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Business and Health Care Reform

Few issues in recent years have been as heavily debated or as highly contentious as health care reform. And for good reason. The issue affects every American, and its impact on the economy is huge. U.S. health spending in 2010 totaled \$2.6 trillion, or almost 18 percent of the total economy. That same year Congress approved, and President Obama signed, a massive overhaul of the U.S. health care system, setting off a firestorm that's still roiling today.

Only a small portion of the law, officially known as the Affordable Care Act, has gone into effect, but business of all sizes are trying to understand and comply with its requirements. Meanwhile, all of the Republican candidates running for president this year have vowed to repeal the law if elected. And those who want to see all, or most, of the law rolled back have time: Its major components don't kick in until January 1, 2014.

Besides political opposition on the right, the law is facing legal hurdles as well. Next month, the U.S. Supreme Court will hear a key challenge to the law's constitutionality, which could partially or entirely upend the law.

One of the plaintiffs in the Supreme Court case is the National Federation of Independent Business, an association representing small businesses throughout the country. NFIB supported health care reform but eventually opposed the Affordable Care Act; NFIB arguing that the law failed to address high and rising costs and that it imposed burdensome monetary and administrative costs on businesses.

For this month's Outlook, we interviewed economist Robert Graboyes, a senior fellow for health and economics at the NFIB Research Foundation. A fierce critic of the legislation, he says Americans are only beginning to understand the profound impacts it will have on business and the health care delivery system in this country.

Editor's note: In order to provide readers with a balance of perspectives, next month's edition of Outlook will feature an interview on health care reform with economist Henry J. Aaron, a supporter of the law and a senior fellow at the Brookings Institution.

About this article

Robert Graboyes is a senior fellow for health and economics at the NFIB Research Foundation in Washington, D.C., which is affiliated with the National Federation for Independent Business. He analyzes federal and state health care legislation from the perspective of small business. He also teaches health economics at Virginia Commonwealth University, the University of Virginia and George Mason University. Previously, Mr. Graboyes was Chase Manhattan Bank's economist for sub-Saharan Africa, economist at the Federal Reserve Bank of Richmond, and associate professor at the University of Richmond.

OUTLOOK: Take us through a timeline – what's happened already with health care implementation, and what's yet to happen?

Robert F. Graboyes: In 2010, a small-business tax credit kicked in, along with the tax on tanning parlors, and a provision that all insurance policies had to allow coverage of children of policy holders up to age 26 if other employer coverage isn't available. In 2011, there was a new tax on drugs, and people were told they could no longer buy over-the-counter medications with a flex plan or health savings account – unless they have a doctor's prescription. Not much that impacts small businesses kicks in this year. But there's a flurry of regulation writing going on. Next year, there are a bunch of new taxes, such as those on medical devices; some 1040 deductions go away; and some additional limits on flex plans kick in. Many small business owners will face new surtaxes on household wages and salaries and on investments; these taxes are officially called "Medicare" taxes, though their proceeds will not actually go to Medicare. But 2014 is the big year – the individual mandate goes into effect, as does the employer mandate, the individual subsidies, the small-business health insurance tax, the exchanges, the benefit mandates, and the Medicaid expansion. And for the rest of the decade, there's about one big change a year, plus endless regulation writing.

OUTLOOK: Remind us: what are the most significant changes Americans will see due to the health care law?

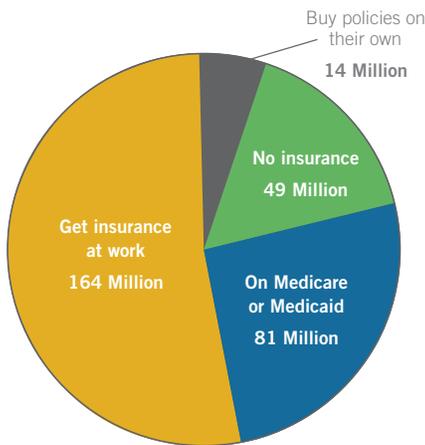
RG: First, there's the individual mandate, which is a requirement that every American, with a few minor exceptions, must have health insurance. It is an unprecedented mandate, as the federal government has never told all Americans they must buy a product or a service. The second part is a recognition that some people can't afford to purchase insurance, especially given the premium increases we expect to see, so there are subsidies for people who meet some fairly generous criteria. Third, there's an employer mandate that says if you are an employer of 50 or more people, and if even one of your employees qualifies for a subsidy, then you will likely be financially penalized through a complicated formula.

OUTLOOK: There are also a number of changes to how health insurance is sold.

RG: The idea is to construct exchanges or centralized marketplaces where consumers can compare insurance plans across prices and other features. They'll be run at the state level, though some states are currently inclined to leave the task to the federal government. Exchanges are supposed to serve small businesses and individuals buying insurance on the private market. If you want to think of a model, Travelocity is sort of an exchange, but there are all sorts of different visions about what an exchange should look like. Some have much more of an activist role than others. I should mention that NFIB

The individual mandate is unprecedented, as the federal government has never told all Americans they must buy a product or a service.

WHO'S COVERED?



Source: Commonwealth Fund

has supported the idea of exchanges, though not necessarily in the form laid out in this law.

There is also a massive expansion of Medicaid. If forecasts hold up, an extra 30 million people would gain health insurance coverage; and about half of them would move into Medicaid, which is a program most of us don't want to be in – for good reason.

Another key change is the regulatory definition of “essential health benefits.” In order to require everyone to buy health insurance, you have to first define what health insurance is. So the Secretary of Health and Human Services is supposed to compile a list of things that every insurance policy purchased in the fully-insured market must cover; but the rules do not apply to the self-insured market. That means the policies small businesses must buy will have all sorts of requirements as to what has to be in them – and those requirements can expand at the flick of the Secretary's pen. But this is not true of governments, big business and labor unions, by and large, because most are self-insured. That is one of the reasons we at NFIB tend not to like it.

And insurance policies can no longer include annual or lifetime maximum payouts. There is also a long list of preventive services that must be provided free of charge.

Outlook: How does the employer mandate and its penalties work?

RG: The mandate requires companies with 50 or more full-time-equivalent employees to provide a health insurance plan that meets certain minimum standards or to pay a penalty in lieu of coverage.

The penalties are very complicated. If a business does not provide insurance and if at least one of its employees receives federal insurance subsidies in a health insurance exchange, the business will have to pay \$2,000 per employee above 30 employees. As an example, a business with 50 employees, two of whom are subsidized, would pay \$40,000 per year – 50 minus 30 times \$2,000.

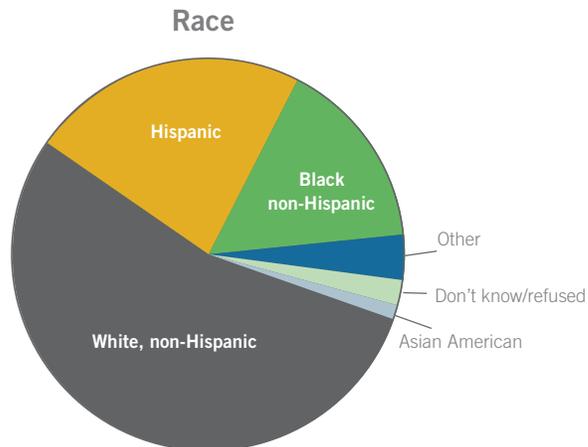
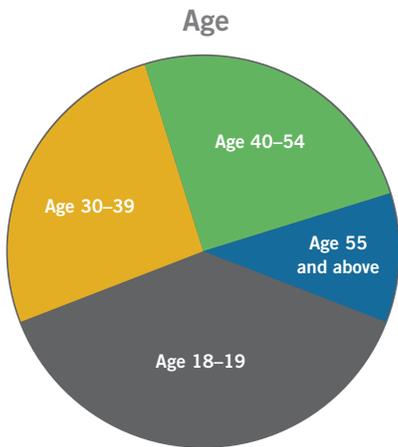
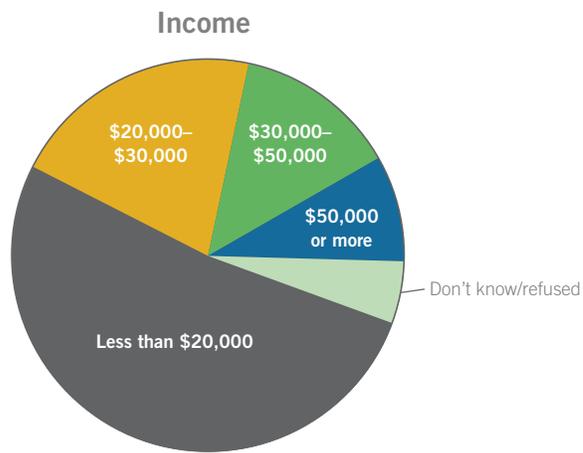
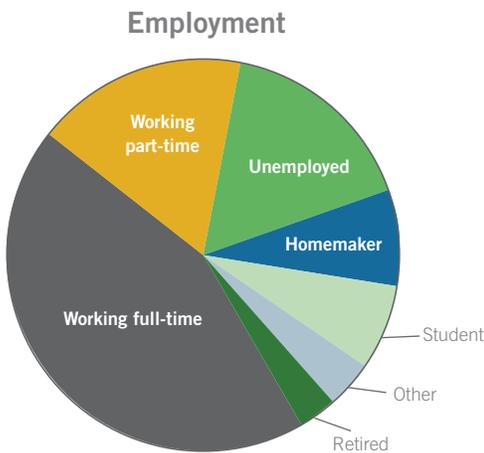
If a business does provide insurance, and if at least one employee receives insurance subsidies, the business will pay \$3,000 per subsidized employee or \$2,000 per employee minus the first 30, whichever is less. So a 50-person firm with two subsidized employees would be fined \$6,000 per year. If the

number of subsidized employees at the firm rose to 14 or more, the tipping point for the formula would kick in and the penalty would be \$40,000 per year.

Outlook: Who qualifies for the subsidy?

RG: The employee qualifies for a subsidy if two conditions are met. First, household income must be less than four times the poverty level, which is a function of income and your family size. Today, a family of four would have to earn less than about \$89,000 a year. That's not rich, but it's not low income. Second, the family's insurance premium has to cost them more than 9.5 percent of household income. So if you meet those two criteria, you can apply for a subsidy starting in 2014.

WHO ARE THE UNINSURED ADULTS?



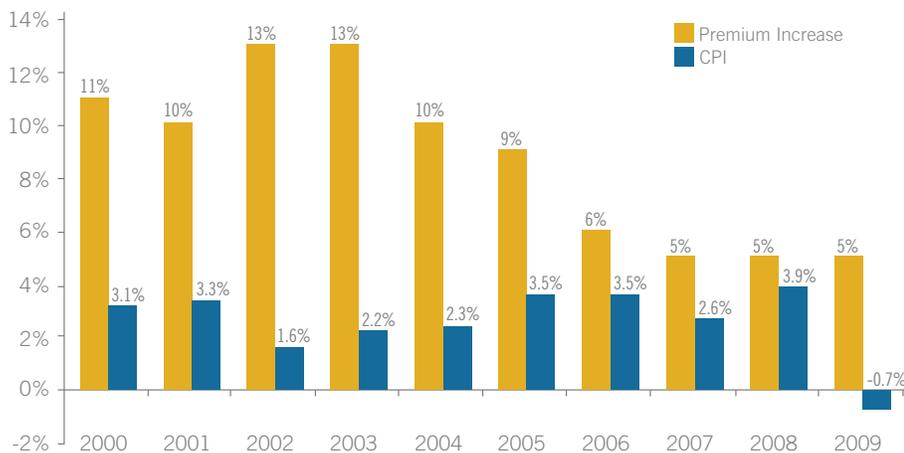
Source: PBS/The Kaiser Family Foundation

What makes it very difficult for businesses is that the penalties involve so much that is outside of their control or even outside of their view. Let's say you're married with two children and you and your wife together earn \$100,000. Now your wife's income drops a bit, and you're below \$89,000. Your employer and your wife's employer will both be slammed with a fine. I have jokingly referred to this as the "employee's spouse's uncle tax," because it is literally true that an employer could be fined because one of its employees has a spouse who has an elderly uncle who moves into their spare bedroom, thereby increasing family size. The employer is not entitled to ask, "Why are you suddenly entitled to a subsidy?" And so you can conceive of a situation where an employee falsely tells the government, "My uncle moved in." The employer has little recourse other than challenging the employee's honesty before the Internal Revenue Service. It puts the employer in a very awkward position. By the way, the IRS has acknowledged that this is a problem and is seeking a solution. I'm skeptical that a good fix can be devised.

Outlook: How are small businesses reacting to this provision of the law?

RG: It certainly discourages job growth. We've already had a number of our members say something like, "I'm already at 45 employees, I've got a contract offer that will allow me to expand, but I'm not going to even contemplate it until I figure out whether I'll be subject to these penalties." The mandate provides a tremendous motive to stay below 50 employees. The mandate also encourages employers to avoid the penalties by firing full-timers and replacing them with part-timers.

PERCENTAGE INCREASE IN HEALTH INSURANCE PREMIUMS COMPARED TO INFLATION



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999–2009. Bureau of Labor Statistics, Consumer Price Index, U.S. City Average of Annual Inflation (April to April), 1999–2009.

OUTLOOK: Proponents of the law said the penalty provision was there to incent employers to provide health care for their employees, rather than having the employees rely on the government.

RG: Whatever the intent, the actual incentives are quite perverse. We feel quite strongly that a lot of employers are going to shift the burden to the government because of the mandates. Employers will be able to say, “I’m going to forget about providing insurance. I’m going to throw my employees into the government subsidies and split the difference with them.” Come 2014, an employer will be able to sit down with his employees and say, “You know, guys, I always bought you insurance, but they’ve got these new rules. What I can do is drop all of you; you get your subsidy and buy your insurance in these new exchanges. Then, I’ll use some of the money I save to give you a raise. I’ll have more to take home and you’ll have more to take home, and the taxpayers will pick up the difference.” One of the analysts at the Employee Benefits Research Institute, a nonpartisan group, recently argued that companies will be lured into dumping coverage when they see that their competitors have done so. And the impact on the federal budget could be enormous.

OUTLOOK: Can’t the law be amended if it ends up creating too many problems for businesses?

RG: One small piece of it has been already amended, but that’s not necessarily reason for comfort. There was going to be a horrifically onerous onslaught of paperwork called the 1099 requirement; it would have mandated the filing of an IRS form any time a business made purchases of \$600 or more to a vendor over a year. Business owners could not believe the extent to which it was going to disrupt their lives and operations – sorting and collating thousands and thousands of receipts. The day after the 2010 elections, the president said the 1099 requirement had to go, the leaders of the House and Senate of both parties agreed it had to go, and business leaders agreed it had to go. Yet it took six months of battling to strip around 170 words out of the law.

“The red-tape and administrative tasks involved in all these mandates are going to be enormous. I have strong doubts as to whether many of them will even be manageable.

OUTLOOK: Beyond the penalties you've described, how challenging will it be for businesses to comply with the law from an administrative standpoint?

RG: The red-tape and administrative tasks involved in all these mandates are going to be enormous. I have strong doubts as to whether many of them will even be manageable.

Gene Steuerle of the Urban Institute wrote in 2009 that the interactions between the individual mandate, the subsidies and the employer mandate are so complicated and wholly dependent on extreme amounts of data flow that he doubted that it would work. In February 2011, two scholars who support the law, Benjamin Sommers and Sara Rosenbaum, warned the way they've structured the math of the subsidies and Medicaid qualification means people will bounce back and forth repeatedly from Medicaid to their employer's plan then to the subsidized plan, on and on.

OUTLOOK: What about government administration of the law?

RG: In 2011, two scholars who oppose the law, Paul Howard and Steve Parente, warned that managing the subsidies and penalties would require ongoing, real-time merger of the data flows from the Department of Labor, the Department of Health and Human Services, the U.S. Treasury, the Department of Homeland Security, the Internal Revenue Service, Medicare, Medicaid, CHIP, Social Security, 50 state exchanges, and private insurers. They argue that there is no history of these agencies ever bringing their data together at this scale and that it would qualify as the largest IT integration project in U.S. history.

The National Governors' Association sent out a scream in September that effectively said, "This thing isn't working. The federal government is missing all of its deadlines. And even if they made their deadlines we're not sure this would be doable by Jan. 1, 2014. Help!" This is going to be a nightmare.

OUTLOOK: Does the law adequately address the problem of the rising costs of health care?

RG: That's easy: No. It sets into motion some long-term experiments that they hope will hold costs down; but there's no evidence that they will. NFIB very, very, very strongly supported health-care reform, and when I began at NFIB in 2007, most of the criticism I heard was from the political right saying, "Why are you guys going up to Ted Kennedy's office and talking to these people and working with them?" And we said we need to get health care reformed, and our interest is cost, cost, cost, cost, cost. In the end, the law was sold on the argument that it would be able to get costs down, but by late 2009, it was obvious to NFIB that it would do no such thing. And we're now seeing torrents of evidence that we were right.

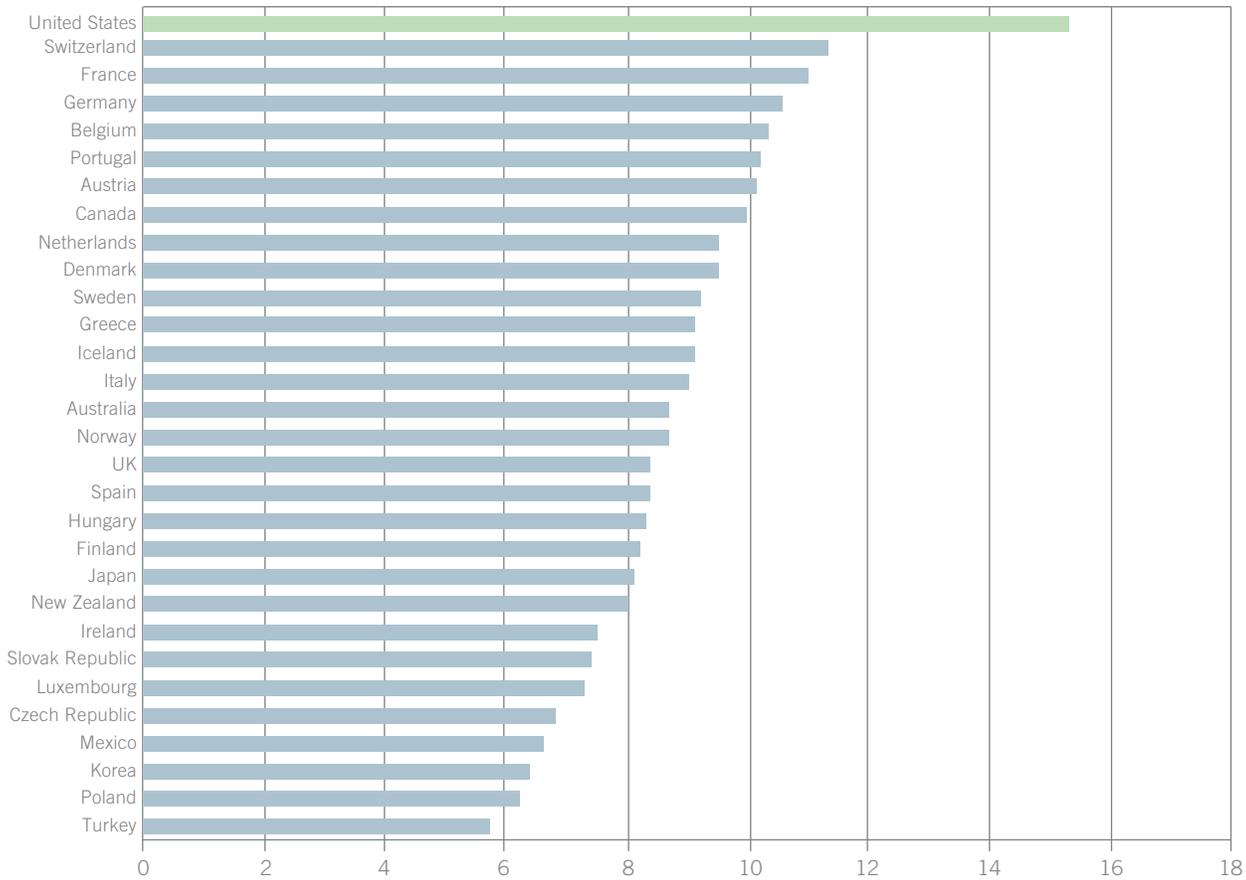
OUTLOOK: What have various courts ruled in relation to the law?

RG: A federal court in Virginia said the individual mandate should go, but the rest could stay; a court in the Midwest that said it could all stay. But I can tell you the most about the case in which the NFIB is a plaintiff, along with 26 states and two individuals, in the federal district court in Florida. The district court judge ruled the individual mandate is unconstitutional, and because the law did not include a severability clause the entire law must fall. A severability clause essentially says, "If any part of this law is struck down by a court, the rest remains intact."

Then it was up to the Obama Administration to appeal, because they lost everything in that ruling. They continued implementing the law and assumed the judge wasn't telling them to stop. They sent a request for clarification. I'm told judges don't like people saying "Would you clarify what you meant?" He issued a very strong clarification saying, essentially, "I've ruled it's unconstitutional, so it has to stop, unless you file an appeal." So it went to the 11th Circuit Court of Appeals, where three judges were chosen randomly. One was clearly a Republican appointee, one a Democratic appointee, and one who'd received appointments under both but was considered more of a Democratic appointee. Ultimately, that court ruled to throw out the individual mandate, and that was viewed as a striking finding because it was the first time Democratic-appointed judges had ruled the individual mandate was unconstitutional and must go. But the appeals court said it would let the rest of the law stand, treating it as if there were a severability clause. I'll stress that I'm an economist, not an attorney, so I'm out of my environment here.

Earlier drafts of the legislation had the severability clause, but for whatever reasons, it was removed by the final draft. One of the theories is it was done to make it an all-or-nothing proposition, to say to a judge if you throw out one comma the whole thing implodes. So the appeals court said, with some precedent, we will void the individual mandate but let the rest of the law

HEALTH CARE SPENDING AS PERCENTAGE OF GDP



Source: Organization for Economic Cooperation and Development, *OECD Health Data, 2008* (Paris OECD, 2008).
 Note: For countries not reporting 2006 data, data from previous years is substituted.

stand. But that created a volatile situation, since both sides are quick to say if you simply remove the individual mandate, the law begins caving in on itself. It is the glue that holds it all together.

Since each side had a partial loss in the decision, either side could appeal, and we appealed the severability part of it. And the government stepped in and appealed the individual mandate part of it. The Supreme Court will hear the case.

OUTLOOK: What, specifically, are the issues that will be considered by the U.S. Supreme Court?

RG: The first is whether the individual mandate is constitutional. The second, assuming it's not constitutional, is whether the law is severable – whether they must strike down the whole law. The third issue refers to what's called the Tax Anti-Injunction Act, which dates back to the 1860s. With the employer mandates, there's a legal question as to whether the penalties are penalties or taxes. Prior to the law's passage, supporters said they were

The longer it goes, the harder it is to undo. But it's early enough that most of it is still reversible.

penalties, not taxes, and nowhere in the law did it say they were taxes. From the president on down, they said, "It's not a tax increase – it's penalties for people who don't meet certain criteria on insurance." But once it became apparent a constitutional challenge would be a serious thing, there was a reversal in those arguments. As I understand it, courts are very hesitant to strike down tax provisions, taking the view it's the government's bailiwick. And the Anti-Injunction Act says the court can't consider the constitutionality of a tax until it's actually collected, which in this case would be 2014. The argument that we endorsed is that it doesn't say anywhere it's a tax, it says it's a penalty, they said it was a penalty, it looks like a penalty, it quacks like a penalty, so there's no reason to think it's a tax – and therefore no problem for the court to look at it now.

And the fourth issue is that this is going to foist enormous costs onto states through Medicaid. Certain states with large Medicaid populations are just going to be demolished by the financial implications of this. Medicaid has always been an allegedly voluntary program, part federal and state funding, with the understanding if a state doesn't want to be in it, it can always leave. However, this law makes states lose vast amounts of money if they leave Medicaid, so the question came up of whether the federal government was exerting coercion to keep the state in. I don't think most observers expected the Supreme Court to look at that issue, but they made it one of the four.

Outlook: When will the case be decided?

RG: The court will hear the arguments in March and will probably rule by the end of June 2012.

Outlook: What will happen if the Supreme Court strikes down the law? Will everything simply return to the way it was before?

RG: Some things have already changed. Some insurance companies have stopped writing some kinds of policies. You haven't scrambled all the eggs yet, but the fork has swirled through several of them. The longer it goes, the harder it is to undo. But it's early enough that most of it is still reversible.

Outlook: If the Supreme Court upholds the law, what do you expect to happen then?

RG: Part of it depends on how bad you think this thing is going to be; I think it has the potential to be disastrous. I think the Congressional Budget Office has grossly underestimated the number of employers who are going to chuck it and pay penalties and walk away. If that happens, the federal deficit swells rapidly. And that might have been OK 10 years ago, but with the current fiscal situation, you start bleeding the federal treasury, and you've got a problem.

Outlook: NFIB supported the idea of health care reform. If you get your wish and the law is repealed or struck down in court, what would you like to see happen next to address the problem of health care costs?

RG: Our website has a list of 12 things that could be done to reform health insurance markets. That's one area of needed change. We're also going to need entitlement reform. The Medicare payment system, fee-for-service reimbursement, is the source of a vast percentage of our problems. It skews resources badly, diverting them to the wrong places. It probably undercompensates general practitioners and overcompensates specialists, distorting practice patterns. And Medicaid's revenue formula rewards states that are profligate and punishes states that are careful.

Finally, we're going to have to change many things about the health-care delivery system. That's a large set of smaller issues and questions. If you're getting a particular service, do you have to get it from a doctor, or can you get it from a nurse practitioner? Can a pharmacist write a prescription? Can you start a specialty hospital, or do they all have to be big general hospitals? This is not going to be something where you'll have a neat bumper sticker that's "the solution." It'll be a long hard slog through an awful lot of experiments.

Outlook: That doesn't sound like something that can easily be achieved.

RG: In the early to mid-1990s, when I was in my late 30s or early 40s, my wife suggested that I shift into health-care economics. After thinking about it, I told her, "I think I'll do it because it will keep me occupied for the rest of my working life. And given what I know about Social Security and Medicare, it's going to be a very long working life." So far, that prediction is coming true. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 01/31/12. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

US Treasury Securities

2011	GDP	CPI	Fed Funds	2-year	10-year
Q4	3.10%	1.40%	0.07%	0.30%	2.00%
2012	GDP	CPI	Funds	2-year	10-year
Q1	2.00%	1.80%	0.10%	0.30%	2.00%
Q2	2.10%	1.70%	0.10%	0.30%	2.10%
Q3	2.30%	2.20%	0.13%	0.30%	2.10%
Q4	2.70%	2.10%	0.13%	0.30%	2.20%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.54%	0.48%	0.57%	0.97%	1.45%	1.93%
0.25	0.28%	0.42%	0.60%	1.06%	1.53%	1.99%
0.50	0.45%	0.48%	0.69%	1.17%	1.63%	2.07%
0.75	0.48%	0.50%	0.76%	1.27%	1.72%	2.15%
1.00	0.48%	0.51%	0.85%	1.38%	1.81%	2.21%
1.50	0.52%	0.58%	1.08%	1.61%	1.97%	2.37%
2.00	0.58%	0.72%	1.30%	1.84%	2.17%	2.51%
2.50	0.82%	1.02%	1.60%	2.07%	2.37%	2.66%
3.00	1.07%	1.31%	1.91%	2.30%	2.57%	2.81%
4.00	1.74%	1.95%	2.42%	2.70%	2.86%	3.04%
5.00	2.24%	2.47%	2.82%	2.98%	3.11%	3.21%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

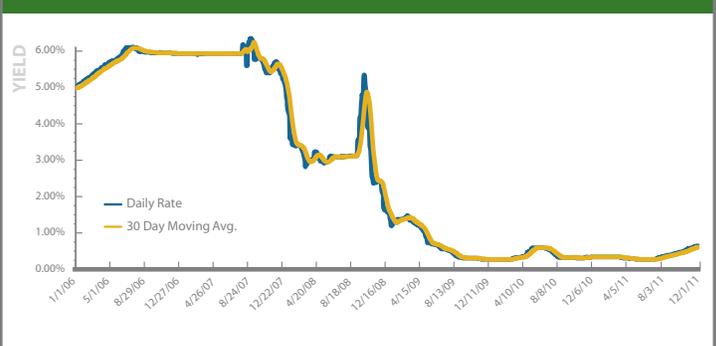
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	5	9	12	12
180	5	13	20	21
365	5	28	42	40

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

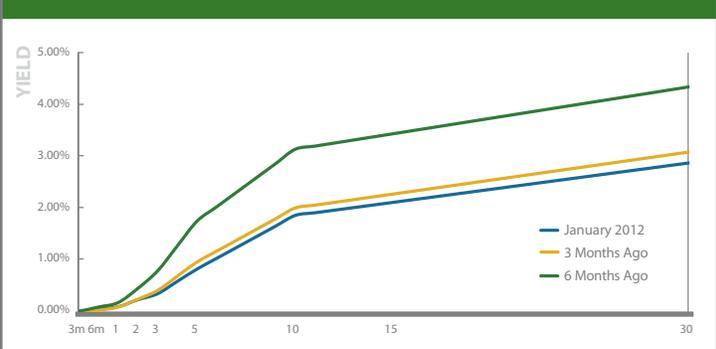
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE





CoBank Reports Full-Year Financial Results For 2011

Net Earnings Increased 15 Percent to \$706.6 Million; Capital And Liquidity Levels Remained Strong. 2011 Patronage Payments To Customers Will Total \$340.7 Million

About CoBank

CoBank is a cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. In addition to serving its direct retail borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank's web site at www.cobank.com.

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

CoBank earlier this month announced its fourth-quarter and full-year financial results for 2011. Full-year earnings and net interest income reached record highs, and loan quality improved throughout the year. CoBank's overall levels of capital and liquidity remained strong.

"We're extremely pleased with CoBank's business performance in 2011," said Robert B. Engel, president and chief executive officer. "Throughout the year, we were able to effectively meet the borrowing needs of customers and build the financial strength of the bank, despite difficult conditions in the financial markets and the broader U.S. economy. In addition, we successfully executed our merger with U.S. AgBank, which expanded our customer base, enhanced the diversification of our loan portfolio and increased our capital position. We remain focused on delivering on our value proposition for customer-owners, and on ensuring the bank can fulfill its mission serving vital industries in rural America."

2011 Financial Results

Average loan volume during 2011 was \$50.2 billion, up 10 percent from the prior year. Most of the increase occurred in the bank's Agribusiness operating segment, where higher prices for corn, soybeans and wheat drove increased seasonal borrowing by many cooperatives and other agricultural businesses. The bank also experienced higher average loan volume in its Rural Infrastructure operating segment, largely due to growth in lending to rural electric distribution cooperatives throughout the country.

"Commodity markets were an important driver of CoBank's financial results during the year, and we're pleased we were able to stand by our agribusiness customers to meet their needs in conditions that remained volatile," Engel said. "Also noteworthy was the bank's success in the rural electric industry, where we continued to demonstrate our value proposition and grow market share."

In CoBank's Strategic Relationships operating segment, average loan volume increased approximately 1 percent in 2011. That segment includes the bank's wholesale loans to affiliated Farm Credit associations and other organizations in the Farm Credit System that are primarily focused on production agriculture. "Ironically, the same higher commodity prices that increased borrowing by cooperatives last year helped suppress loan demand

from association customers,” Engel said. “Many farmers around the country experienced strong profits in 2011 and opted to finance their operations with cash, reducing their need for loans from associations. While association lending grew only moderately last year, we’re pleased that the overall health of the U.S. farm economy remains so strong.”

In the fourth quarter of 2011, CoBank experienced year-over-year declines in seasonal agribusiness lending due to lower prices of some commodities as well as changing delivery patterns at grain cooperatives. Total loan volume for the bank at December 31, 2011, was \$46.3 billion, compared with \$50.0 billion at the end of 2010.

Full-year net interest income for CoBank rose 13 percent to \$1.1 billion, from \$950.8 million in 2010. In the fourth quarter, net interest income was \$241.3 million, compared to \$275.9 million the prior year, largely due to the fourth-quarter factors cited above. CoBank’s full-year net income was \$706.6 million, up 15 percent from \$613.8 million in 2010. Net income for the fourth quarter of 2011 was \$143.9 million, compared with \$162.8 million in the same period the prior year.

In March, the bank will pay \$340.7 million in total patronage distributions, including \$230.7 million in cash and \$110.0 million in common stock. For most customers, that represents 100 basis points of average loan volume, lowering their overall net cost of debt capital from CoBank. “Strong, dependable patronage is an important component of the CoBank value proposition,” Engel said. “As a cooperatively organized lender, we’re delighted with the patronage payout authorized by our board this year and with the benefit it will provide to our customers.”

Credit quality across the bank’s loan portfolio improved during 2011 and remained well within the risk-bearing capacity of the bank. At year-end, 1.25 percent of the bank’s loans were classified as adverse assets, compared to 1.46 percent at the end of the third quarter of 2011 and 1.71 percent at December 31, 2010. The provision for loan losses totaled \$58.0 million in 2011, compared with \$60.0 million the year before. Nonaccrual loans were \$134.9 million at December 31, 2011, compared with \$167.0 million at year-end 2010.

The bank’s reserve for credit exposure totaled \$542.0 million at year-end, or 1.92 percent of nonguaranteed loans and leases outstanding when loans to Farm Credit associations are excluded. “Our reserve for credit exposure is strong and provides a solid level of protection against losses in our loan portfolio,” said David P. Burlage, CoBank’s chief financial officer.

Capital and liquidity levels at the bank remain strong and well in excess of regulatory minimums. As of December 31, 2011, shareholders' equity totaled \$4.9 billion, and the bank's permanent capital ratio was 16.4 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration (FCA), the bank's independent regulator. At year end, the bank held approximately \$15.8 billion in cash and investments. The bank averaged 199 days of liquidity during 2011 and had 234 days at year end, compared with the 90-day FCA minimum.

During the year, the bank recorded \$10.0 million in impairment losses on investment securities compared to \$44.0 million in 2010. These impairments relate to the 2 percent of the bank's investment portfolio that consists of non-agency mortgage-backed securities or asset-backed securities. The remainder of the portfolio – approximately 98 percent – consists of securities that carry an implicit or explicit guarantee from the U.S. government.

U.S. AgBank Financial Results

As previously announced, CoBank closed its merger with U.S. AgBank on January 1, 2012, and the banks' results for 2011 are being reported separately. U.S. AgBank served primarily as a wholesale provider of financing to Farm Credit associations in the western, southwestern and mid-plains regions of the country and had total assets of \$25.1 billion at December 31, 2011.

AgBank's net interest income for the year was \$148.1 million, compared with \$152.3 million in 2010. Full-year net income was \$129.2 million, compared with \$136.6 million the year before. Credit quality in the AgBank loan portfolio was very strong, reflecting the low risk profile of its association customer base. At year-end 2011, none of AgBank's loans were classified as adverse assets.

CoBank will begin reporting combined financial results in the first quarter of 2012. "Given the excellent credit profile of AgBank's former association customers, we expect to see an improvement in overall credit quality for CoBank as a result of the merger," Burlage said. "At the same time, we expect overall average margins to decrease commensurate with the addition of AgBank's low-risk, low-spread association loan portfolio." ■