# Farm Credit Services of Mandan, ACA

**Quarterly Report**
**September 30, 2016**

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following commentary reviews the consolidated financial condition and consolidated results of operations of Farm Credit Services of Mandan, ACA (the parent) and Farm Credit Services of Mandan, FLCA and Farm Credit Services of Mandan, PCA (the subsidiaries). This discussion should be read in conjunction with both the unaudited consolidated financial information and related notes included in this Quarterly Report as well as Management's Discussion and Analysis included in our Annual Report for the year ended December 31, 2015 (2015 Annual Report).

AgriBank, FCB's (AgriBank) financial condition and results of operations materially impact members' investment in Farm Credit Services of Mandan, ACA. To request free copies of the AgriBank and combined AgriBank and affiliated Associations' financial reports or additional copies of our report, contact us at:

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## FORWARD-LOOKING INFORMATION

Any forward-looking statements in this Quarterly Report are based on current expectations and are subject to uncertainty and changes in circumstances. Actual results may differ materially from expectations due to a number of risks and uncertainties. More information about these risks and uncertainties is contained in our 2015 Annual Report. We undertake no duty to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

## AGRICULTURAL AND ECONOMIC CONDITIONS

The predominant commodities raised in the territory served by our Association are small grains, corn, soybeans and beef cattle. Many producers also raise sunflowers and canola in order to rotate crops and further diversify their operations.

Production results from the 2016 small grains harvest varied from satisfactory with good yields and quality for most producers in our local service area to marginal in the southwest corner due to dry conditions. Yield projections for row and oil crops are excellent. The hay crop was short due to early dry conditions; however, pasture conditions have improved dramatically since recent rains. Our overall moisture situation has greatly improved since spring, and we are headed into winter in a much improved situation from last fall.

Current commodity prices, particularly for small grains, will limit profitability for producers in our territory. In some parts of the territory, above average yields will help to off-set the lower crop prices and improve financial performance.

Livestock prices have continued their drop since the highs in 2014. Producers with a cow/calf operation should still see modest profitability. Producers with purchased feeder and yearling operations will be more challenged to show a profit. A lower purchase price for feeders combined with cheap cost of grains should allow for some profit potential in 2017.

Real estate sales have continued to be strong, however are leveling off on the price per acre. Machinery sales have softened as producers are limiting capital purchases. These changes have not been drastic and have been anticipated with the current conditions.

## LOAN PORTFOLIO

### Loan Portfolio

Total loans were $1.1 billion at September 30, 2016, an increase of $46.1 million from December 31, 2015. The increase was primarily in our agribusiness portfolio from our Commercial Finance Group alliance as well as production and intermediate term loans and participations from seasonal draws on operating lines.

### Portfolio Credit Quality

The credit quality of our portfolio declined slightly from December 31, 2015. Adversely classified loans increased to 1.2% of the portfolio at September 30, 2016, from 1.0% of the portfolio at December 31, 2015. Adversely classified loans are loans we have identified as showing some credit weakness outside our credit standards. We have considered portfolio credit quality in assessing the reasonableness of our allowance for loan losses.

In certain circumstances, government guarantee programs are used to reduce the risk of loss. At September 30, 2016, $29.1 million of our loans were, to some level, guaranteed under these government programs.

### Risk Assets

Risk assets are comprised of nonaccrual loans, accruing restructured loans, accruing loans 90 days or more past due, and other property owned.

**Components of Risk Assets**

| (dollars in thousands) As of: | **September 30 2016** | December 31 2015 |
|---|---|---|
| Loans: | | |
| Nonaccrual | **$ 1,921** | $ 2,481 |
| Accruing restructured | **2** | 2 |
| Accruing loans 90 days or more past due | **308** | 34 |
| Total risk loans | **2,231** | 2,517 |
| Other property owned | **--** | -- |
| Total risk assets | **$ 2,231** | $ 2,517 |
| Total risk loans as a percentage of total loans | **0.2%** | 0.2% |
| Nonaccrual loans as a percentage of total loans | **0.2%** | 0.2% |
| Current nonaccrual loans as a percentage of total nonaccrual loans | **42.4%** | 81.0% |
| Total delinquencies as a percentage of total loans | **0.3%** | 0.1% |

Note: Accruing loans include accrued interest receivable.

Our risk assets have not changed significantly from December 31, 2015 and remain at acceptable levels. Total risk loans as a percentage of total loans remains well within our established risk management guidelines.

The increase in accruing 90 days or more past due resulted from delinquencies in the production and intermediate term loan category.

### Allowance for Loan Losses

The allowance for loan losses is an estimate of losses on loans in our portfolio as of the financial statement date. We determine the appropriate level of allowance for loan losses based on periodic evaluation of factors such as loan loss history, estimated probability of default, estimated loss severity, portfolio quality, and current economic and environmental conditions.

**Allowance Coverage Ratios**

| As of: | **September 30 2016** | December 31 2015 |
|---|---|---|
| Allowance as a percentage of: | | |
| Loans | **0.3%** | 0.2% |
| Nonaccrual loans | **145.4%** | 82.9% |
| Total risk loans | **125.2%** | 81.7% |

The increase to the allowance for loan losses from December 31, 2015 primarily resulted from increases in specific reserves in certain production and intermediate term loans along with credit quality changes. In our opinion, the allowance for loan losses was reasonable in relation to the risk in our loan portfolio at September 30, 2016.

## RESULTS OF OPERATIONS

**Profitability Information**

| (dollars in thousands) For the nine months ended September 30 | **2016** | 2015 |
|---|---|---|
| Net income | **$ 13,806** | $ 13,500 |
| Return on average assets | **1.7%** | 1.9% |
| Return on average members' equity | **9.1%** | 9.7% |

Changes in the chart above are directly related to the changes in income discussed in this section, changes in assets discussed in the Loan Portfolio section, and changes in capital discussed in the Funding, Liquidity, and Capital section.

**Changes in Significant Components of Net Income**

| (in thousands)<br>For the nine months ended September 30 | **2016** | 2015 | **Increase (decrease) in net income** |
|---|---|---|---|
| Net interest income | **$ 21,637** | $ 21,315 | **$ 322** |
| Provision for loan losses | **919** | 36 | **(883)** |
| Patronage income | **2,646** | 1,606 | **1,040** |
| Other income, net | **4,504** | 4,286 | **218** |
| Operating expenses | **13,118** | 12,416 | **(702)** |
| Provision for income taxes | **944** | 1,255 | **311** |
| Net income | **$ 13,806** | $ 13,500 | **$ 306** |

**Changes in Net Interest Income**

| (in thousands)<br>For the nine months ended September 30 | **2016 vs 2015** |
|---|---|
| Changes in volume | **$ 2,439** |
| Changes in interest rates | **(2,167)** |
| Changes in nonaccrual income and other | **50** |
| Net change | **$ 322** |

The change in the provision for loan loss is related to our estimate of losses in our portfolio, primarily due to a decline in credit quality, and increases to specific reserves.

The increase in patronage income was primarily due to additional patronage accrued related to an increase in wholesale spread on our note payable.

The change in operating expenses was primarily due to increased salaries and employee benefit expenses and the Farm Credit System Insurance Corporation (FCSIC) expense. FCSIC expense increased in 2016 primarily due to an increase in the premium rate charged on accrual loans by FCSIC from 13 basis points in 2015 to 16 basis points for the first half and 18 basis points for the second half of 2016. The FCSIC board meets periodically throughout the year to review premium rates and has the ability to change these rates at any time.

## FUNDING, LIQUIDITY, AND CAPITAL

We borrow from AgriBank, under a note payable, in the form of a line of credit. Our note payable matures on February 28, 2017, at which time the note will be renegotiated. The repricing attributes of our line of credit generally correspond to the repricing attributes of our loan portfolio which significantly reduces our market interest rate risk. Due to the cooperative structure of the Farm Credit System and as we are a stockholder of AgriBank, we expect this borrowing relationship to continue into the foreseeable future.

The components of cost of funds associated with our note payable include:

- A marginal cost of debt component
- A spread component, which includes cost of servicing, cost of liquidity, and bank profit
- A risk premium component, if applicable

We were not subject to a risk premium at September 30, 2016 or December 31, 2015.

In addition, with approval from AgriBank, on July 24, 2006, we entered into a loan agreement with CoBank, ACB (CoBank) to obtain funding in the amount not to exceed $20.0 million in connection with specific CoBank related transactions. The interest rate on such indebtedness will be established at the time of the related transactions. There was no outstanding principal at September 30, 2016 or December 31, 2015.

Total members' equity increased $12.2 million from December 31, 2015 primarily due to net income for the period which was partially offset by patronage distribution accruals.

Farm Credit Administration regulations require us to maintain a certain level for our permanent capital ratio, total surplus ratio, and core surplus ratio. Refer to Note 7 in our 2015 Annual Report for a more complete description of these ratios.

**Select Capital Ratios**

| As of | Regulatory Minimums | **September 30 2016** | December 31 2015 |
|---|---|---|---|
| Permanent capital ratio | 7.0% | **15.1%** | 15.0% |
| Total surplus ratio | 7.0% | **14.9%** | 14.8% |
| Core surplus ratio | 3.5% | **14.9%** | 14.8% |

The capital adequacy ratios are directly impacted by the changes in capital as more fully explained in this section and the changes in assets as discussed in the Loan Portfolio section. As discussed in Note 3 of the accompanying Consolidated Financial Statements we will be subject to new regulations and capital requirements effective January 1, 2017.

## REGULATORY MATTERS

### Regulatory Capital Requirements

On March 10, 2016, the FCA Board approved a final rule to modify the regulatory capital requirements for System Banks and Associations. The stated objectives of the rule are to:

- Modernize capital requirements while ensuring that institutions continue to hold sufficient regulatory capital to fulfill their mission as a government-sponsored enterprise
- Ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach that the federal banking regulatory agencies have adopted, but also to ensure that the rules recognize the cooperative structure and the organization of the System
- Make System regulatory capital requirements more transparent
- Meet the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The final rule replaces existing core surplus and total surplus ratios with common equity tier 1, tier 1, and total capital risk-based capital ratios. The final rule also adds a tier 1 leverage ratio. The permanent capital ratio continues to remain in effect with the final rule. Refer to Note 3 of the accompanying Consolidated Financial Statements for additional information regarding these ratios.

The effective date of the new capital requirements is January 1, 2017. We are currently evaluating the impact of the recently announced changes.

### Investment Securities Eligibility

On June 12, 2014, the FCA Board approved a proposed rule to revise the requirements governing the eligibility of investments for System Banks and Associations. The stated objectives of the proposed rule are to:

- Strengthen the safety and soundness of System Banks and Associations
- Ensure that System Banks hold sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption
- Enhance the ability of the System Banks to supply credit to agricultural and aquatic producers
- Comply with the requirements of section 939A of the Dodd-Frank Act
- Modernize the investment eligibility criteria for System Banks
- Revise the investment regulation for System Associations to improve their investment management practices so they are more resilient to risk

The public comment period ended on October 23, 2014. FCA has not issued any further information regarding this proposed rule.

## CERTIFICATION

The undersigned have reviewed the September 30, 2016 Quarterly Report of Farm Credit Services of Mandan, ACA, which has been prepared under the oversight of the Audit Committee and in accordance with all applicable statutory or regulatory requirements. The information contained herein is true, accurate, and complete to the best of our knowledge and belief.

Kent Albers

Kent Albers
Chairperson of the Board
Farm Credit Services of Mandan, ACA

Aaron Vetter

Aaron Vetter
Chief Executive Officer
Farm Credit Services of Mandan, ACA

Sandy Nagel

Sandy Nagel
Vice President – Corporate Finance
Farm Credit Services of Mandan, ACA

November 8, 2016

# CONSOLIDATED STATEMENTS OF CONDITION

*Farm Credit Services of Mandan, ACA*
*(in thousands)*
*(Unaudited)*

| As of: | | September 30 2016 | | December 31 2015 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Loans | $ | 1,061,501 | $ | 1,015,414 |
| Allowance for loan losses | | 2,794 | | 2,057 |
| Net loans | | 1,058,707 | | 1,013,357 |
| Investment in Farm Credit Institutions | | 21,910 | | 20,074 |
| Accrued interest receivable | | 16,189 | | 12,449 |
| Other assets | | 10,928 | | 9,983 |
| Total assets | $ | 1,107,734 | $ | 1,055,863 |
| **LIABILITIES** | | | | |
| Note payable to AgriBank, FCB | $ | 889,938 | $ | 850,673 |
| Accrued interest payable | | 3,113 | | 2,106 |
| Deferred tax liabilities, net | | 822 | | 713 |
| Patronage distribution payable | | 1,597 | | 2,075 |
| Other liabilities | | 4,686 | | 4,891 |
| Total liabilities | | 900,156 | | 860,458 |
| Contingencies and commitments (Note 4) | | | | |
| **MEMBERS' EQUITY** | | | | |
| Capital stock and participation certificates | | 2,397 | | 2,435 |
| Unallocated surplus | | 205,181 | | 192,970 |
| Total members' equity | | 207,578 | | 195,405 |
| Total liabilities and members' equity | $ | 1,107,734 | $ | 1,055,863 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

# CONSOLIDATED STATEMENTS OF INCOME

*Farm Credit Services of Mandan, ACA*
*(in thousands)*
*(Unaudited)*

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| *For the period ended September 30* | **2016** | 2015 | **2016** | 2015 |
| **Interest income** | **$ 10,649** | $ 9,489 | **$ 30,502** | $ 27,006 |
| **Interest expense** | **3,113** | 2,018 | **8,865** | 5,691 |
| Net interest income | **7,536** | 7,471 | **21,637** | 21,315 |
| **Provision for loan losses** | **83** | 35 | **919** | 36 |
| Net interest income after provision for loan losses | **7,453** | 7,436 | **20,718** | 21,279 |
| **Other income** | | | | |
| Patronage income | **919** | 560 | **2,646** | 1,606 |
| Financially related services income | **987** | 812 | **3,635** | 3,365 |
| Fee income | **253** | 276 | **863** | 832 |
| Miscellaneous income, net | **2** | 24 | **6** | 89 |
| Total other income | **2,161** | 1,672 | **7,150** | 5,892 |
| **Operating expenses** | | | | |
| Salaries and employee benefits | **2,949** | 2,765 | **8,804** | 8,575 |
| Other operating expenses | **1,464** | 1,241 | **4,314** | 3,841 |
| Total operating expenses | **4,413** | 4,006 | **13,118** | 12,416 |
| Income before income taxes | **5,201** | 5,102 | **14,750** | 14,755 |
| **Provision for income taxes** | **354** | 473 | **944** | 1,255 |
| Net income | **$ 4,847** | $ 4,629 | **$ 13,806** | $ 13,500 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

# CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY

*Farm Credit Services of Mandan, ACA*
*(in thousands)*
*(Unaudited)*

| | Capital Stock and Participation Certificates | Unallocated Surplus | Total Members' Equity |
|---|---|---|---|
| Balance at December 31, 2014 | $ 2,468 | $ 177,159 | $ 179,627 |
| Net income | -- | 13,500 | 13,500 |
| Unallocated surplus designated for patronage distributions | -- | (1,499) | (1,499) |
| Capital stock and participation certificates issued | 83 | -- | 83 |
| Capital stock and participation certificates retired | (123) | -- | (123) |
| Balance at September 30, 2015 | $ 2,428 | $ 189,160 | $ 191,588 |
| Balance at December 31, 2015 | $ 2,435 | $ 192,970 | $ 195,405 |
| Net income | **--** | **13,806** | **13,806** |
| Unallocated surplus designated for patronage distributions | **--** | **(1,595)** | **(1,595)** |
| Capital stock and participation certificates issued | **84** | **--** | **84** |
| Capital stock and participation certificates retired | **(122)** | **--** | **(122)** |
| **Balance at September 30, 2016** | **$ 2,397** | **$ 205,181** | **$ 207,578** |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1: ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

The Consolidated Financial Statements contain all adjustments necessary for a fair presentation of the interim consolidated financial condition and consolidated results of operations. While our accounting policies conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and the prevailing practices within the financial services industry, this interim Quarterly Report is prepared based upon statutory and regulatory requirements and, accordingly, does not include all disclosures required by U.S. GAAP. The results of the nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2016. The interim financial statements and the related notes in this Quarterly Report should be read in conjunction with the Consolidated Financial Statements and related notes included in our Annual Report for the year ended December 31, 2015 (2015 Annual Report).

The Consolidated Financial Statements present the consolidated financial results of Farm Credit Services of Mandan, ACA (the parent) and Farm Credit Services of Mandan, FLCA and Farm Credit Services of Mandan, PCA (the subsidiaries). All material intercompany transactions and balances have been eliminated in consolidation.

#### Recently Issued or Adopted Accounting Pronouncements

In June 2016, the Financial Accounting Standards Board (FASB) issued guidance entitled "Measurement of Credit Losses on Financial Instruments." The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. The guidance is effective for nonpublic entities for annual reporting periods beginning after December 15, 2020 and interim periods within annual periods beginning after December 15, 2021. Early adoption is permitted as of annual reporting periods beginning after December 15, 2018, including interim periods within those annual periods. We are currently evaluating the impact of the guidance on our financial condition, results of operations, cash flows, and financial statement disclosures.

Refer to Note 2 in our 2015 Annual Report for additional information on other accounting standards that have been issued, but are not yet effective. We are currently evaluating the impact of the guidance on our Consolidated Financial Statements. No accounting pronouncements were adopted during the nine months ended September 30, 2016.

### NOTE 2: LOANS AND ALLOWANCE FOR LOAN LOSSES

**Loans by Type**

(dollars in thousands)

| As of: | September 30, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| | Amount | % | Amount | % |
| Real estate mortgage | **$ 335,740** | **31.6%** | $ 324,979 | 32.0% |
| Production and intermediate term | **464,541** | **43.8%** | 448,052 | 44.1% |
| Agribusiness | **161,391** | **15.2%** | 142,811 | 14.1% |
| Other | **99,829** | **9.4%** | 99,572 | 9.8% |
| Total | **$ 1,061,501** | **100.0%** | $ 1,015,414 | 100.0% |

The other category is primarily comprised of energy, communication, and international related loans and certain assets originated under the Mission Related Investment authority, as well as finance leases.

#### Delinquency

**Aging Analysis of Loans**

| (in thousands)<br>**As of September 30, 2016** | 30-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Not Past Due or Less than 30 Days Past Due | Total | 90 Days or More Past Due and Accruing |
|---|---|---|---|---|---|---|
| Real estate mortgage | **$ --** | **$ 309** | **$ 309** | **$ 343,398** | **$ 343,707** | **$ --** |
| Production and intermediate term | **1,393** | **1,098** | **2,491** | **469,591** | **472,082** | **308** |
| Agribusiness | **--** | **--** | **--** | **161,853** | **161,853** | **--** |
| Other | **--** | **--** | **--** | **100,044** | **100,044** | **--** |
| Total | **$ 1,393** | **$ 1,407** | **$ 2,800** | **$ 1,074,886** | **$ 1,077,686** | **$ 308** |

| As of December 31, 2015 | | 30-89 Days Past Due | | 90 Days or More Past Due | | Total Past Due | | Not Past Due or Less than 30 Days Past Due | | Total | | 90 Days or More Past Due and Accruing |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real estate mortgage | $ | 156 | $ | 25 | $ | 181 | $ | 330,544 | $ | 330,725 | $ | 25 |
| Production and intermediate term | | 815 | | 476 | | 1,291 | | 452,869 | | 454,160 | | 9 |
| Agribusiness | | -- | | -- | | -- | | 143,236 | | 143,236 | | -- |
| Other | | -- | | -- | | -- | | 99,739 | | 99,739 | | -- |
| Total | $ | 971 | $ | 501 | $ | 1,472 | $ | 1,026,388 | $ | 1,027,860 | $ | 34 |

Note: Accruing loans include accrued interest receivable.

## Risk Loans

Risk loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms.

**Risk Loan Information**

| (in thousands) As of: | | **September 30 2016** | | December 31 2015 |
|---|---|---|---|---|
| Volume with specific reserves | **$** | **472** | $ | 236 |
| Volume without specific reserves | | **1,759** | | 2,281 |
| Total risk loans | **$** | **2,231** | $ | 2,517 |
| Total specific reserves | **$** | **392** | $ | 201 |
| For the nine months ended September 30 | | **2016** | | 2015 |
| Income on accrual risk loans | **$** | **20** | $ | 16 |
| Income on nonaccrual loans | | **125** | | 75 |
| Total income on risk loans | **$** | **145** | $ | 91 |
| Average risk loans | **$** | **2,731** | $ | 2,391 |

Note: Accruing loans include accrued interest receivable.

We did not have any material commitments to lend additional money to borrowers whose loans were at risk at September 30, 2016.

## Troubled Debt Restructurings (TDRs)

In situations where, for economic or legal reasons related to the borrower's financial difficulties, we grant a concession for other than an insignificant period of time to the borrower that we would not otherwise consider, the related loan is classified as a troubled debt restructuring, also known as a restructured loan. A concession is generally granted in order to minimize economic loss and avoid foreclosure. Concessions vary by program and borrower and may include interest rate reductions, term extensions, payment deferrals, or an acceptance of additional collateral in lieu of payments. In limited circumstances, principal may be forgiven. Loans classified as TDRs are considered risk loans. All risk loans are analyzed within our allowance for loan losses. We record a specific allowance to reduce the carrying amount of the restructured loan to the lower of book value or net realizable value of collateral.

We completed TDRs of certain production and intermediate term loans during the nine months ended September 30, 2016 and 2015. Our recorded investment in these loans just prior to restructuring was $4 thousand and $25 thousand during the nine months ended September 30, 2016 and 2015, respectively. Our recorded investment in these loans immediately following the restructuring was $5 thousand and $25 thousand during the nine months ended September 30, 2016 and 2015, respectively. The recorded investment of the loan is the face amount of the receivable increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, and acquisition costs and may also reflect a previous direct charge-off.

The primary type of modification was extension of maturity.

There were no TDRs that defaulted during the nine months ended September 30, 2016 in which the modification was within twelve months of the respective reporting period. We had TDRs in the production and intermediate term loan category of $3 thousand that defaulted during the nine months ended September 30, 2015 in which the modifications were within twelve months of the respective reporting period.

**TDRs Outstanding**

| (in thousands)<br>As of: | | September 30<br>2016 | | December 31<br>2015 |
|---|---|---|---|---|
| Accrual status: | | | | |
| Real estate mortgage | **$** | **--** | $ | -- |
| Production and intermediate term | | **2** | | 2 |
| Other | | **--** | | -- |
| Total TDRs in accrual status | **$** | **2** | $ | 2 |
| Nonaccrual status: | | | | |
| Real estate mortgage | **$** | **39** | $ | 56 |
| Production and intermediate term | | **35** | | 70 |
| Other | | **--** | | 877 |
| Total TDRs in nonaccrual status | **$** | **74** | $ | 1,003 |
| Total TDRs status: | | | | |
| Real estate mortgage | **$** | **39** | $ | 56 |
| Production and intermediate term | | **37** | | 72 |
| Other | | **--** | | 877 |
| Total TDRs | **$** | **76** | $ | 1,005 |

The decrease in other loans resulted from two communication loans to one borrower being refinanced during the second quarter of 2016, and subsequently, are no longer classified as TDRs.

There were no material commitments to lend to borrowers whose loans have been modified in a TDR at September 30, 2016.

### Allowance for Loan Losses

**Changes for Allowance for Loan Losses**

| (in thousands)<br>Nine months ended September 30 | | 2016 | | 2015 |
|---|---|---|---|---|
| Balance at beginning of period | **$** | **2,057** | $ | 1,954 |
| Provision for loan losses | | **919** | | 36 |
| Loan recoveries | | **42** | | 29 |
| Loan charge-offs | | **(224)** | | (111) |
| Balance at end of period | **$** | **2,794** | $ | 1,908 |

The increase to the allowance for loan losses from December 31, 2015 primarily resulted from increases in specific reserves in certain production and intermediate term risk loans along with credit quality changes and loan growth.

## NOTE 3: MEMBERS' EQUITY

### Regulatory Capitalization Requirements

On March 10, 2016, the FCA Board approved a final rule to modify the regulatory capital requirements for System Banks and Associations. The final rule replaces existing core surplus and total surplus ratios with common equity tier 1, tier 1, and total capital risk-based capital ratios. The final rule also adds a tier 1 leverage ratio. The permanent capital ratio continues to remain in effect with the final rule. The effective date of the new capital requirements is January 1, 2017.

**FCA Revised Capital Requirements**

| | Regulatory Minimums | Capital Conservation Buffer | Total |
|---|---|---|---|
| Risk adjusted: | | | |
| Common equity Tier 1 ratio | 4.5% | 2.5% | 7.0% |
| Tier 1 capital ratio | 6.0% | 2.5% | 8.5% |
| Total capital ratio | 8.0% | 2.5% | 10.5% |
| Non-risk adjusted: | | | |
| Tier 1 leverage ratio | 4.0% | 1.0% | 5.0% |

If the capital ratios fall below the total requirements, including the buffer amounts, capital distributions (equity redemptions, dividends, and patronage) and discretionary senior executive bonuses are restricted or prohibited without prior FCA approval.

## NOTE 4: CONTINGENCIES AND COMMITMENTS

In the normal course of business, we have various contingent liabilities and commitments outstanding, primarily commitments to extend credit, which may not be reflected in the Consolidated Financial Statements. We do not anticipate any material losses because of these contingencies or commitments.

We may be named as a defendant in certain lawsuits or legal actions in the normal course of business. At the date of these Consolidated Financial Statements, our management team was not aware of any material actions. However, management cannot ensure that such actions or other contingencies will not arise in the future.

## NOTE 5: FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or most advantageous market for the asset or liability. Accounting guidance also establishes a fair value hierarchy, with three levels of inputs that may be used to measure fair value. Refer to Note 2 in our 2015 Annual Report for a more complete description of the three input levels.

We did not have any assets or liabilities measured at fair value on a recurring basis at September 30, 2016 or December 31, 2015.

### Non-Recurring

We may be required, from time to time, to measure certain assets at fair value on a non-recurring basis.

**Assets Measured at Fair Value on a Non-recurring Basis**

| (in thousands) | **As of September 30, 2016** | | | | **Nine months ended September 30, 2016** |
|---|---|---|---|---|---|
| | Fair Value Measurement Using | | | Total Fair | Total (Losses) |
| | Level 1 | Level 2 | Level 3 | Value | Gains |
| Impaired loans | **$ --** | **$ --** | **$ 84** | **$ 84** | **$ (415)** |
| Other property owned | **--** | **--** | **--** | **--** | **3** |
| | As of December 31, 2015 | | | | Nine months ended September 30, 2015 |
| | Fair Value Measurement Using | | | Total Fair | Total (Losses) |
| | Level 1 | Level 2 | Level 3 | Value | Gains |
| Impaired loans | $ -- | $ -- | $ 36 | $ 36 | $ (47) |
| Other property owned | -- | -- | -- | -- | 1 |

### Valuation Techniques

**Impaired loans:** Represents the carrying amount and related write-downs of loans which were evaluated for individual impairment based on the appraised value of the underlying collateral. When the value of the collateral, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established. Costs to sell represent transaction costs and are not included as a component of the asset's fair value. If the process uses independent appraisals and other market-based information, they are classified as Level 2. If the process requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters, they are classified as Level 3.

**Other property owned:** Represents the fair value and related losses of foreclosed assets that were measured at fair value based on the collateral value, which is generally determined using appraisals, or other indications based on sales of similar properties. Costs to sell represent transaction costs and are not included as a component of the asset's fair value. If the process uses independent appraisals and other market-based information, they are classified as Level 2. If the process requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the property and other matters, they are classified as Level 3.

## NOTE 6: SUBSEQUENT EVENTS

We have evaluated subsequent events through November 8, 2016, which is the date the Consolidated Financial Statements were available to be issued. There have been no material subsequent events that would require recognition in our Quarterly Report or disclosure in the Notes to Consolidated Financial Statements.