultimate trend rate	2016	2016	2016

**Expected Future Cash Flows**

2008                      2007                      2006

**Expected Benefit Payments (net of employee contributions)**

Fiscal 2009	\$ 29,465	\$ -	\$ -
Fiscal 2010	38,940	-	-
Fiscal 2011	47,374	-	-
Fiscal 2012	60,161	-	-
Fiscal 2013	59,289	-	-
Fiscal 2014–2018	338,113	-	-

**Expected Contributions**

Fiscal 2009	\$ 29,465	\$ -	\$ -
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**NOTE 9 — RELATED PARTY TRANSACTIONS:**

Directors of the Association, except for any director-elected directors, are required to be borrowers/stockholders of the Association. Also, in the ordinary course of business, the Association may enter into loan origination or servicing transactions with its officers, relatives of officers and directors or with organizations with which such persons are associated. Such loans are subject to special approval requirements contained in FCA regulations and are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons for the Association amounted to \$5,006,193, \$4,724,716 and \$3,715,266 at December 31, 2008, 2007 and 2006, respectively. During 2008, \$3,003,313 of new loans were made and repayments totaled \$1,568,641. In the opinion of management, no such loans outstanding at December 31, 2008, 2007 and 2006 involved more than a normal risk of collectability.

Expenses included in purchased services may include purchased services such as administrative services, marketing, information systems, accounting services and allocations of expenses incurred by the Bank passed through to the associations such as FCSIC expenses. The Bank charges the individual associations directly for these services based on each association's proportionate usage. These expenses totaled \$303,021, \$297,803 and \$302,233 in 2008, 2007 and 2006, respectively.

The Association received patronage payments from the Bank totaling \$1,286,594, \$1,203,318 and \$1,012,052 during 2008, 2007 and 2006, respectively.

**NOTE 10 — COMMITMENTS AND CONTINGENCIES:**

In addition to those commitments and contingencies discussed in Note 2, "Summary of Significant Accounting Policies," the Association is involved in various legal proceedings in the ordinary course of business. In the opinion of legal counsel and management, there are no legal proceedings at this time that are likely to materially affect the Association.

The Association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers in the form of commitments to extend credit and commercial letters of credit. These financial instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2008, \$31,985,233 of commitments and \$1,650,763 of commercial letters of credit were outstanding.

Since some of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the balance sheet until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers, and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

**NOTE 11 — DISCLOSURE ABOUT THE FAIR VALUE OF FINANCIAL INSTRUMENTS:**

The following table presents the carrying amounts and estimated fair values of the Association's financial instruments at December 31, 2008, 2007 and 2006. Quoted market prices are generally not available for certain System financial instruments, as described below. Accordingly, fair values are based on judgments regarding anticipated cash flows, future expected loss experience, discount rates, 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.

The estimated fair values of the Association's financial instruments as of December 31 follow:

	2008		2007		2006	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets						
Cash	\$ 60,000	\$ 60,000	\$ 61,792	\$ 61,792	\$ 66,924	\$ 66,924
Loans, net	407,901,945	425,690,687	385,581,248	391,814,657	349,391,382	341,987,778
Financial liabilities						
Note payable to the bank	333,802,614	348,359,859	315,621,025	315,301,701	283,097,264	277,098,433

A description of the methods and assumptions used to estimate the fair value of each class of the Association's financial instruments for which it is practicable to estimate that value follows:

**A. Cash:**

The carrying value is a reasonable estimate of fair value.

**B. Loans:**

Because no active market exists for the Association's loans, fair value is estimated by discounting the expected future cash flows using the Association's current interest rates at which similar loans would be made to borrowers with similar credit risk. As the discount rates are based on the Association's loan rates as well as on management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics. Expected future cash flows and discount rates reflecting appropriate credit risk are determined separately for each individual pool.

Fair value of loans in nonaccrual status that are current as to principal and interest is estimated as described above, with appropriately higher discount rates to reflect the uncertainty of continued cash flows. For noncurrent nonaccrual loans, it is assumed that collection will result only from the disposition of the underlying collateral. Fair value of these loans is estimated to equal the aggregate net realizable value of the underlying collateral, discounted at an interest rate that appropriately reflects the uncertainty of the expected future cash flows over the average disposal period. Where the net realizable value of the collateral exceeds the legal obligation for a particular loan, the legal obligation is generally used in place of net realizable value.

The carrying value of accrued interest approximates its fair value.

**C. Investment in the Bank:**

Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 2, "Summary of Significant Accounting Policies," the investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying consolidated balance sheet. The Association owns 2.9 percent of the issued common stock of the Bank as of December 31, 2008. As of that date, the Bank's assets totaled \$14.8 billion and members' equity totaled \$744.5 million. The Bank's earnings were \$76.7 million during 2008.

**D. Note Payable to the Bank:**

The note payable to the Bank is not regularly traded; thus, quoted market prices are not available. Fair value of this instrument is discounted based on the Association's and Bank's loan rates as well as on management estimates. For the purposes of this estimate it is assumed that the cash flow on the note is equal to the principal payments on the Association's loan receivables plus accrued interest on the note payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures. Management has no basis to determine whether the fair values would be indicative of the value negotiated in an actual sale.

**E. Commitments to extend credit:**

The Association does not normally assess fees on its commitments to extend credit; hence, there is no fair value to be assigned to these commitments until they are funded.

**NOTE 12 – QUARTERLY FINANCIAL INFORMATION (UNAUDITED):**

Quarterly results of operations for the years ended December 31 (in thousands) follow:

	2008				
	First	Second	Third	Fourth	Total
Net interest income	\$ 3,009	\$ 2,973	\$ 3,036	\$ 2,873	\$ 11,891
(Provision for) reversal of loan losses	(50)	(50)	(50)	(1,939)	(2,089)
Noninterest expense, net	(924)	(769)	(957)	(283)	(2,933)
Net income	<u>\$ 2,035</u>	<u>\$ 2,154</u>	<u>\$ 2,029</u>	<u>\$ 651</u>	<u>\$ 6,869</u>

	2007				
	First	Second	Third	Fourth	Total
Net interest income	\$ 2,808	\$ 2,653	\$ 2,852	\$ 2,934	\$ 11,247
(Provision for) reversal of loan losses	(29)	(2,562)	(3)	1,988	(606)
Noninterest expense, net	(806)	(914)	(860)	(359)	(2,939)
Net income (loss)	<u>\$ 1,973</u>	<u>\$ (823)</u>	<u>\$ 1,989</u>	<u>\$ 4,563</u>	<u>\$ 7,702</u>

	2006				
	First	Second	Third	Fourth	Total
Net interest income	\$ 2,518	\$ 2,550	\$ 2,610	\$ 2,704	\$ 10,382
(Provision for) reversal of loan losses	(8)	(5)	(9)	(60)	(82)
Noninterest expense, net	(790)	(718)	(699)	(330)	(2,537)
Net income	<u>\$ 1,720</u>	<u>\$ 1,827</u>	<u>\$ 1,902</u>	<u>\$ 2,314</u>	<u>\$ 7,763</u>

In the fourth quarter of 2008, 2007, and 2006 the Association received its patronage from the Bank which offset a significant portion of the fourth quarter expenses.

## **DISCLOSURE INFORMATION AND INDEX**

### *Disclosures Required by Farm Credit Administration Regulations*

#### **DESCRIPTION OF BUSINESS**

The description of the territory served, the persons eligible to borrow, the types of lending activities engaged in and the financial services offered, and related Farm Credit organizations required to be disclosed in this section are incorporated herein by reference from Note 1 to the consolidated financial statements, "Organization, Restructuring, and Operations," included in this annual report.

The descriptions of significant developments that had or could have a material impact on earnings or interest rates to borrowers and acquisitions or dispositions of material assets, if any, required to be disclosed in this section are incorporated herein by reference from "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in this annual report.

#### **DESCRIPTION OF PROPERTY**

Texas Land Bank, ACA (Association) serves its 16-county territory through its main administrative and lending office at 13525 Sandalwood, Waco, Texas 76712, (254) 772-9343. Additionally, there are six branch lending offices located throughout the territory. The Association owns the office buildings in Waco, Corsicana, Hillsboro, Lampasas, and Temple, Texas, free of debt, and leases office space for the Dallas branch and Georgetown and Marble Falls contact offices.

#### **LEGAL PROCEEDINGS**

In the ordinary course of business, the Association is involved in various legal proceedings. In the opinion of legal counsel and management, there are no legal proceedings at this time that are likely to materially affect the consolidated financial statements of the Association.

#### **DESCRIPTION OF CAPITAL STRUCTURE**

The information required to be disclosed in this section is incorporated herein by reference from Note 6 to the consolidated financial statements, "Members' Equity," included in this annual report.

#### **DESCRIPTION OF LIABILITIES**

The description of contingent liabilities required to be disclosed in this section is incorporated herein by reference from Notes 2 and 10 to the consolidated financial statements, "Summary of Significant Accounting Policies" and "Commitments and Contingencies," respectively, included in this annual report.

#### **RELATIONSHIP WITH THE FARM CREDIT BANK OF TEXAS**

The Association's financial condition may be impacted by factors that affect the Farm Credit Bank of Texas (Bank), as discussed in Note 1 to the consolidated financial statements, "Organization, Restructuring, and Operations," included in this annual report. The financial condition and results of operations of the Bank may materially affect the stockholders' investment in the Association.

The Tenth Farm Credit District's (District) annual and quarterly stockholder reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag Agency, P.O. Box 202590, Austin, Texas 78720-2590 or calling (512) 483-9204. Copies of the District's annual and quarterly stockholder reports can also be requested by e-mailing [fcf@farmcreditbank.com](mailto:fcf@farmcreditbank.com). The District's annual and quarterly stockholder reports are also available on its website at [www.farmcreditbank.com](http://www.farmcreditbank.com).

The Association's quarterly stockholder reports are also available free of charge, upon request. These reports will be available approximately 40 days after quarter end and can be obtained by writing to Texas Land Bank, ACA P. O. Box 20997, Waco, Texas 76702-0997 or calling (254) 772-9343. Copies of the Association's quarterly stockholder reports can also be requested by e-mailing [sharla.chambers@texaslandbank.com](mailto:sharla.chambers@texaslandbank.com) or on the Association's website at [www.texaslandbank.com](http://www.texaslandbank.com). The Association's annual stockholder report is available on its website 75 days after the fiscal year end. Copies of the Association's annual stockholder report can also be requested 90 days after the fiscal year end.

## SELECTED FINANCIAL DATA

The selected financial data for the five years ended December 31, 2008, required to be disclosed, is incorporated herein by reference to the “Five-Year Summary of Selected Combined Financial Data” included in this annual report to stockholders.

## MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

“Management’s Discussion and Analysis,” which precedes the combined financial statements in this annual report, is incorporated herein by reference.

## DIRECTORS AND SENIOR OFFICERS

The Association’s member-elected and director-elected board of directors and senior officers are as follows:

<u>NAME</u>	<u>POSITION</u>	<u>DATE ELECTED/ EMPLOYED</u>	<u>TERM EXPIRES</u>
Barnett “Barney” Baker	Chairman	1977	2012
Burt Richards	Vice Chairman	1988	2009
Arthur Bancroft	Director	1990	2009
Derwood Cobb	Director	2000	2012
John Courtney	Director	1982	2011
N. “Sonny” Foote, Jr.	Director	1975	2011
Charles L. Hansen	Director	1970	2010
Jarvis Herbst	Director	1975	2011
Gary Murphy	Director	1988	2010
John R. Sawyer	Director	2006	2010
Clarence Fischer	Director-Elected Director	1989	2010
David W. Conrad	Director-Elected Director	2005	2009
Charles P. Gant	President/Chief Executive Officer	1981	-
J. Keith Finstad	Chief Credit Officer	1981	-
Sharla Chambers	Chief Financial Officer	2006	-
Weldon R. Schiller	Credit Office President	1979	-
Kasey McGraw	Credit Office President	2006	-
Lee Loeffler	Credit Office President	1994	-
Justin L. Wiethorn	Credit Office President	1999	-
Ryan Janek	Credit Office President	2004	-

A brief statement of the business and employment background of each director and senior officer is provided for informational purposes.

**Barnett “Barney” Baker**, age 70. Mr. Baker ranches in Burnet County near Burnet. He owns 2,969 acres, leases 1,767 acres, and has approximately 208 cows and 350 goats. He was past president and is currently a director of Burnet County Farm Bureau. During the summer, he is director of food service and construction at Camp Longhorn. He serves as a member of the Association Audit Committee. In addition, Mr. Baker serves as the Association’s representative on the District Stockholder’s Advisory Committee.

**Burt Richards**, age 66. Mr. Richards is from Fairfield, Texas. He owns and operates 2,250 acres of land in Freestone County and leases 150 acres as well as maintaining an ownership interest in Diamond Cattle Feeders in the Texas Panhandle. He serves as a director of the Navasota Valley Electric Co-Op and Elkhart Farmers Co-Op. He serves as chairman of the Association Compensation Committee and as the Association’s representative on the District Farm Credit Council.

**Arthur Bancroft**, age 70. Mr. Bancroft resides in Powell, Texas. He is a farmer, rancher and owner of Kerens Grain Elevator and Sonny’s Farm Service. Mr. Bancroft owns 1,000 acres of land in Navarro County and leases 3,000 acres. He grows milo, corn, wheat and cotton. He is a director of the Texas Cotton Growers Association. He serves as a member of the Association Compensation Committee.

**Derwood Cobb**, age 74. Mr. Cobb farms and ranches near Cameron in Milam County. He owns 887 acres and leases 3,710 acres. His farming operation consists of corn, cotton and cattle. He is a director of the Milam County Farm Bureau. He serves as a member of the Association Compensation Committee.

**John Courtney**, age 63. Mr. Courtney farms and ranches near Jonesboro in Hamilton County. He owns 1,035 acres and leases 1,825 acres. His farming operation consists of wheat, milo, oats, and hay and he runs approximately 200 cows and 100 stockers. He serves as a member of the Association Audit Committee.

**N. "Sonny" Foote, Jr.**, age 71. Mr. Foote farms and ranches near Turnersville in Coryell County. He owns 750 acres and leases 450 acres. His farming operation consists of milo, wheat, and corn, and he runs approximately 85 cows, 300 stockers and 400 sheep. In addition, he serves as a director for McLennan County Electric Co-Op and Hamilton County Soil and Water Conservation District. He serves as a member of the Association Compensation Committee.

**Charles L. Hansen**, age 84. Mr. Hansen is from Chilton, Texas. He farms and ranches in Falls and McLennan counties with principal crops of corn and wheat. He owns 554 acres and leases 540 acres. He serves as a director of Levi Water Supply Corporation, and Cottonwood Cemetery Association.

**Jarvis Herbst**, age 69. Mr. Herbst ranches near Adamsville, in Lampasas County. He owns 1,250 acres of which 330 acres are cultivated. His ranching operation consists of approximately 70 cows, 400 stockers, 75 goats and 60 sheep.

**Gary Murphy**, age 60. Mr. Murphy resides in Hubbard, Texas. He is a farmer, rancher and owner of J.P.M., Inc. and Central Texas Cotton & Grain. He owns 5,535 acres of land and leases 2,959 acres. He is a director the Texas Wheat Producers Board. He serves as a member of the Association Audit Committee.

**John R. Sawyer**, age 49. Mr. Sawyer resides in Hillsboro, Texas. He is a farmer, rancher, and operates Sawyer Farms Partnership farming approximately 3,500 acres and he owns 1,005 acres and leases another 2,595 acres. He is a board member and chairman of the Hill County Blackland Soil & Water Conservation District. He serves as a member of the Association Compensation Committee.

**Clarence Fischer**, age 81. Mr. Fischer is from Bartlett, Texas. He owns 503 acres and leases 250 acres in Bell County. His farming operation consists of milo, corn and wheat, and he owns 40 cows.

**David W. Conrad**, age 54. Mr. Conrad is from Round Rock, Texas. He is the owner of a professional accounting practice in Round Rock. He is a Certified Public Accountant. Early in his career he was employed by the Farm Credit Bank of Texas from 1982 to 1990 and served as internal auditor and director of Association Financial Operations. He is a member of the American Institute of CPAs. He serves as chairman of the Association Audit Committee.

**Charles P. Gant**, age 58. Mr. Gant serves as president and chief executive officer. He has served as senior vice president of the Association, loan officer and director of credit at the Farm Credit Bank of Texas, and president of the Federal Land Bank Association of Stephenville. He has 28 years of experience with the Farm Credit System.

**J. Keith Finstad**, age 50. Mr. Finstad serves as chief credit officer of the Association. He has served as credit office president in the Waco credit office, a loan officer and director of credit at the Farm Credit Bank of Texas, vice president of the Federal Land Bank Association of Hillsboro and loan officer trainee of the Federal Land Bank Association of Waco. He has 27 years of experience with the Farm Credit System.

**Sharla Chambers**, age 32. Ms. Chambers serves as chief financial officer of the Association, effective July 1, 2007. She began her career with the Association as controller in 2006. In addition to being a Certified Public Accountant (CPA), she has experience in corporate accounting as well as retirement plan administration and compliance. She has two years of experience with the Farm Credit System.

**Weldon R. Schiller**, age 52. Mr. Schiller serves as credit office president in the Temple credit office. He began his career with the Waco PCA in 1979, worked as a loan officer for the FLBA of Waco, and served as the regional vice president of the Farm Credit Bank of Texas, Extraco Bank in Temple and CoBank in Denver. He has 26 years of experience with the Farm Credit System.

**Kasey McGraw**, age 33. Mr. McGraw serves as credit office president of the Corsicana credit office. He has two years of experience with the Farm Credit System in addition to considerable commercial lending experience having previously served as a loan officer for a large commercial bank.

**Lee Loeffler**, age 37. Mr. Loeffler serves as credit office president in the Lampasas credit office. His prior work experience includes four years as vice president of the FLBA of South Texas and one year with the Farm Credit Bank of Texas. He has 13 years of experience with the Farm Credit System.

**Justin L. Wiethorn**, age 31. Mr. Wiethorn serves as credit office president in the Waco credit office, where he began as a loan officer trainee in June 1999. He has 8 years of experience with the Farm Credit System.

**Ryan Janek**, age 30. Mr. Janek serves as credit office president in the Hillsboro credit office. Mr. Janek has served as a credit office president for one year and prior to that was a vice president loan officer for Lone Star Ag Credit. He has 4 years' experience with the Farm Credit System.

### COMPENSATION OF DIRECTORS AND SENIOR OFFICERS

All directors other than the chairman of the board and chairman of the Audit Committee were compensated for their service to the Association in the form of an honorarium at the rate of \$600 per day for director meetings and committee meetings and \$300 per day if such meetings were held via conference call. The chairman of the board and chairman of the Audit Committee were compensated \$750 per day for director meetings and committee meetings and \$375 per day if such meetings were held via conference call. All members were reimbursed for certain expenses incurred while representing the Association in an official capacity. Mileage for attending official meetings during 2008 was paid at the IRS-approved rate per mile. A copy of the travel policy is available to stockholders of the Association per request.

Director	Number of Days Served Associated With		Total Compensation in 2008
	Board Meetings	Other Official Activities	
Barnett "Barney" Baker	11	15	\$ 18,750
Burt Richards	10	14	14,400
Arthur Bancroft	11	12	13,800
Derwood Cobb	11	12	13,800
John Courtney	11	16	15,600
N. "Sonny" Foote, Jr.	11	8	11,400
Charles L. Hansen	11	10	12,600
Jarvis Herbst	11	10	12,600
Gary Murphy	10	17	15,600
John R. Sawyer	10	7	10,200
Clarence Fischer	10	11	12,600
David W. Conrad	9	13	16,500
			<u>\$ 167,850</u>

The aggregate compensation paid to directors in 2008, 2007 and 2006 was \$167,850, \$160,125 and \$120,500, respectively. Additional detail regarding director compensation paid for committee service (which is included in the table above) is as follows:

Director	Committee	
	Audit	Compensation
Barnett "Barney" Baker	\$ 2,250	\$ -
Burt Richards	-	1,200
Arthur Bancroft	-	1,200
Derwood Cobb	-	1,200
John Courtney	3,000	-
N. "Sonny" Foote, Jr.	-	600
Charles L. Hansen	-	-
Jarvis Herbst	-	-
Gary Murphy	3,000	-
John R. Sawyer	-	1,200
Clarence Fischer	-	-
David W. Conrad	3,750	-
	<u>\$ 12,000</u>	<u>\$ 5,400</u>

The aggregate amount of reimbursement for travel, subsistence and other related expenses paid to directors and on their behalf was \$53,781, \$51,167 and \$47,657 in 2008, 2007 and 2006, respectively.

<u>Name of Individual or Group</u>	<u>Year</u>	<u>Salary</u>	<u>Bonus</u>	<u>Deferred/Perquisite</u>	<u>Total</u>
Charles P. Gant, CEO	2008	\$ 155,000	\$ 38,750	\$ 3,997	\$ 197,747
Charles P. Gant, CEO	2007	\$ 140,000	\$ 28,000	\$ 3,495	\$ 171,495
Charles P. Gant, CEO	2006	\$ 125,000	\$ 25,000	\$ 3,438	\$ 153,438
Aggregate No. of Senior Officers in Year					
(3 – includes CEO)	2008	\$ 350,000	\$ 73,750	\$ 14,884	\$ 438,634
(3 – includes CEO)	2007	\$ 319,500	\$ 53,400	\$ 17,815	\$ 390,715
(3 – includes CEO)	2006	\$ 305,000	\$ 52,050	\$ 17,575	\$ 374,625

Disclosure of information on the total compensation paid and the arrangements of the compensation plans during the last fiscal year to any senior officer or to any other officer included in the aggregate are available and will be disclosed to shareholders of the institution upon request.

Total compensation paid to the five most highly paid officers of the Association, including bonuses, was \$678,615, \$639,660 and \$565,460 in 2008, 2007 and 2006, respectively. Bonuses paid to such officers for 2008, 2007 and 2006 were \$124,075, \$118,840 and \$86,960 respectively.

Employees who use their personal automobile for business purposes were reimbursed during 2008 at the IRS-approved rate.

In addition to a base salary, employees may earn additional compensation under the Association's Performance Incentive Plan. This plan is designed to motivate employees to exceed specific performance targets related to growth and other financial measures. The plan is applicable to all employees. Bonuses are shown in the year earned. Payment of the 2008 bonus was made in December 2008.

## **TRANSACTIONS WITH DIRECTORS AND SENIOR OFFICERS**

The Association's policies on loans to and transactions with its officers and directors, required to be disclosed in this section, are incorporated herein by reference from Note 9 to the consolidated financial statements, "Related Party Transactions," included in this annual report.

## **DIRECTORS' AND SENIOR OFFICERS' INVOLVEMENT IN CERTAIN LEGAL PROCEEDINGS**

During the past five years, none of the Association's officers or directors has been involved in legal proceedings that are material to an evaluation of the ability or integrity of any person who served as a director or senior officer on January 1, 2009, or at any time during the fiscal year just ended.

## **RELATIONSHIP WITH INDEPENDENT AUDITOR**

There were no changes in the relationship with the independent auditor during 2008. The Association continues to utilize the audit and permissible tax return preparation services provided by PricewaterhouseCoopers LLP and paid \$30,955 and \$5,300 for such services in 2008.

## **FINANCIAL STATEMENTS**

The financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated March 2, 2009, and the report of management in this annual report to stockholders, are incorporated herein by reference.

## **CREDIT AND SERVICES TO YOUNG, BEGINNING AND SMALL FARMERS AND RANCHERS, AND PRODUCERS OR HARVESTERS OF AQUATIC PRODUCTS**

As an agricultural lender in Central Texas, the Association Board and management are aware that the average age of full-time agricultural operators in the area continues to grow. Board and management are also aware that the profile of producers continues to shift away from full-time operators seeking farming and ranching as a primary vocation and income source to part-time operators who seek to pursue agricultural interest to supplement off-farm income and/or for lifestyle or recreational purposes. These trending demographics are illustrated in most recent USDA census surveys.

The Association, having provided financing to agricultural interests in Central Texas for more than 91 years, recognizes the importance of having Young, Beginning and Small (YBS) farmers and ranchers to help sustain ongoing production agriculture in the local service area (LSA). Accordingly, the Association encourages entry into agriculture by providing competitively priced loan products and services tailored to fit the needs of present day operators.

In addition to competitively priced credit, the Association's New Generation Loan Program is available to Young and Beginning farmers and ranchers and provides ease for entry within this group through less stringent loan underwriting standards and reduced interest rate spreads for qualifying candidates.

The Association has established quantitative goals with an action plan to accomplish its YBS goals.

Most recent USDA census data and management's knowledge of local markets in the LSA are used to establish and monitor YBS goals and action plans. Included within the Association's action plan are coordination with other lenders and educational outreach.

For 2008, the Association's goals were:

- 1) to originate 80% of the new loan business (by number of loans) to borrowers meeting the definition(s) of YBS farmers and ranchers; and
- 2) to originate 80% of the new loan volume (by dollar amount) to borrowers meeting the definition(s) of YBS farmers and ranchers.

The following represents: a) an evaluation of the Association's achievement towards quantitative goals during 2008; and b) a comparison of the percentage of YBS loans in the Association's portfolio to the percentage of YBS farms in the LSA based on most recent USDA census data:

	<b>2008 Goal</b>	<b>2008 Results</b>
By Number of Loans	282	293
By Volume of Loans	\$62.85 million	\$67.23 million

	<b>Young</b>	<b>Beginning</b>	<b>Small</b>
Association	18.99%	52.55%	71.30%
YBS Populations in LSA	5.7%	38.9%	98.2%

The Association coordinates with other lenders to make constructive use of programs offered through governmental entities. It also offers life and disability insurance services along with leasing products through outside providers and dealers which would assist YBS candidates in their operations.

Lastly, the Association, through its outreach efforts, provides financial support to agricultural youth programs and to Texas Cooperative Extension Service programs. FFA chapters and 4-H clubs provide youth with excellent opportunities for agricultural experience and to develop leadership training which can be used later in adult life. These programs, both at local and state levels, are included within the Association's outreach program. The Texas Cooperative Extension Service provides continued education programs for current producers, many of which are YBS farmers and ranchers. The Association, through its outreach program, fully supports the Extension Service and its mission by making financial contributions and providing other forms of assistance.

Definitions for YBS farmers and ranchers

**Young:** A farmer, rancher or producer or harvester of aquatic products who is age 35 or younger as of the loan transaction date.

**Beginning:** A farmer, rancher or producer or harvester of aquatic products who has 10 years or less farming, ranching or aquatic experience as of the loan transaction date.

(A loan or lease to a "young " or "beginning" borrower qualifies for reporting if the young or beginning borrower is either obligated on the note or is an owner of the closely-held entity financed. A loan to a publicly held entity or other entity that is not closely held does not qualify for reporting.)

**Small:** A farmer, rancher or producer or harvester of aquatic products who normally generates less than \$250,000 in annual gross sales of agricultural or aquatic products.