

LONE STAR, ACA

2023 Quarterly Report First Quarter



For the Quarter Ended March 31, 2023

REPORT OF MANAGEMENT

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

/s/ Joe H. Hayman
Joe H. Hayman, Chief Executive Officer

May 10, 2023

/s/ Nicholas Acosta
Nicholas Acosta, Chief Financial Officer

May 10, 2023

/s/ Brent Neuhaus
Brent Neuhaus, Chairman, Board of Directors

May 10, 2023

/s/ David Conrad
David Conrad, Chairman, Audit Committee

May 10, 2023

First Quarter 2023 Financial Report

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LONE STAR, ACA MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis reviews the consolidated financial performance of the Lone Star, ACA, (ACA) including its wholly-owned subsidiaries Lone Star, FLCA and Lone Star, PCA, (collectively referred to herein as the "Association") for the three months ended March 31, 2023. The discussion should be read in conjunction with the Association's Annual Report to Stockholders, and notes thereto, for the year ended December 31, 2022. Operating results for the three months ended March 31, 2023, are not necessarily indicative of the results for the year ending December 31, 2023, or any future period.

The Association is a member of the Farm Credit System (System), a nationwide network of cooperatively owned financial institutions established by and subject to the provisions of the Farm Credit Act of 1971, as amended, and the regulations of the Farm Credit Administration (FCA) promulgated thereunder.

Since 1917, the Association and its predecessors have provided its members with quality financial services. The Board 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.

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The consolidated financial statements were prepared under the oversight of the Association's Audit Committee.

Patronage Refunds by Association:

In December 2022, the Board declared a cash patronage in the amount of \$25,897,526 paid in March 2023, based on 2022 patronage-sourced earnings. The patronage was paid to eligible borrowers based on their net interest margin of all Patronage Transactions outstanding for the year ending December 31, 2022. The Association's total capital position remains strong after the declaration and distribution of patronage at 14.8 percent for the period ending March 31, 2023.

Patronage Refunds Received from the Farm Credit Bank of Texas (Bank):

The following table provides information on the patronage received from the Bank for the year ended December 31, 2022:

	2022
Direct loan patronage	\$ 13,464,849
Stock investment in the Bank	785,113
Participation's patronage	709,454
Agricultural mortgage backed securities investment patronage	75,735
Total Patronage Received	<u>\$ 15,035,151</u>

The direct loan patronage received represents 66 basis points on average daily balance of the Association's direct loan with the Bank.

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 infrastructure loans through purchased participations. These loan products are available to eligible borrowers with competitive variable, fixed, adjustable, SOFR-based, and prime-based interest rates. Commercial loans primarily consist of operating loans and short-term loans for working capital, equipment and livestock. Mortgage loans primarily consist of 5- to 30- year maturities. 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.

Total loans outstanding at March 31, 2023, including nonaccrual loans, were \$2,512,485,804 compared to \$2,488,863,549 at December 31, 2022, reflecting an increase of 1.0 percent. Total nonaccrual loans outstanding at March 31, 2023, were \$7,821,993 compared to \$1,835,657 at December 31, 2022, reflecting an increase of 326.1% attributed to a capital markets relationship moving to nonaccrual status. Nonaccrual loans as a percentage of total loans outstanding were 0.3 percent at March 31, 2023, compared to 0.1 percent at December 31, 2022.

The Association recorded \$2,114 in recoveries and no charge-offs for the quarter ended March 31, 2023, and \$3,153 in recoveries and no charge-offs for the same period in 2022. The Association's allowance for credit losses was 0.2 percent and 0.2 percent of total loans outstanding as of March 31, 2023, and December 31, 2022, respectively.

Risk Exposure:

High-risk assets include nonaccrual loans, loans that 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.

	March 31, 2023		December 31, 2022	
	Amount	%	Amount	%
Nonaccrual	\$ 7,821,993	100.0%	\$ 1,835,657	63.0%
Accruing restructured loans	-	0.0%	1,079,596	37.0%
Total	\$ 7,821,993	100.0%	\$ 2,915,253	100.0%

At March 31, 2023, and December 31, 2022, the Association held no property classified as other property owned, net, and no loans that are past due 90 days or more and still accruing interest.

Results of Operations:

The Association had net income of \$12,522,405 for the three months ended March 31, 2023, as compared to net income of \$13,673,179 for the same period in 2022, reflecting a decrease of 8.4 percent. Net interest income was \$17,167,240 for the three months ended March 31, 2023, compared to \$16,556,927 for the same period in 2022.

	Three Months Ended		March 31, 2022	
	March 31, 2023		March 31, 2022	
	Average Balance	Interest	Average Balance	Interest
Loans	\$ 2,507,105,359	\$ 32,533,357	\$ 2,338,943,214	\$ 25,977,172
Total interest-earning assets	2,507,105,359	32,533,357	2,338,943,214	25,977,172
Interest-bearing liabilities	2,108,773,903	15,366,117	1,959,170,544	9,420,245
Impact of capital	\$ 398,331,456		\$ 379,772,670	
Net interest income		\$ 17,167,240		\$ 16,556,927

	2023	2022
	Average Yield	Average Yield
Yield on loans	5.26%	4.50%
Total yield on interest-earning assets	5.26%	4.50%
Cost of interest-bearing liabilities	2.96%	1.95%
Interest rate spread	2.30%	2.55%

	Three months ended:		
	March 31, 2023 vs. March 31, 2022		
	Increase (decrease) due to		
	Volume	Rate	Total
Interest income - loans	\$ 1,867,692	\$ 4,688,493	\$ 6,556,185
Interest expense	719,326	5,226,546	5,945,872
Net interest income	\$ 1,148,366	\$ (538,053)	\$ 610,313

Interest income for the three months ended March 31, 2023, increased by \$6,556,185 or 25.2 percent, from the same period of 2022, primarily due to an increase in average interest-earning assets and yield on interest-earning assets. Interest expense for the three months ended March 31, 2023, increased by \$5,945,872 or 63.1 percent, from the same period of 2022, due to an increase in interest-bearing liabilities and cost of interest-bearing liabilities. Average loan volume for the first quarter of 2023 was \$2,507,105,359, compared to \$2,338,943,214 for the first quarter of 2022. The average net interest rate spread on the loan portfolio for the first quarter of 2023 was 2.30 percent, compared to 2.55 percent for the first quarter of 2022.

The Association's return on average assets for the three months ended March 31, 2023, was 1.98 percent compared to 2.32 percent for the same period in 2022. The Association's return on average equity for the three months ended March 31, 2023, was 12.14 percent, compared to 14.15 percent for the same period in 2022.

Noninterest income for the three months ended March 31, 2023, increased by \$58,816 or 1.6 percent, compared to the same period of 2022, primarily due to an increase in patronage income from the Bank offset by a decrease in other noninterest income. Noninterest expenses for the three months ended March 31, 2023, increased by \$1,726,550 or 24.5 percent, compared to the same period of 2022, primarily due to an increase in salary and employee benefits attributed to planned merit increases and an increase in purchased services.

Provisions for credit losses for the three months ended March 31, 2023, increased by \$95,586 or 23.8 percent, compared to the same period last year, primarily due to an increase in loan assets in 2023.

Liquidity and Funding Sources:

The Association secures the majority of its lendable funds from the Bank, which obtains its funds through the issuance of System-wide obligations and with lendable equity. The following schedule summarizes the Association's borrowings.

	March 31, 2023	December 31, 2022
Note payable to the Bank	\$ 2,126,799,732	\$ 2,081,970,432
Accrued interest on note payable	5,445,374	4,983,163
Total	<u>\$ 2,132,245,106</u>	<u>\$ 2,086,953,595</u>

The outstanding balance of the note payable to the Bank of \$2,126,799,732 as of March 31, 2023, is recorded as a liability on the Association's balance sheet. The note carried a weighted average interest rate of 3.01 percent at March 31, 2023. The indebtedness is collateralized by a pledge of substantially all of the Association's assets to the Bank and is governed by the General Financing Agreement (GFA). The increase in note payable to the Bank since December 31, 2022, correlates directly with the overall increase in the Association's accrual loan volume for the period. The Association's own funds, which represent the amount of the Association's loan portfolio funded by the Association's equity, were \$389,215,278 at March 31, 2023. The maximum amount the Association may borrow from the Bank as of March 31, 2023, was \$2,521,908,642 as defined by the GFA. The indebtedness continues in effect until the expiration date of the GFA, which is September 30, 2023, unless sooner terminated by the Bank upon the occurrence of an event of default, or by the Association, in the event of a breach of this agreement by the Bank, upon giving the Bank 30 calendar days' prior written notice, or in all other circumstances, upon giving the Bank 120 days' prior written notice.

Capital Resources:

The Association's capital position increased by \$12,289,686 at March 31, 2023, compared to December 31, 2022. The Association's debt as a percentage of members' equity was 5.05:1 as of March 31, 2023, compared to 5.17:1 as of December 31, 2022.

FCA regulations require the Association to maintain minimums for various regulatory capital ratios. New regulations became effective January 1, 2017, which replaced the previously required core surplus and total surplus ratios with common equity tier 1, tier 1 capital, and total capital risk-based capital ratios. The new regulations also added tier 1 leverage and unallocated retained earnings and equivalents (UREE) ratios. The permanent capital ratio continues to remain in effect, with some modifications to align with the new regulations. As of March 31, 2023, the Association exceeded all regulatory capital requirements.

Economic Conditions:

The Association continues to fulfill its mission to support agriculture and rural communities by providing access to reliable and consistent credit. The Association is closely monitoring its loan portfolio overall and is particularly focused on sectors that may be pressured by factors such as persistently high inflation, a rapidly increasing interest rate environment, and financial market stress that led to the failure of two U.S. regional banks in March 2023. Capital levels remained strong to support any adversity.

The Consumer Price Index for All Urban Consumers increased by 5.0 percent for the 12-month period ending March 2023, down from 6.5 percent in December, and 8.5 percent for the same period in 2022. A four-decade high of 9.1 percent was reached in June 2022, but the rate of inflation has been receding month-over-month since that time. As of May 3, 2023, the range of the Federal funds target rate was 5.00 – 5.25 percent, including the latest 25 basis point increase that became effective on May 3, 2023. At the meeting on May 3, 2023, the Federal Open Market Committee (FOMC) signaled it could now pause rate hikes if inflation continues to ease as expected.

On March 30, the U.S. Bureau of Economic Analysis (BEA) released its third estimate of real gross domestic product (GDP) for the fourth quarter of 2022. After two consecutive quarters of negative growth during the first half of 2022, the U.S. economy expanded at annualized rates of 3.2 percent and 2.6 percent, respectively, in the third and fourth quarters of 2022. The International Monetary Fund's World Economic Outlook Update released in April 2023 stated that U.S. real GDP growth is estimated to be 1.6 percent in 2023 and 1.1 percent in 2024. Additionally, the BEA released fourth quarter 2022 annualized real GDP growth rates for the Texas District on March 31. Growth rates ranged from a low of 1.5 percent in Mississippi to a high of 7.0 percent in Texas. Texas led the nation in real GDP growth during the fourth quarter.

The U.S. Bureau of Labor Statistics indicated that the U.S. unemployment rate increased month-over-month from 3.4 percent in January to 3.6 percent in February 2023. Despite the slight increase, the unemployment rate remained below the prior year level and historical averages. The February 2023 state unemployment rates in the Texas District ranged from a low of 2.5 percent in Alabama to a high of 4.0 percent in Texas. Although unemployment rates increased in three of five Texas District states month-over-month during February and from December 2022, employment conditions remained strong.

The West Texas Intermediate (WTI) crude oil futures price (front-month) decreased to an average of about \$76 per barrel during the first quarter of 2023 from \$83 per barrel in the prior quarter and about \$95 per barrel during the same period a year ago. In the March 2023 edition of the Short-Term Energy Outlook, the U.S. Energy Information Administration estimated that the monthly average WTI spot price would be about \$77 per barrel in 2023 and nearly \$72 per barrel in 2024. However, production cuts announced by major oil-exporting countries in early April are likely to contribute to higher global oil prices relative to earlier estimates.

On March 31, 2023, the U.S. Department of Agriculture (USDA) released its 2023 Prospective Plantings report. Corn planted area was estimated at 92.0 million acres in 2023, up nearly 4.0 percent from last year. Corn planted acreage is expected to be up or unchanged in 40 of the 48 estimating states. Soybean planted area for 2023 was estimated at 87.5 million acres, up slightly from last year. All wheat planted area is estimated at 49.9 million acres, up about 9.1 percent from 2022. All cotton planted area was estimated at 11.3 million acres, down about 18.2 percent from last year. These estimates are derived via a survey of farmers' intentions and are subject to change throughout the season.

USDA indicated in its March 2023 World Agricultural Supply and Demand Estimates (WASDE) report that farmers are likely to receive higher prices for corn (+10.0 percent), soybeans (+7.5 percent), and wheat (+18.0 percent) in the 2022/23 marketing year compared to the previous season. However, cotton producers are projected to receive lower prices (-9.2 percent) as exports and domestic use are expected to decline. Additionally, the average price received by farmers for all milk is projected to decrease by about 20.0 percent year-over-year in 2023, after rising nearly 38.0 percent in 2022. USDA projects that average steer prices (5-Area, Direct) will continue rising year-over-year by about 12.2 percent in 2023, while broilers and barrows and gilts prices are projected to decline by about 7.3 percent and 9.6 percent, respectively. Random length lumber futures prices declined by more than 60.0 percent year-over-year as of March 2023, as interest rates have continued to rise and the possibility of a recession remains elevated.

At least two significant climate-related events impacted the Texas District during the first quarter of 2023. A winter storm brought freezing rain and sleet to Texas during late January and early February. The storm resulted in power outages for more than 300,000 customers, damage to vegetation and dangerous travel conditions. Additionally, powerful thunderstorms swept through Mississippi and Alabama on the evening of March 24, 2023, producing multiple tornadoes. The National Weather Service indicated that there were 20 reports of tornadoes across the two states on March 24. Although these storms caused significant damage in some local areas, none are anticipated to have a material impact on the Association's loan portfolio.

During 2023, agricultural producers and processors may be negatively impacted by several factors, including volatile commodity prices, high input costs, export market disruptions, geopolitical challenges, economic slowdown, and adverse weather conditions.

Significant Recent Accounting Pronouncements:

Refer to Note 1 – "Organization, Mergers, and Significant Accounting Policies" in this quarterly report for disclosures of recent accounting pronouncements which may impact the Association's consolidated financial position and results of operations and for critical accounting policies.

Relationship With the Bank:

The Association's financial condition may be impacted by factors that affect the Bank. The financial condition and results of operations of the Bank may materially affect the stockholder's investment in the Association. The Management's Discussion and Analysis and Notes to Financial Statements contained in the 2022 Annual Report of the Association more fully describe the Association's relationship with the Bank.

The annual and quarterly stockholder reports of the Bank are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, Corporate Communications, P.O. Box 202590, Austin, Texas 78720, or by calling (512) 465-1881. The annual and quarterly stockholder reports are also available on its website at www.farmcreditbank.com.

The Association's annual and quarterly stockholder reports are also available free of charge, upon request. The annual and quarterly stockholder reports are available approximately 75 days after year end and 40 days after quarter end, respectively, and can be obtained by writing to Lone Star, ACA, 1612 Summit Avenue, Suite 300, Fort Worth, Texas 76102 or calling (817) 332-6565. The annual and quarterly stockholder reports for the Association are also available on its website at www.lonestaragcredit.com. Copies of the reports can also be requested by e-mailing ShareHolderRelations@lonestaragcredit.com.

LONE STAR, ACA

CONSOLIDATED BALANCE SHEETS

	March 31, 2023 (unaudited)	December 31, 2022
<u>ASSETS</u>		
Cash	\$ 84,977	\$ 34,734
Loans	2,512,485,804	2,488,863,549
Less: allowance for credit losses on loans	<u>(5,541,826)</u>	<u>(5,746,994)</u>
Net loans	2,506,943,978	2,483,116,555
Accrued interest receivable	14,129,493	12,614,518
Investment in and receivable from the Bank:		
Capital stock	40,636,415	40,638,710
Other	3,232,941	2,356,854
Premises and equipment, net	3,799,405	3,770,067
Other assets	<u>3,910,064</u>	<u>4,122,189</u>
Total assets	<u><u>\$ 2,572,737,273</u></u>	<u><u>\$ 2,546,653,627</u></u>
<u>LIABILITIES</u>		
Note payable to the Bank	\$ 2,126,799,732	\$ 2,081,970,432
Accrued interest payable	5,445,374	4,983,163
Drafts outstanding	20,366	257,815
Patronage dividends payable	-	25,897,526
Other liabilities	<u>15,558,273</u>	<u>20,920,849</u>
Total liabilities	<u><u>2,147,823,745</u></u>	<u><u>2,134,029,785</u></u>
<u>MEMBERS' EQUITY</u>		
Capital stock and participation certificates	5,797,790	5,816,750
Additional paid-in capital	91,343,553	91,343,553
Unallocated retained earnings	327,597,031	315,281,755
Accumulated other comprehensive income	<u>175,154</u>	<u>181,784</u>
Total members' equity	<u><u>424,913,528</u></u>	<u><u>412,623,842</u></u>
Total liabilities and members' equity	<u><u>\$ 2,572,737,273</u></u>	<u><u>\$ 2,546,653,627</u></u>

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

LONESTAR, ACA

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)

	Three Months Ended March 31,	
	2023	2022
<u>INTEREST INCOME</u>		
Loans	\$ 32,533,357	\$ 25,977,172
Total interest income	32,533,357	25,977,172
<u>INTEREST EXPENSE</u>		
Note payable to the Bank	15,363,825	9,420,176
Advance conditional payments	2,292	69
Total interest expense	15,366,117	9,420,245
Net interest income	17,167,240	16,556,927
<u>REVERSAL OF PROVISION FOR CREDIT LOSSES</u>	(306,849)	(402,435)
Net interest income after reversal of provision for credit losses	17,474,089	16,959,362
<u>NONINTEREST INCOME</u>		
Income from the Bank:		
Patronage income	3,567,149	3,368,567
Loan fees	130,565	176,334
Financially related services income	542	824
Gain on sale of premises and equipment, net	73,866	25,235
Other noninterest income	48,007	190,353
Total noninterest income	3,820,129	3,761,313
<u>NONINTEREST EXPENSES</u>		
Salaries and employee benefits	4,765,648	3,687,828
Directors' expense	160,914	126,201
Purchased services	813,370	516,739
Travel	141,543	182,153
Occupancy and equipment	691,213	673,093
Communications	66,696	62,923
Advertising	196,872	262,437
Public and member relations	526,031	389,601
Supervisory and exam expense	171,948	158,909
Insurance Fund premiums	921,823	720,802
Other components of net periodic postretirement benefit cost	50,166	50,451
Other noninterest expense	260,436	208,973
Total noninterest expenses	8,766,660	7,040,110
Income before income taxes	12,527,558	13,680,565
Provision for income taxes	5,153	7,386
NET INCOME	12,522,405	13,673,179
Other comprehensive income:		
Change in postretirement benefit plans	(6,630)	7,827
COMPREHENSIVE INCOME	\$ 12,515,775	\$ 13,681,006

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY
(unaudited)

	Capital Stock/ Participation Certificates	Additional Paid-in-Capital	Retained Earnings		Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
			Allocated	Unallocated		
Balance at December 31, 2021	\$ 5,929,630	\$ 91,343,553	\$ -	\$ 290,017,251	\$ (954,347)	\$ 386,336,087
Comprehensive income	-	-	-	13,673,179	7,827	13,681,006
Capital stock/participation certificates issued	237,610	-	-	-	-	237,610
Capital stock/participation certificates retired	(238,965)	-	-	-	-	(238,965)
Dividends declared	-	-	-	55,124	-	55,124
Balance at March 31, 2022	<u>\$ 5,928,275</u>	<u>\$ 91,343,553</u>	<u>\$ -</u>	<u>\$ 303,745,554</u>	<u>\$ (946,520)</u>	<u>\$ 400,070,862</u>
Balance at December 31, 2022	\$ 5,816,750	\$ 91,343,553	\$ -	\$ 315,281,755	\$ 181,784	\$ 412,623,842
Comprehensive income	-	-	-	12,522,405	(6,630)	12,515,775
Capital stock/participation certificates issued	106,685	-	-	-	-	106,685
Capital stock/participation certificates retired	(125,645)	-	-	-	-	(125,645)
Dividends declared	-	-	-	(74,756)	-	(74,756)
Cumulative impact of adoption of new accounting standard	-	-	-	(132,373)	-	(132,373)
Balance at March 31, 2023	<u>\$ 5,797,790</u>	<u>\$ 91,343,553</u>	<u>\$ -</u>	<u>\$ 327,597,031</u>	<u>\$ 175,154</u>	<u>\$ 424,913,528</u>

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

LONE STAR, ACA
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 — ORGANIZATION, MERGERS, AND SIGNIFICANT ACCOUNTING POLICIES:

Lone Star, ACA, including its wholly-owned subsidiaries, Lone Star, PCA and Lone Star, FLCA, 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, Borden, Bosque, Bowie, Burnet, Camp, Cass, Cooke, Coryell, Dallas, Delta, Denton, Eastland, Ellis, Erath, Falls, Fannin, Fisher, Freestone, Grayson, Hamilton, Hill, Hood, Johnson, Kent, Lamar, Lampasas, Limestone, McLennan, Milam, Mitchell, Morris, Navarro, Nolan, Palo Pinto, Parker, Red River, Scurry, Shackelford, Somervell, Stephens, Tarrant, Taylor, Throckmorton, Titus, Williamson, Wise and Young in the state of Texas. The Association is a lending institution of the Farm Credit System, which was established by Acts of Congress to meet the needs of American agriculture.

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. (GAAP) for interim financial information. Accordingly, they do not include all of the disclosures required by GAAP for annual financial statements and should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2022, as contained in the 2022 Annual Report to Stockholders.

In the opinion of management, the accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles (GAAP), except for the inclusion of a statement of cash flows. GAAP require a business enterprise that provides a set of financial statements reporting both financial position and results of operations to also provide a statement of cash flows for each period for which results of operations are provided. In regulations issued by FCA, associations have the option to exclude statements of cash flows in interim financial statements. Therefore, the Association has elected not to include a statement of cash flows in these consolidated financial statements. These interim financial statements should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2022, as contained in the 2022 Annual Report to Stockholders. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year ending December 31, 2023. Descriptions of the significant accounting policies are included in the 2022 Annual Report to Stockholders. In the opinion of management, these policies and the presentation of the interim financial condition and results of operations conform with GAAP and prevailing practices within the banking industry.

Effective December 16, 2022, the Association signed a letter of intent to pursue a mutually beneficial merger transaction with Ag New Mexico Farm Credit, ACA, pending completion of due diligence of each other's operations. This is the first step in a process for developing definitive terms and conditions for a plan of merger. The proposed effective date for the merger is October 2, 2023, or as soon as practicable thereafter. Additional disclosures will be provided to stockholders during 2023 under timelines dictated by Farm Credit regulations.

In March 2022, the Financial Accounting Standards Board (FASB) issued an update entitled, "Financial Instruments - Credit Losses: Troubled Debt Restructurings and Vintage Disclosures." The guidance eliminates the accounting guidance for troubled debt restructurings (TDRs) by creditors while enhancing disclosure requirements for certain loan refinancing and restructurings when a borrower is experiencing financial difficulty. The creditor will have to apply the guidance to determine whether a modification results in a new loan or a continuation of an existing loan. In addition to the TDR guidance, the update requires public business entities, including the Association, to disclose current period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of the credit losses standard. These amendments became effective for the Association at the time of adoption of the measurement of credit losses on financial instruments standard on January 1, 2023.

In June 2016, the FASB issued guidance entitled "Measurement of Credit Losses on Financial Instruments." The guidance replaces the current incurred loss impairment methodology with a single allowance framework for financial assets carried at amortized cost, which reflects management's estimate of expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For public business entities that are not U.S. Securities and Exchange Commission filers including the Association, this guidance became effective for interim and annual reporting periods beginning after December 15, 2022.

The Association estimates losses over a two-year forecast period using a range of macroeconomic variables and then revert to the Association's historical loss experience over an extended period of time. The impact of adoption of the standard was immaterial to the Association's financial condition.

Recently Adopted Accounting Pronouncements:

The Association adopted the Financial Accounting Standards Board (FASB) guidance entitled “Measurement of Credit Losses on Financial Instruments” and other subsequently issued accounting standards updates related to credit losses on January 1, 2023. This guidance replaced the current incurred loss impairment methodology with a single allowance framework for financial assets carried at amortized cost and certain off-balance sheet credit exposures. This guidance requires management to consider in its estimate of the allowance for credit losses (ACL) relevant historical events, current conditions and reasonable and supportable forecasts that affect the collectability of the assets.

Also adopted effective January 1, 2023, was the updated guidance entitled “Financial Instruments – Credit Losses: Troubled Debt Restructurings and Vintage Disclosure.” This guidance requires the creditor to determine whether a modification results in a new loan or a continuation of an existing loan, among other disclosures specific to modifications with borrowers that are experiencing financial difficulties. The update eliminated the accounting guidance for troubled debt restructurings by creditors. The update also requires disclosure of current period gross write-offs by year of origination for financing receivables and net investments in leases.

The following table presents the impact to the allowance for credit losses and retained earnings upon adoption of this guidance on January 1, 2023:

	December 31, 2022	CECL adoption impact	January 1, 2023
Assets:			
Allowance for credit losses on loans	\$ 5,746,994	\$ (30,078)	\$ 5,716,916
Liabilities:			
Allowance for credit losses on unfunded commitments	\$ 114,594	\$ 162,451	\$ 277,045
Retained earnings:			
Unallocated retained earnings, net of tax	\$ 315,281,755	\$ (132,373)	\$ 315,149,382

Loans

Loans are generally carried at their principal amount outstanding adjusted for charge-offs, deferred loan fees or costs, and valuation adjustments relating to hedging activities. Loan origination fees and direct loan origination costs are netted and capitalized and the net fee or cost is amortized over the average life of the related loan as an adjustment to interest income. Loan prepayment fees are reported in interest income. Interest on loans is accrued and credited to interest income based on the daily principal amount outstanding.

Nonaccrual Loans

Nonaccrual loans are loans for which there is reasonable doubt that all principal and interest will not be collected according to the original contractual terms and are generally considered substandard or doubtful, which is in accordance with the loan rating model, as described below. 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 modified or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full.

Consistent with prior practice, 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), circumstances indicate that collection of principal and interest is in doubt or legal action, including foreclosure or other forms of collateral conveyance, has been initiated to collect the outstanding principal and interest. At the time a loan is placed in nonaccrual status, accrued interest that is considered uncollectible is reversed (if accrued in the current year) or charged against the allowance for credit losses (if accrued in prior years). Loans are charged-off at the time they are determined to be uncollectible.

When loans are in nonaccrual status, interest payments received in cash are generally recognized as interest income if the collectability of the loan principal is fully expected and certain other criteria are met. Otherwise, payments received on nonaccrual loans are applied against the recorded investment in the loan asset. Nonaccrual loans are returned to accrual status if all contractual principal and interest is current, the borrower is fully expected to fulfill the contractual repayments terms and after remaining current as to principal and interest for a sustained period or have a recent repayment pattern demonstrating future repayment capacity to make on-time payments. If previously unrecognized interest income exists at the time the loan is transferred to accrual status, cash received at the time of or subsequent to the transfer should first be recorded as interest income until such time as the recorded balance equals the contractual indebtedness of the borrower.

Accrued interest receivable

The Association elected to continue classifying accrued interest on loans in accrued interest receivable and not as part of loans or investments on the Consolidated Balance Sheet. The Association also elected to not estimate an allowance on interest receivable balances because the nonaccrual policies in place provide for the accrual of interest to cease on a timely basis when all contractual amounts are not expected.

Loan Modifications to Borrowers Experiencing Financial Difficulty

Loan modifications may be granted to borrowers experiencing financial difficulty. Modifications can be in the form of one or a combination of principal forgiveness, interest rate reduction, other-than-insignificant payment delay or a term extension. Covenant waivers and modifications of contingent acceleration clauses are not considered term extensions.

Collateral dependent loans

Collateral dependent loans are loans secured by collateral, including but not limited to agricultural real estate, crop inventory, equipment and livestock. CECL requires the Association to measure the expected credit losses based on fair value of the collateral at the reporting date when the Association determines that foreclosure is probable. Additionally, CECL allows a fair value practical expedient as a measurement approach for loans when the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulties. Under the practical expedient measurement approach, the expected credit losses is based on the difference between the fair value of the collateral less estimated costs to sell and the amortized cost basis of the loan.

Allowance for Credit Losses

Beginning January 1, 2023, the allowance for credit losses (ACL) represents the estimated current expected credit losses over the remaining contractual life of financial assets measured at amortized cost and certain off-balance sheet credit exposures. The ACL takes into consideration relevant information about past events, current conditions and reasonable and supportable macroeconomic forecasts of future conditions. The contractual term excludes expected extensions, renewals and modifications unless the extension or renewal options are not unconditionally cancellable. The ACL comprises:

- the allowance for credit losses on loans (ACLL)
- the allowance for unfunded commitments, which is presented on the balance sheet in other liabilities

Determining the appropriateness of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, considering macroeconomic conditions, forecasts and other factors prevailing at the time, may result in significant changes in the ACL in those future periods.

Methodology for Allowance for Credit Losses on Loans

The ACLL represents management's estimate of credit losses over the remaining expected life of loans. Loans are evaluated on the amortized cost basis, including premiums, and discounts.

The Association employs a disciplined process and methodology to establish its ACLL that has two basic components: first, an asset-specific component involving individual loans that do not share risk characteristics with other loans and the measurement of expected credit losses for such individual loans; and second, a pooled component for estimated expected credit losses for pools of loans that share similar risk characteristics.

Asset-specific loans are generally collateral-dependent loans (including those loans for which foreclosure is probable) and nonaccrual loans. For an asset-specific loan, expected credit losses are measured as the difference between the amortized cost basis in the loan and the present value of expected future cash flows discounted at the loan's effective interest rate except that, for collateral-dependent loans, credit loss is measured as the difference between the amortized cost basis in the loan and the fair value of the underlying collateral. The fair value of the collateral is adjusted for the estimated cost to sell if repayment or satisfaction of a loan is dependent on the sale (rather than only on the operation) of the collateral. In accordance with the institution's appraisal policy, the fair value of collateral-dependent loans is based upon independent third-party appraisals or on collateral valuations prepared by in-house appraisers. When an updated appraisal or collateral valuation is received, management reassesses the need for adjustments to the loan's expected credit loss measurements and, where appropriate, records an adjustment. If the calculated expected credit loss is determined to be permanent, fixed or non-recoverable, the credit loss portion of the loan will be charged off against the allowance for credit losses.

In estimating the component of the ACLL that share common risk characteristics, loans are evaluated collectively and segregated into loan pools considering the risk associated with the specific pool. Relevant risk characteristics include loan type, commodity, credit quality rating, delinquency category or business segment or a combination of these classes. The allowance is determined based on a quantitative calculation of the expected life-of-loan loss percentage for each loan category by considering the probability of default, based on the migration of loans from performing to loss by credit quality rating or delinquency buckets using historical life-of-loan analysis periods for loan types, and the severity of loss, based on the aggregate net lifetime losses incurred per loan pool.

The component of the ACLL also considers factors for each loan pool to adjust for differences between the historical period used to calculate historical default and loss severity rates and expected conditions over the remaining lives of the loans in the portfolio related to:

- lending policies and procedures;
- national, regional and local economic business conditions and developments that affect the collectability of the portfolio, including the condition of various markets;
- the nature of the loan portfolio, including the terms of the loans;
- the experience, ability and depth of the lending management and other relevant staff;
- the volume and severity of past due and adversely classified or graded loans and the volume of nonaccrual loans;
- the quality of the loan review and process;
- the value of underlying collateral for collateral-dependent loans;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio.

The Association uses multiple scenarios over reasonable and supportable forecast period of two years. Subsequent to the forecast period, the Association reverts to long run historical loss experience beyond the two years on a straight-line basis over a one-year reversion period to inform the estimate of losses for the remaining contractual life of the loan portfolio.

The economic forecasts incorporate macroeconomic variables, including unemployment rates, U.S. BBB Credit Spread, and Dow Jones Total Stock Market Index. Also considered are loan and borrower characteristics, such as internal risk ratings, delinquency status, collateral type, and the remaining term of the loan, adjusted for expected prepayments.

In addition to the quantitative calculation, the Association considers the imprecision inherent in the process and methodology, emerging risk assessments and other subjective factors, which may lead to a management adjustment to the modeled ACLL results. Expected credit loss estimates also include consideration of expected cash recoveries on loans previously charged-off or expected recoveries on collateral dependent loans where recovery is expected through sale of the collateral. The economic forecasts are updated on a quarterly basis.

Prior to January 1, 2023, the allowance for credit losses was maintained at a level considered adequate to provide for probable losses existing in and inherent in the loan portfolio. The allowance was based on a periodic evaluation of the loan portfolio in which numerous factors are considered, including economic conditions, collateral values, borrowers' financial conditions, loan portfolio composition and prior loan loss experience. The allowance for credit losses encompassed various judgments, evaluations and appraisals with respect to the loans and their underlying collateral that, by their nature, contain elements of uncertainty and imprecision. Changes in the agricultural economy and their impact on borrower repayment capacity would cause these various judgments, evaluations and appraisals to change over time. Management considered a number of factors in determining and supporting the levels of the allowances for credit losses, which include, but are not limited to, the concentration of lending in agriculture, combined with uncertainties associated with farmland values, commodity prices, exports, government assistance programs, regional economic effects and weather-related influences.

Allowance for Credit Losses on Unfunded Commitments

The Association evaluates the need for an allowance for credit losses on unfunded under CECL and, if required, an amount is recognized and included in other liabilities on the Consolidated Balance Sheet. The amount of expected losses is determined by calculating a commitment usage factor over the contractual period for exposures that are not unconditionally cancellable by the Association and applying the loss factors used in the ACLL methodology to the results of the usage calculation. No allowance for credit losses are recorded for commitments that are unconditionally cancellable.

NOTE 2 — LOANS AND ALLOWANCE FOR CREDIT LOSSES:

A summary of loans follows:

Loan Type	March 31, 2023	December 31, 2022
	Amount	Amount
Production agriculture:		
Real estate mortgage	\$ 2,049,219,518	\$ 2,051,012,187
Production and intermediate-term	145,457,414	142,928,419
Agribusiness:		
Loans to cooperatives	18,291,142	14,324,718
Processing and marketing	161,665,101	152,485,459
Farm-related business	43,759,031	46,743,665
Communication	44,941,516	42,348,853
Energy	29,634,818	21,699,213
Water and wastewater	968,611	982,235
Rural residential real estate	8,616,787	7,940,684
International	9,931,866	8,398,116
Total	<u>\$ 2,512,485,804</u>	<u>\$ 2,488,863,549</u>

The Association purchases or sells participation interests with other parties in order to diversify risk, manage loan volume and comply with Farm Credit Administration regulations. The following table presents information regarding the balances of participations purchased and sold at March 31, 2023:

	Other Farm Credit Institutions		Non-Farm Credit Institutions		Total	
	Participations	Participations	Participations	Participations	Participations	Participations
	Purchased	Sold	Purchased	Sold	Purchased	Sold
Real estate mortgage	\$ 24,073,213	\$ 199,815,746	\$ 4,545,563	\$ -	\$ 28,618,776	\$ 199,815,746
Production and intermediate-term	80,743,354	17,305,907	-	-	80,743,354	17,305,907
Agribusiness	204,129,521	5,224,745	-	-	204,129,521	5,224,745
Communication	44,941,516	-	-	-	44,941,516	-
Energy	29,634,818	-	-	-	29,634,818	-
Water and wastewater	968,611	-	-	-	968,611	-
International	9,931,866	-	-	-	9,931,866	-
Total	<u>\$ 394,422,899</u>	<u>\$ 222,346,398</u>	<u>\$ 4,545,563</u>	<u>\$ -</u>	<u>\$ 398,968,462</u>	<u>\$ 222,346,398</u>

The Association is authorized under the Farm Credit Act to accept “advance conditional payments” (ACPs) from borrowers. To the extent the borrower’s access to such ACPs is restricted and the legal right of setoff exists, the ACPs are netted against the borrower’s related loan balance. Unrestricted advance conditional payments are included in other liabilities. ACPs are not insured, and interest is generally paid by the Association on such balances. Balances of ACPs were \$15,441,911 and \$18,126,378 at March 31, 2023, and December 31, 2022, respectively.

Credit Quality

Credit risk arises from the potential inability of an obligor to meet its payment obligation and exists in our outstanding loans, letters of credit and unfunded loan commitments. The Association manages credit risk associated with the retail lending activities through an analysis of the credit risk profile of an individual borrower using its own set of underwriting standards and lending policies, approved by its board of directors, which provides direction to its loan officers. The retail credit risk management process begins with an analysis of the borrower’s credit history, repayment capacity, financial position and collateral, which includes an analysis of credit scores for smaller loans. Repayment capacity focuses on the borrower’s ability to repay the loan based on cash flows from operations or other sources of income, including off-farm income. Real estate mortgage loans must be secured by first liens on the real estate (collateral). As required by Farm Credit Administration regulations, each institution that makes loans on a secured basis must have collateral evaluation policies and procedures. Real estate mortgage loans may be made only in amounts up to 85% of the original appraised value of the property taken as security or up to 97% of the appraised value if guaranteed by a state, federal, or other

governmental agency. The actual loan to appraised value when loans are made is generally lower than the statutory maximum percentage. Loans other than real estate mortgage may be made on a secured or unsecured basis.

The Association uses a two-dimensional risk rating model based on an internally generated combined System risk rating guidance that incorporates a 14-point probability of default rating scale to identify and track the probability of borrower default and a separate scale addressing loss given default. Probability of default is the probability that a borrower will experience a default during the life of the loan. The loss given default is management's estimate as to the anticipated principal loss on a specific loan assuming default occurs during the remaining life of the loan. A default is considered to have occurred if the lender believes the borrower will not be able to pay its obligation in full or the borrower or the loan is classified nonaccrual. This credit risk rating process incorporates objective and subjective criteria to identify inherent strengths, weaknesses and risks in a particular relationship. The Association reviews, at least on an annual basis, or when a credit action is taken the probability of default category.

Each of the probability of default categories carries a distinct percentage of default probability. The probability of default rate between one and nine of the acceptable categories is very narrow and would reflect almost no default to a minimal default percentage. The probability of default rate grows more rapidly as a loan moves from acceptable to other assets especially mentioned and grows significantly as a loan moves to a substandard (viable) level. A substandard (non-viable) rating indicates that the probability of default is almost certain. These categories are defined as follows:

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

The following table presents credit quality indicators by loan type and the related principal balance:

	Term Loans Amortized Cost by Origination Year						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term Loans Amortized Cost Basis	Total
	2023	2022	2021	2020	2019	Prior			
Real estate mortgage									
Acceptable	\$ 47,401,454	\$ 461,635,392	\$ 556,993,567	\$ 377,879,847	\$ 164,756,259	\$ 433,433,366	\$ -	\$ -	\$ 2,042,099,885
OAEM	-	-	116,544	148,848	748,807	3,396,122	-	-	4,410,321
Substandard/Doubtful	-	-	-	371,474	196,913	2,140,925	-	-	2,709,312
	\$ 47,401,454	\$ 461,635,392	\$ 557,110,111	\$ 378,400,169	\$ 165,701,979	\$ 438,970,413	\$ -	\$ -	\$ 2,049,219,518
Production and intermediate-term									
Acceptable	\$ 5,058,468	\$ 19,855,667	\$ 25,728,684	\$ 13,771,955	\$ 1,903,039	\$ 7,756,608	\$ 71,197,916	\$ -	\$ 145,272,337
Substandard/Doubtful	-	-	-	153,774	-	31,303	-	-	185,077
	\$ 5,058,468	\$ 19,855,667	\$ 25,728,684	\$ 13,925,729	\$ 1,903,039	\$ 7,787,911	\$ 71,197,916	\$ -	\$ 145,457,414
Agribusiness									
Acceptable	\$ 1,893,930	\$ 70,605,782	\$ 41,048,926	\$ 29,292,184	\$ 11,271,971	\$ 17,119,125	\$ 41,344,258	\$ 5,059,950	\$ 217,636,126
Substandard/Doubtful	-	-	-	-	6,079,148	-	-	-	6,079,148
	\$ 1,893,930	\$ 70,605,782	\$ 41,048,926	\$ 29,292,184	\$ 17,351,119	\$ 17,119,125	\$ 41,344,258	\$ 5,059,950	\$ 223,715,274
Communication									
Acceptable	\$ 9,985,052	\$ -	\$ 6,049,911	\$ 27,123,406	\$ -	\$ -	\$ 1,783,147	\$ -	\$ 44,941,516
	\$ 9,985,052	\$ -	\$ 6,049,911	\$ 27,123,406	\$ -	\$ -	\$ 1,783,147	\$ -	\$ 44,941,516
Energy									
Acceptable	\$ 7,988,440	\$ -	\$ -	\$ -	\$ -	\$ 20,664,879	\$ 675,064	\$ -	\$ 29,328,383
Substandard/Doubtful	-	-	-	-	-	306,435	-	-	306,435
	\$ 7,988,440	\$ -	\$ -	\$ -	\$ -	\$ 20,971,314	\$ 675,064	\$ -	\$ 29,634,818
Water and wastewater									
Acceptable	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 968,611	\$ -	\$ -	\$ 968,611
	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 968,611	\$ -	\$ -	\$ 968,611
Rural residential real estate									
Acceptable	\$ 1,130,659	\$ 928,308	\$ 1,692,254	\$ 1,921,543	\$ 751,192	\$ 2,186,249	\$ -	\$ -	\$ 8,610,205
Substandard/Doubtful	-	-	-	-	-	6,582	-	-	6,582
	\$ 1,130,659	\$ 928,308	\$ 1,692,254	\$ 1,921,543	\$ 751,192	\$ 2,192,831	\$ -	\$ -	\$ 8,616,787
International									
Acceptable	\$ -	\$ 5,536,062	\$ -	\$ -	\$ -	\$ -	\$ 4,395,804	\$ -	\$ 9,931,866
	\$ -	\$ 5,536,062	\$ -	\$ -	\$ -	\$ -	\$ 4,395,804	\$ -	\$ 9,931,866
Total Loans									
Acceptable	\$ 73,458,003	\$ 558,561,211	\$ 631,513,342	\$ 449,988,935	\$ 178,682,461	\$ 482,128,838	\$ 119,396,189	\$ 5,059,950	\$ 2,498,788,929
OAEM	-	-	116,544	148,848	748,807	3,396,122	-	-	4,410,321
Substandard/Doubtful	-	-	-	525,248	6,276,061	2,485,245	-	-	9,286,554
	\$ 73,458,003	\$ 558,561,211	\$ 631,629,886	\$ 450,663,031	\$ 185,707,328	\$ 488,010,206	\$ 119,396,189	\$ 5,059,950	\$ 2,512,485,804

Accrued interest receivable on loans of \$14,129,493 and \$12,614,518 at March 31, 2023, and December 31, 2022, have been excluded from the amortized cost of loans and reported separately in the Balance Sheet. The Association did not write off any accrued interest receivable for the three months ended March 31, 2023, and 2022.

The following table shows loans under the Farm Credit Administration Uniform Loan Classification System as a percentage of total loans by loan type:

	March 31, 2023	December 31, 2022
Real estate mortgage		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Production and intermediate term		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Loan to cooperatives		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Processing and marketing		
Acceptable	96%	96%
OAEM	0%	0%
Substandard/doubtful	4%	4%
	100%	100%
Farm-related business		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Communication		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Energy		
Acceptable	99%	98%
OAEM	0%	0%
Substandard/doubtful	1%	2%
	100%	100%
Water and wastewater		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Rural residential real estate		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
International		
Acceptable	100%	100%
OAEM	0%	0%
Substandard/doubtful	0%	0%
	100%	100%
Total loans		
Acceptable	99%	99%
OAEM	0%	0%
Substandard/doubtful	1%	1%
	100%	100%

There were no loans and related interest in the loss category.

The following table reflects nonperforming assets, which consist of nonaccrual loans, accruing loans 90 days or more delinquent, and other property owned and related credit quality statistics:

	March 31, 2023	December 31, 2022
Nonaccrual loans:		
Real estate mortgage	\$ 1,401,940	\$ 1,461,521
Production and intermediate-term	31,303	32,878
Agribusiness	6,079,148	-
Energy	306,435	334,090
Rural residential real estate	3,167	7,168
Total nonaccrual loans	7,821,993	1,835,657
Total nonperforming assets	\$ 7,821,993	\$ 1,835,657
Nonaccrual loans as a percentage of total loans	0.3%	0.1%
Nonperforming assets as a percentage of total loans and other property owned	0.3%	0.1%
Nonperforming assets as a percentage of capital	1.8%	0.4%

The following table provides the amortized cost for nonaccrual loans with and without a related allowance for loan losses, as well as interest income recognized on nonaccrual during the period:

	March 31, 2023			Interest Income Recognized for the Three Months Ended March 31, 2023
	Amortized Cost with Allowance	Amortized Cost without Allowance	Total	
Nonaccrual loans:				
Real estate mortgage	\$ -	\$ 1,401,940	\$ 1,401,940	\$ 16,196
Production and intermediate-term	-	31,303	31,303	-
Agribusiness	6,079,148	-	6,079,148	126,254
Energy	306,435	-	306,435	-
Rural residential real estate	-	3,167	3,167	1,440
Total nonaccrual loans	\$ 6,385,583	\$ 1,436,410	\$ 7,821,993	\$ 143,890

The following tables provide an aging analysis of past due loans at amortized cost by portfolio segment as of:

<u>March 31, 2023</u>	<u>30-89 Days Past Due</u>	<u>90 Days or More Past Due</u>	<u>Total Past Due</u>	<u>Not Past Due or Less Than 30 Days Past Due</u>	<u>Total Loans</u>
Real estate mortgage	\$ 11,507,327	\$ 76,404	\$ 11,583,731	\$ 2,037,635,787	\$ 2,049,219,518
Production and intermediate term	48,500	-	48,500	145,408,914	145,457,414
Loans to cooperatives	-	-	-	18,291,142	18,291,142
Processing and marketing	-	-	-	161,665,101	161,665,101
Farm-related business	-	-	-	43,759,031	43,759,031
Communication	-	-	-	44,941,516	44,941,516
Energy	-	-	-	29,634,818	29,634,818
Water and wastewater	-	-	-	968,611	968,611
Rural residential real estate	-	-	-	8,616,787	8,616,787
International	-	-	-	9,931,866	9,931,866
Total	\$ 11,555,827	\$ 76,404	\$ 11,632,231	\$ 2,500,853,573	\$ 2,512,485,804

Prior to the adoption of CECL, the aging analysis of past due loans reported included accrued interest as follows:

<u>December 31, 2022</u>	<u>30-89 Days Past Due</u>	<u>90 Days or More Past Due</u>	<u>Total Past Due</u>	<u>Not Past Due or Less Than 30 Days Past Due</u>	<u>Total Loans</u>
Real estate mortgage	\$ 508,353	\$ 315,940	\$ 824,293	\$ 2,060,256,735	\$ 2,061,081,028
Production and intermediate term	4,289	-	4,289	144,082,025	144,086,314
Loans to cooperatives	-	-	-	14,346,406	14,346,406
Processing and marketing	-	-	-	153,254,734	153,254,734
Farm-related business	-	-	-	46,931,645	46,931,645
Communication	-	-	-	42,473,341	42,473,341
Energy	-	-	-	21,871,080	21,871,080
Water and wastewater	-	-	-	981,441	981,441
Rural residential real estate	3,569	-	3,569	7,958,806	7,962,375
International	-	-	-	8,489,703	8,489,703
Total	\$ 516,211	\$ 315,940	\$ 832,151	\$ 2,500,645,916	\$ 2,501,478,067

Allowance for Credit Losses

The credit risk rating methodology is a key component of the Association's allowance for credit losses evaluation, and is incorporated into the Association's loan underwriting standards and internal lending limits. In addition, borrower and commodity concentration lending and leasing limits have been established to manage credit exposure. The regulatory limit to a single borrower or lessee is 15% of the Association's lending and leasing limit base but the System Institution's boards of directors have generally established more restrictive lending limits. This limit applies to associations with long-term and short- and intermediate-term lending authorities.

Effective January 1, 2023, the System adopted the CECL accounting guidance as described in Note 1. A summary of changes in the allowance for credit losses by portfolio segment are as follows:

	Real Estate Mortgage	Production and intermediate- term	Agribusiness	Communications	Energy	Water and Wastewater	Rural Residential Real Estate	International	Total
Allowance for Credit Losses on Loans:									
Balance at December 31, 2022	\$ 4,342,114	\$ 385,628	\$ 769,541	\$ 83,506	\$ 130,241	\$ 1,752	\$ 17,835	\$ 16,377	\$ 5,746,994
Cumulative effect of a change in accounting principle	224,230	(244,862)	67,965	(45,873)	(21,401)	(1,429)	1,217	(9,925)	(30,078)
Balance at January 1, 2023	4,566,344	140,766	837,506	37,633	108,840	323	19,052	6,452	5,716,916
Recoveries	-	1,337	777	-	-	-	-	-	2,114
(Reversal of) provision for credit losses on loans	(324,466)	(16,762)	161,139	(417)	4,698	(20)	(2,183)	807	(177,204)
Balance at March 31, 2023	4,241,878	125,341	999,422	37,216	113,538	303	16,869	7,259	5,541,826
Allowance for Unfunded Commitments:									
Balance at December 31, 2022	\$ 45	\$ 26,375	\$ 83,273	\$ 935	\$ 707	\$ -	\$ -	\$ 3,259	\$ 114,594
Cumulative effect of a change in accounting principle	2	(7,263)	163,127	1,090	692	-	-	4,803	162,451
Balance at January 1, 2023	47	19,112	246,400	2,025	1,399	-	-	8,062	277,045
Reversal of provision for credit losses on unfunded commitments	(17)	(2,862)	(124,302)	(634)	(303)	-	-	(1,527)	(129,645)
Balance at March 31, 2023	30	16,250	122,098	1,391	1,096	-	-	6,535	147,400
Total allowance for credit losses	\$ 4,241,908	\$ 141,591	\$ 1,121,520	\$ 38,607	\$ 114,634	\$ 303	\$ 16,869	\$ 13,794	\$ 5,689,226
Allowance for Credit Losses on loans*:									
Balance at December 31, 2021	\$ 5,552,628	\$ 468,317	\$ 970,569	\$ 122,826	\$ 151,869	\$ 14,337	\$ 29,682	\$ 25,316	\$ 7,335,544
Recoveries	-	3,153	-	-	-	-	-	-	3,153
Reversal of provision for credit losses on loans	(243,952)	(33,529)	(68,244)	(6,201)	(5,902)	(10,299)	(3,809)	(1,604)	(373,540)
Balance at March 31, 2022	5,308,676	437,941	902,325	116,625	145,967	4,038	25,873	23,712	6,965,157
Allowance for Unfunded Commitments:									
Balance at December 31, 2021	\$ 49	\$ 38,126	\$ 83,909	\$ 764	\$ 250	\$ 134	\$ -	\$ 2,528	\$ 125,760
(Reversal of) provision for credit losses on unfunded commitments	(42)	(16,026)	(12,511)	(356)	13	1	-	27	(28,894)
Balance at March 31, 2022	7	22,100	71,398	408	263	135	-	2,555	96,866
Total allowance for credit losses	\$ 5,308,683	\$ 460,041	\$ 973,723	\$ 117,033	\$ 146,230	\$ 4,173	\$ 25,873	\$ 26,267	\$ 7,062,023

* For periods prior to January 1, 2023, the allowance for loan losses was based on probable and estimable losses inherent in the loan portfolio.

The Association did not have any loan modifications granted to borrowers experiencing financial difficulty for the three months ended March 31, 2023.

Troubled Debt Restructurings

Prior to January 1, 2023, the adoption of updated FASB guidance on loan modifications, a restructuring of a loan constituted a troubled debt restructuring, also known as formally restructured, if the creditor for economic or legal reasons related to the borrower's financial difficulties granted a concession to the borrower that it would not otherwise consider. Concessions varied by program and were borrower-specific and could include interest rate reductions, term extensions, payment deferrals or the acceptance of additional collateral in lieu of payments. In limited circumstances, principal may have been forgiven. When a restructured loan constituted a troubled debt restructuring, these loans were included within our impaired loans under nonaccrual or accruing restructured loans.

As of March 31, 2022, the Association did not have any loans that met the criteria as a troubled debt restructuring and that occurred within the previous 12 months of that year for which there was a payment default.

The following table provides information on outstanding loans restructured in troubled debt restructurings:

	December 31, 2022	
	Loans Modified as Troubled Debt Restructurings	Troubled Debt Restructurings in Nonaccrual Status*
Real estate mortgage	\$ 1,168,258	\$ 88,662
Total	\$ 1,168,258	\$ 88,662

*Represents the portion of loans modified as troubled debt restructurings that were in nonaccrual status.

NOTE 4 —LEASES:

The components of lease expense were as follows:

	For the Three Months Ended	
	March 31, 2023	March 31, 2022
Operating lease cost	\$ 154,278	\$ 154,280
Net lease cost	\$ 154,278	\$ 154,280

Other information related to leases was as follows:

	For the Three Months Ended	
	March 31, 2023	March 31, 2022
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 153,818	\$ 146,957

Lease term and discount rate are as follows:

	March 31, 2023	December 31, 2022
Weighted average remaining lease term in years		
Operating leases	2.2	2.4
Weighted average discount rate		
Operating leases	2.4%	2.4%

Future minimum lease payments under non-cancellable leases as of March 31, 2023, were as follows:

	Operating Leases
2023	\$ 439,473
2024	349,515
2025	138,489
2026	86,838
Total	\$ 1,014,315

NOTE 5 — CAPITAL:

The Association's Board 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 patronage, 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 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.

	March 31, 2023	December 31, 2022
Capital stock and participation certificates	\$ 5,797,790	\$ 5,816,750
Additional paid-in-capital	\$ 91,343,553	\$ 91,343,553
Accumulated other comprehensive income	\$ 175,154	\$ 181,784
Retained earnings ¹	\$ 327,597,031	\$ 315,281,755
Total capital	\$ 424,913,528	\$ 412,623,842

¹ Retained earnings for the quarter ended March 31, 2023, reflects a decrease from the cumulative effect of a change in accounting principle for CECL on January 1, 2023.

Regulatory Capitalization Requirements

Risk-adjusted:	Regulatory Requirements Including Capital Conservation Buffers	As of March 31, 2023
Common equity tier 1 ratio	7.00%	14.75%
Tier 1 capital ratio	8.50%	14.75%
Total capital ratio	10.50%	14.99%
Permanent capital ratio	7.00%	14.78%
Non-risk-adjusted:		
Tier 1 leverage ratio	5.00%	14.93%
UREE leverage ratio	1.50%	14.70%

Risk-adjusted assets have been defined by FCA Regulations as the Statement of Condition assets and off-balance-sheet commitments adjusted by various percentages, depending on the level of risk inherent in the various types of assets. The primary changes which generally have the impact of increasing risk-adjusted assets (decreasing risk-based regulatory capital ratios) were as follows:

- Inclusion of off-balance-sheet commitments less than 14 months
- Increased risk-weighting of most loans 90 days past due or in nonaccrual status

Risk-adjusted assets is calculated differently for the permanent capital ratio (referred herein as PCR risk-adjusted assets) compared to the other risk-based capital ratios. The primary difference is the deduction of the allowance for credit losses from risk-adjusted assets for the permanent capital ratio.

The ratios are based on a three-month average daily balance in accordance with FCA regulations and are calculated as follows:

- Common equity tier 1 ratio is statutory minimum purchased borrower stock, other required borrower stock held for a minimum of 7 years, allocated equities held for a minimum of 7 years or not subject to revolvment, unallocated retained earnings, paid-in capital, less certain regulatory required deductions including the amount of allocated investments in other System institutions, and the amount of purchased investments in other System institutions under the corresponding deduction approach, divided by average risk-adjusted assets.
- Tier 1 capital ratio is common equity tier 1 plus non-cumulative perpetual preferred stock, divided by average risk-adjusted assets.
- Total capital is tier 1 capital plus other required borrower stock held for a minimum of 5 years, allocated equities held for a minimum of 5 years, subordinated debt and limited-life preferred stock greater than 5 years to maturity at issuance subject to certain limitations, allowance and reserve for credit losses under certain limitations less certain investments in other System institutions under the corresponding deduction approach, divided by average risk-adjusted assets.
- Permanent capital ratio (PCR) is all at-risk borrower stock, any allocated excess stock, unallocated retained earnings, paid-in capital, subordinated debt and preferred subject to certain limitations, less certain allocated and purchased investments in other System institutions, divided by PCR risk-adjusted assets.
- Tier 1 leverage ratio is tier 1 capital, including regulatory deductions, divided by average assets less regulatory deductions subject to tier 1 capital.

- UREE leverage ratio is unallocated retained earnings, paid-in capital, allocated surplus not subject to revolvment less certain regulatory required deductions including the amount of allocated investments in other System institutions divided by average assets less regulatory deductions subject to tier 1 capital.

If the capital ratios fall below the minimum regulatory requirements, including the capital conservation and leverage buffer amounts, capital distributions (equity redemptions, dividends, and patronage) and discretionary bonus payments to senior officers are restricted or prohibited without prior FCA approval.

The components of the Association's risk-adjusted capital, based on 90 day average balances, were as follows at March 31, 2023:

	Common equity tier 1 ratio	Tier 1 capital ratio	Total capital ratio	Permanent capital ratio
Numerator:				
Unallocated retained earnings	\$ 253,963,403	\$ 253,963,403	\$ 253,963,403	\$ 253,963,403
Paid-in capital	91,343,553	91,343,553	91,343,553	91,343,553
Common Cooperative Equities:				
Statutory minimum purchased borrower stock	5,804,771	5,804,771	5,804,771	5,804,771
Nonqualified allocated equities not subject to retirement	65,733,966	65,733,966	65,733,966	65,733,966
Allowance for credit losses and reserve for credit losses subject to certain limitations	-	-	5,990,988	-
Regulatory Adjustments and Deductions:				
Amount of allocated investments in other System institutions	(40,093,233)	(40,093,233)	(40,093,233)	(40,093,233)
	<u>\$ 376,752,460</u>	<u>\$ 376,752,460</u>	<u>\$ 382,743,448</u>	<u>\$ 376,752,460</u>
Denominator:				
Risk-adjusted assets excluding allowance	\$ 2,594,198,547	\$ 2,594,198,547	\$ 2,594,198,547	\$ 2,594,198,547
Regulatory Adjustments and Deductions:				
Regulatory deductions included in total capital	(40,093,233)	(40,093,233)	(40,093,233)	(40,093,233)
Allowance for credit losses	-	-	-	(5,769,541)
	<u>\$ 2,554,105,314</u>	<u>\$ 2,554,105,314</u>	<u>\$ 2,554,105,314</u>	<u>\$ 2,548,335,773</u>

The components of the Association's non-risk-adjusted capital, based on 90 day average balances, were as follows at March 31, 2023:

	Tier 1 leverage ratio	UREE leverage ratio
Numerator:		
Unallocated retained earnings	\$ 253,963,403	\$ 253,963,403
Paid-in capital	91,343,553	91,343,553
Common Cooperative Equities:		
Statutory minimum purchased borrower stock	5,804,771	-
Nonqualified allocated equities not subject to retirement	65,733,966	65,733,966
Regulatory Adjustments and Deductions:		
Amount of allocated investments in other System institutions	(40,093,233)	(40,093,233)
	<u>\$ 376,752,460</u>	<u>\$ 370,947,689</u>
Denominator:		
Total Assets	\$ 2,564,817,713	\$ 2,564,817,713
Regulatory Adjustments and Deductions:		
Regulatory deductions included in tier 1 capital	(41,473,250)	(41,473,250)
	<u>\$ 2,523,344,463</u>	<u>\$ 2,523,344,463</u>

The Association's accumulated other comprehensive loss relates entirely to its nonpension other postretirement benefits. The following table summarizes the change in accumulated other comprehensive loss for the three months ended March 31:

	<u>2023</u>	<u>2022</u>
Accumulated other comprehensive income (loss) at January 1	\$ 181,784	\$ (954,347)
Amortization of prior service credit included in salaries and employee benefits	(6,630)	(6,629)
Amortization of actuarial loss included in salaries and employee benefits	-	14,456
Other comprehensive (loss) income, net of tax	(6,630)	7,827
Accumulated other comprehensive income (loss) at March 31	<u>\$ 175,154</u>	<u>\$ (946,520)</u>

NOTE 6 — INCOME TAXES:

Lone Star, ACA conducts its business activities through two wholly-owned subsidiaries. Long-term mortgage lending activities are conducted through a wholly-owned FLCA subsidiary which is exempt from federal and state income tax. Short- and intermediate-term lending activities are conducted through a wholly-owned PCA subsidiary. The PCA subsidiary and the ACA holding company are subject to income tax. Lone Star, ACA operates as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, Lone Star, ACA can exclude from taxable income amounts distributed as qualified patronage in the form of cash, stock or allocated retained earnings. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage. Deferred taxes are recorded at 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 (more than 50 percent probability), based on management's estimate, that they will not be realized.

As of March 31, 2023, the deferred income tax valuation allowance was \$10,421,365.

NOTE 7 — FAIR VALUE MEASUREMENTS:

FASB guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 15 to the 2022 Annual Report to Stockholders for a more complete description.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

<u>March 31, 2023</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Value</u>
Assets:				
Assets held in non-qualified benefits trusts	\$454,861	\$ -	\$ -	\$ 454,861
Total assets	<u>\$454,861</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 454,861</u>
<u>December 31, 2022</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Value</u>
Assets:				
Assets held in non-qualified benefits trusts	\$ 374,027	\$ -	\$ -	\$ 374,027
Total assets	<u>\$ 374,027</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 374,027</u>

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

<u>March 31, 2023</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Loans	\$ -	\$ -	\$5,766,908	\$5,766,908
<u>December 31, 2022</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Loans	\$ -	\$ -	\$ 233,536	\$ 233,536

Valuation Techniques

As more fully discussed in Note 2 to the 2022 Annual Report to Stockholders, authoritative guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the Association's assets and liabilities. For a more complete description, see Notes to the 2022 Annual Report to Stockholders.

Assets Held in Nonqualified Benefits Trusts

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

Standby Letters of Credit

The fair value of letters of credit approximate the fees currently charged for similar agreements or the estimated cost to terminate or otherwise settle similar obligations.

Loans Evaluated for Impairment

For certain loans evaluated for impairment under impairment guidance, the fair value is based upon the underlying collateral since the loans are collateral-dependent loans for which real estate is the collateral. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, a majority of these loans have fair value measurements that fall within Level 3 of the fair value hierarchy. When the value of the real estate, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established. The fair value of these loans would fall under Level 2 of the hierarchy if the process uses independent appraisals and other market-based information.

Other Property Owned

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

NOTE 8 — EMPLOYEE BENEFIT PLANS:

The following table summarizes the components of net periodic benefit costs of nonpension other postretirement employee benefits for the three months ended March 31:

	<u>Other Benefits</u>	
	<u>2023</u>	<u>2022</u>
Service cost	\$ 15,318	\$ 20,652
Interest cost	56,796	42,624
Amortization of prior credits	(6,630)	(6,629)
Amortization of net actuarial loss	-	14,456
Net periodic benefit cost	<u>\$ 65,484</u>	<u>\$ 71,103</u>

The Association's liability for the unfunded accumulated obligation for these benefits at March 31, 2023, was \$4,490,527 and is included in other liabilities on the balance sheet.

The components of net periodic benefit cost other than the service cost component are included in the line item "other components of net periodic postretirement benefit cost" in the income statement. The Association previously disclosed in its financial statements for the year ended December 31, 2022, that it expects to contribute \$207,067 to the district's DC plan in 2023.

The structure of the district's DB plan, which is noncontributory and benefits are based on salary and years of service, is characterized as multiemployer since the assets, liabilities and cost of the plan are not segregated or separately accounted for by participating employers (Bank and associations). The Association recognizes its amortized annual contributions to the DB plan as an expense. The Association has contributed \$231,320 to fund the DB plan for 2023. As of March 31, 2023, the Association has expensed and recognized \$57,830.

NOTE 9 — COMMITMENTS AND CONTINGENT LIABILITIES:

The Association is involved in various legal proceedings in the normal 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.

NOTE 10 — SUBSEQUENT EVENTS:

The Association has evaluated subsequent events through May 10, 2023, which is the date the financial statements were issued or available to be issued.

There were no subsequent events requiring disclosure as of May 10, 2023.