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The Election and the Economy

In the wake of the presidential election of 2012, the U.S. seems an increasingly divided country from a political standpoint. The nation heads into 2013 with a split government: President Obama and his fellow Democrats in charge of the White House and Senate, and Republicans in control of the House of Representatives. Forward progress will depend on compromise, but common political ground may prove difficult to find.

When it comes to economic policy, the divide is particularly deep. For evidence, look no further than *OUTLOOK*'s interview below with two highly respected economists from either side of the ideological spectrum. William Albrecht is a conservative, formerly with the University of Iowa, who supported Republican presidential candidate Mitt Romney. James Galbraith is a liberal economist and government professor at the University of Texas in Austin. Both have starkly different opinions about what U.S. political leaders should be doing to restore robust economic growth and put the country back on firmer economic footing.

OUTLOOK: Give us a snapshot of the current health of the economy in terms of growth, employment, business investment, consumer confidence, housing prices, etc. What do the key indicators tells us about the year ahead? Are you generally optimistic or generally pessimistic?

William Albrecht: It's very disappointing. Growth for 2012 will be about 2 percent of GDP, and you need growth of 3 percent just to keep the employment rate constant. So we're not making much progress. It has been a very weak recovery, and it continues to be weak. I am pessimistic.

James Galbraith: The economy is essentially stable. It's not on the edge of some new precipice, but it's not dynamic or going anywhere quickly either. We've seen growth rates that are very modest, but positive. That said, I do not think there is an easy path to return to the kinds of growth rates that became embedded in our economic DNA, imprinted on us since the early 1950s.

What we really need is tax reform, but that's not going to happen by the end of the year and I don't think it's ever going to happen with President Obama in charge.

About this article



William Albrecht is an economist who taught at the University of Iowa, where he was the Justice Professor of International Business, a professor of Economics and director of the Institute for International Business in the Henry B. Tippie College of Business.

Albrecht is an expert in international business and frequently visited Asia and Latin America to study the development and regulation of derivatives exchanges. In 1988, he was nominated by President Reagan to the Commodity Futures Trading Commission, where he served as chairman. He also served on the U.S. Small Business National Advisory Council, and as a consultant for the World Bank. He also acted as an adviser to financial institutions and governments in Africa, Asia, Australia and Latin America.

OUTLOOK: *With the election now over, political leaders are now scrambling to deal with the so-called "fiscal cliff," a combination of mandatory spending cuts and tax hikes that will kick in on January 1, 2013. What do you expect to happen there? How dire will the consequences be to the economy if no political compromise is reached on the fiscal cliff?*

WA: I think it's pretty dire. It's a huge tax increase during a weak recovery that shows no signs of speeding up significantly. The president wants to raise taxes on high income people. The Republicans in control of the House do not. But something has to be resolved.

My guess is the president will get more or less what he wants. They'll come back with a deal that raises taxes on people not earning more than \$1 million but maybe \$5 million to \$10 million. Obama can say he has done that, and the GOP can say, "We've compromised."

What we really need is tax reform, but that's not going to happen by the end of the year and I don't think it's ever going to happen with President Obama in charge.

JG: The fiscal cliff is an illusion. I would say it's more like a fiscal beach and a very, very shallow one. It's ludicrous to say the economy is going to fall off the cliff on January 1. Congress could act on middle-class taxes on the 15th of January or February, and the effect of the "cliff" would wash out in the data.

More broadly the cliff itself is contrived. Yes, clearly, some of the spending cuts would hurt over time. People who get unemployment insurance would be cut off and that's hard because they need cash. The income tax for the middle class would go up, but that's a change in withholding rates and would affect people very gradually. The military cuts are big, but that's a bit of a head fake, meaning it looks dramatic but the military spending is going down anyway and the sequester levels are in line with what will happen anyway to the military budget.

So if Congress went away for a year and didn't act you would see a bad effect on overall economic activity. But on the first of January you'll have a better Congress with seven new senators coming in. With the Bush tax cut expired, there is at that point no long-term deficit "problem" anymore, and everything you do on taxes from then on is a tax cut, not a tax increase. It's much easier

Adopting the austerity deficit reduction line that has become the worldwide orthodoxy will only make things worse. It would make a whole segment of the population feel less confident and more impoverished.

About this article



James Galbraith is an economist who writes frequently for mainstream and liberal publications on economic topics. He is a professor at the Lyndon B. Johnson School of Public Affairs and at the Department of Government, University of Texas at Austin. He is also a senior scholar with the Levy Economics Institute of Bard College. He is also part of the executive committee of the World Economics Association, which was created in 2011.

Mr. Galbraith has degrees from Harvard and Yale universities. He studied as a Marshall Scholar at King's College, Cambridge, and served in several positions on the staff of the U.S. Congress, including executive director of the Joint Economic Committee.

to say "Let's cut the taxes for the middle class." And they would not be raising taxes on the rich; those will already have gone up. So all the political issues are easier after the first of January, and the chance of making bad decisions about Social Security, Medicare and Medicaid under the press of a phony deadline would be less.

OUTLOOK: *Beyond the immediate issue of the fiscal cliff, what would you like to see from a divided government in terms of a long-term fix to U.S. fiscal policy and reductions in deficit spending?*

WA: The optimist in me says that Obama will decide his legacy depends on achieving something in his second term and he'll bring the top Democrats and Republicans from the House and Senate together and say "Let's get a tax reform proposal." That could be done. Tax reform that lowers marginal tax rates and broadens the tax base and gets rid of most exemptions and loopholes should increase government revenue and could help economic growth.

JG: The notion that debt is some over-riding issue is belied by the long-term interest rate on U.S. Treasuries. You pick up the paper and look at that Treasury interest rate, and you know the U.S. does not have a long-term debt problem. The U.S. government has no difficulty borrowing in the markets.

Adopting the austerity deficit reduction line that has become the worldwide orthodoxy will only make things worse. It's code for cutting Social Security, Medicare and Medicaid. It would make a whole segment of the population feel less confident and more impoverished. That would affect spending patterns and general economic activity. That has happened in Southern Europe, where governments imposed austerity programs. Instead of fixing their deficit problems, it makes them worse because their tax bases collapse. Why? Government spending is itself part of the national GDP. The notion that you can do this without having any underlying effect on the economy is one of the great mental blocks of the public discourse.

Corporations are sitting on a lot of cash that they're not investing because they don't know what is going to happen. They're afraid if they're successful they'll be punished.

OUTLOOK: *American consumers and businesses have lived with an enormous amount of uncertainty in terms of tax rates over the past several years. How important is it that government establishes a stable, permanent tax regime? Do you foresee that occurring in the year ahead?*

WA: It's very important. One thing we've learned is that temporary tax cuts don't do much good. Permanent tax cuts have an impact. Corporations are sitting on a lot of cash that they're not investing because they don't know what is going to happen. They're afraid if they're successful they'll be punished. There's a lot of uncertainty about how far the regulatory burden is going to go, and that can really stifle economic growth.

There is probably too much disagreement between Congress and the President to get any kind of stable tax regime in the next year. They'll probably come up with a temporary fix, unless Obama is willing to compromise more than he has in the past. This is the first president we've had who didn't really believe in free markets, and that is disastrous.

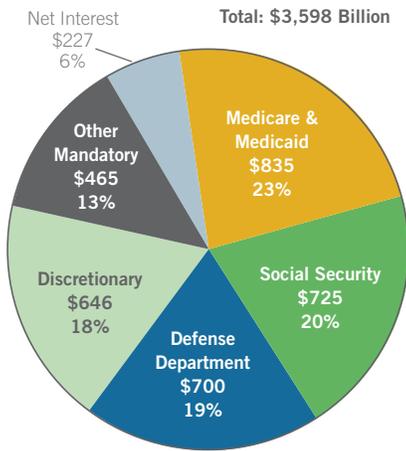
JG: A permanent tax regime is certainly not coming. The Constitution of the United States gives every Congress the right to write laws – including tax laws. There is no way to guarantee that the tax code will be stable. There is no reason why any reasonable person would expect it to remain stable. I don't think the uncertainties today are any larger than they were in 1980 when Ronald Reagan campaigned on a massive tax program.

OUTLOOK: *Obama has proposed an additional round of fiscal stimulus that he claims would create 2 million jobs. Is that a good idea from an economic policy standpoint? Is it likely to get through Congress?*

WA: I don't think it's a good idea. It's pretty clear that the previous fiscal stimulus didn't do much good. Most of the money basically went to constituents of the Democratic Party – labor unions and teachers. A stimulus means you have to borrow more money, take it out of somebody's pocket and give it to someone else. That doesn't do much to stimulate the economy over the long term and the multiplier effect is pretty small. I also don't think a stimulus plan would get through Congress unless Obama gives the Republicans something they want.

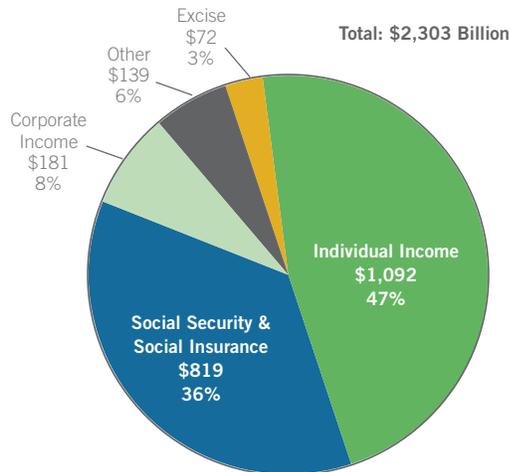
U.S. FEDERAL SPENDING

Fiscal year 2011 (\$ Billions)



U.S. FEDERAL TAX RECEIPTS

Fiscal year 2011 (\$ Billions)



Source: CBO Historical Tables

JG: I don't know what will happen in Congress, but I hope we can retire the word "stimulus" because it conveys the notion that what's wrong with the engine is a lack of gas. This is wrong; the engine suffered a meltdown.

The president needs to use his four years to set a direction that can carry on after his term. I'm not in favor of wasting time pressing for spending for spending sake. You want to stabilize the economy but raining money on it is not the right use of the political moment. That strategy holds out the false promise that we are going back to the economy we had five years ago. Instead, we need to figure out what the most important problems are and then start working on them. For instance, in 1933, Congress created the Tennessee Valley Authority, a federal agency to provide flood control, economic development and electricity generation in an area affected by the Great Depression. It came out of the New Deal and industrialized the deep south along the Tennessee River. You could do the same thing today to address climate change, rising sea levels along the coasts and hyper-energetic storms. There are things that need to be done about emissions and storm mitigation. After Hurricane Katrina, I proposed we create the Gulf Coast Authority. Now following SuperStorm Sandy, it looks like we need the East Coast Authority too. How many times do we have to experience this before we start dealing with it?

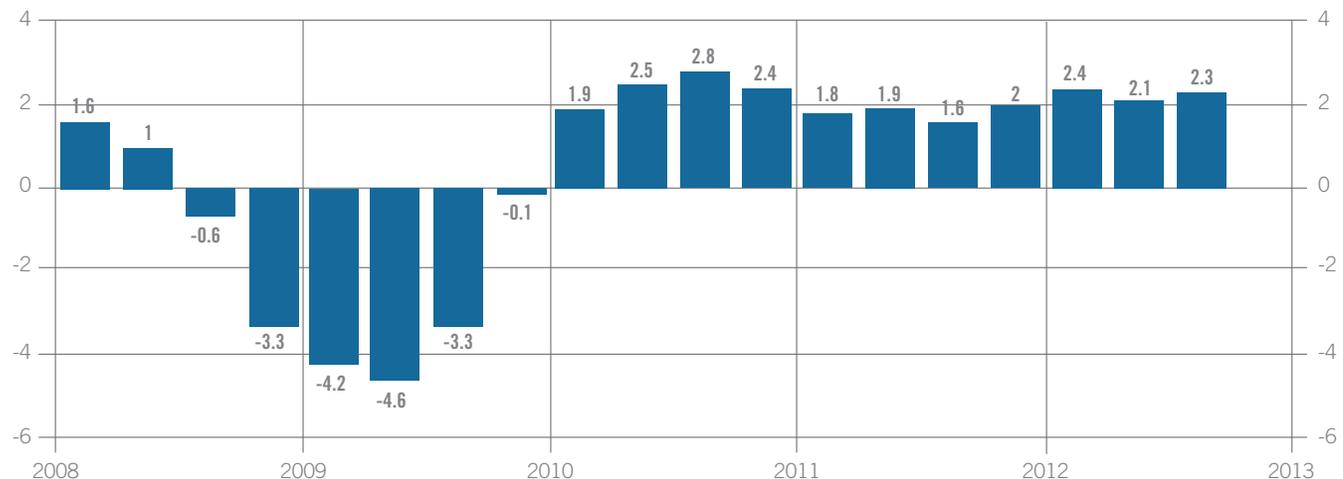
OUTLOOK: *Health care spending represents almost one fifth of the total economy. With President Obama re-elected, implementation of the Affordable Care Act will proceed. What impact on the economy do you expect to see as the key provisions of the law take effect?*

WA: It's the law, and it's going to be implemented. But in the meantime there's going to be a lot of uncertainty while all the provisions of the law are worked out. There are a lot of costs on businesses that have to now expand health care for employees and people are going to be a lot more cautious with hiring. For example, employers with part-time workers are not required to provide them with health insurance. Already we see more employers taking on more part-time workers, and that does not help the employment situation. I think it will slow down the rate of hiring and will be a drag on the economy. And ultimately, I would be very surprised if the law achieved its goals of lowering health care costs. For one, it doesn't require much in the way of a copayment or deductible, so people do not have much of an incentive to economize on health care. If you're going to have some sort of national health plan, people ought to have some skin in the game. We'll also end up devoting a higher percentage of GDP to health care.

JG: It's a complex area, and I follow it with a general eye. My understanding of the law is that it brings coverage to people who ordinarily did not have coverage, which ought to make overall insurance a little less expensive. When you bring more healthy people into the system, then in principle it's cheaper. Yet we don't have a clear sense that this new system has controlled cost to ensure coverage is affordable. The rate of health care cost inflation is uncertain, and if health care costs continue to rise, then the whole business of making people pay these premiums just becomes unviable.

U.S. GDP ANNUAL GROWTH RATE

Percent change in gross domestic product



Source: www.tradingeconomics.com, Bureau of Economic Analysis

OUTLOOK: What do you expect to see in terms of interest rates in Obama's second term?

WA: That's decided by the Federal Reserve, which has committed to keep interest rates low. From the perspective of a retired person, low interest rates are not good because you're not getting much interest on your retired savings. But the big question in my mind is this: Can the Fed really keep interest rates low? At some point, they're going to have to start raising them. If inflation occurs, prices go up and long-term interest rates go up. When that happens, it means the federal government will see its borrowing costs increase substantially.

JG: The Fed has already indicated it will keep the short-term interest rate at zero for long enough in the future, and the Congressional Budget Office forecast is now consistent with that. If the Federal Reserve did raise the short-term interest rate, the economy would collapse.

The whole credit-based growth model, which has been driving the economy for 30 years, is not functioning now. Too many middle class homeowners are insolvent on their home mortgages. The banks have gotten religion, tightening lending standards, and regulators are telling them to do that. So you're not going to get a job boom that will push the employment-to-population ratio back up. We're not going to see the kind of new credit-based expansion that began in 1994 and lasted until 2000.

OUTLOOK: The housing market is a critical component of the overall economy, and home values drive personal wealth and consumer confidence. The housing market seems to have bottomed out and begun to rebound. How strong a recovery do you expect in that sector?

WA: It hasn't bottomed out everywhere but it has bottomed out in some places. I think the housing market will do moderately well – unless you get a big recession again.

JG: Where housing is a real contributor to the economy is in new construction and the use of a home's equity for borrowing and spending. I would be surprised if you see a big rebound in that.

OUTLOOK: What do you expect to see in equity markets over the next four years?

WA: I don't predict stock prices, but they do reflect the overall economy. I think the economy will limp along. In the next couple of months, it will be interesting to see how the markets react to the shenanigans out of Washington.

JG: No prediction will be ventured. I do not give investment advice.

OUTLOOK: What is the single most important thing the president and Congress can do in 2013 to put the U.S. economy on the right track?

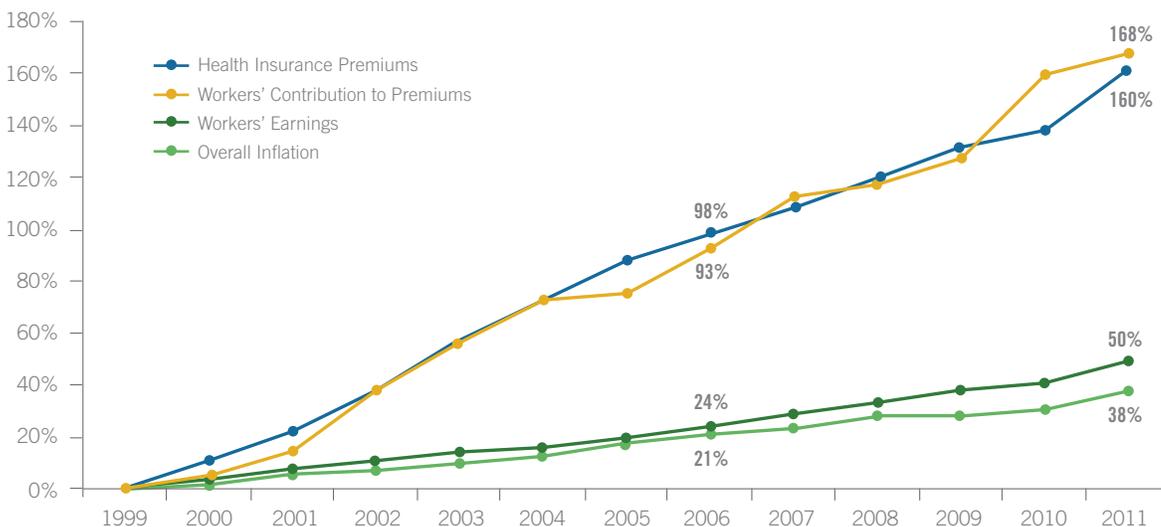
WA: Two things: Start to control entitlements. That's terribly important. The longer we postpone dealing with the long-term costs of these programs, the worse it's going to be. The second: enact tax reform. If they could do those two things, we would be well on the road to a better performing economy. But I don't think that's going to happen unless the president really changes his stripes.

JG: There are two things. Resisting the propaganda campaign to cut so-called entitlements, such as Social Security, Medicare, Medicaid, is the first job. If they keep these programs as they are, that will stabilize the economy for a large part of the population.

The second thing is to increase the minimum wage, which would increase purchasing power where it is most squeezed, which is the lower end of the labor force. There are economists who bemoan that it would cost jobs. However, they undervalue the jobs created when workers have more money to spend. In the United Kingdom, they put in a very high minimum wage and jobs remained stable. You get a social transformation where people with low-income jobs feel much more stable and prosperous, poverty rates decline – all with no detectable effect on employment. In the UK, the issue is no longer even controversial, so far as I can tell. ■

CUMULATIVE INCREASES IN HEALTH INSURANCE PREMIUMS

1999-2011



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999-2011. Bureau of Labor Statistics, Consumer Price Index, U.S. City Average of Annual Inflation (April to April), 1999-2011; Bureau of Labor Statistics, Seasonally Adjusted Data from the Current Employment Statistics Survey, 1999-2011 (April to April).

The Election and U.S. Monetary Policy

This month's presidential election results will reverberate in myriad different ways throughout the economy, from government spending and tax rates to international trade, business regulation and health care reform. Another key area – generally overlooked during the campaign – will be monetary policy and leadership at the U.S. Federal Reserve. Current Fed Chairman Ben Bernanke was first appointed in 2006 by President George Bush and reappointed by President Barack Obama in 2010. Last month, *The New York Times* reported that Bernanke is likely to step down when his current term expires. If true, that means President Obama will need to appoint a new Fed chairman as Bernanke's successor in January 2014.

For perspective on what's likely to happen at the Fed in the event of a Bernanke retirement, Outlook turned to renowned economist Laurence Meyer. Meyer served as a member of the Federal Reserve Board of Governors for six years, from 1996 to 2002, and today is a senior managing director at Macroeconomic Advisors, a consulting firm specialized in economic forecasting and policy analysis. Previously, he served for many years as a professor of economics at Washington University in St. Louis. He holds a bachelor's degree from Yale University and a doctorate from the Massachusetts Institute of Technology.

OUTLOOK: *For context, explain the power of the Fed chairman in relation to the other Fed governors and the degree of control he exerts over U.S. monetary policy as head of the Federal Open Market Committee.*

Laurence Meyer: I call the Chairman “the Decider.” He's the dominant player. With respect to meeting-to-meeting decisions he always dominates, and his judgment is rarely questioned by the other Fed governors.

That doesn't mean that he doesn't listen to the other governors – he does – and so everybody in some sense has an opportunity to change his views. But there are very few members of the committee that he seriously listens to. This has been true under Paul Volker, it was true under Alan Greenspan, and it's true under Bernanke.

That's what makes the appointment of the chairman so important. It's the main opportunity a president has to put his mark on monetary policy.

About this article



Laurence Meyer is an economist and was a U.S. Federal Reserve System governor from June

1996 to January 2002. He then taught at Washington University in St. Louis for 27 years and ran an economic consulting firm with two former students. He won several economic forecasting awards while running the company.

Mr. Meyer has a bachelor's degree from Yale University and a doctorate in economics from the Massachusetts Institute of Technology.

The president has to be thrilled that Bernanke is the chairman under today's circumstances.

OUTLOOK: Do you believe President Obama has been happy with Bernanke's tenure as Fed chairman?

LM: The president has to be thrilled that Bernanke is the chairman under today's circumstances. We all understand that the word in terms of fiscal policy in Washington is "paralysis." We have no-compromise attitudes on both sides between Republicans and Democrats. So that means that we really don't have an opportunity to have fiscal policy that deals with today's problems. That means there's only one game in town, and that's the Fed.

Bernanke has carried out an extraordinarily aggressive monetary policy in response to the economic crisis of the last few years. But nobody could have better prepared for the situation than Bernanke. As a professor at Princeton he studied the Great Depression – that was one of the things he was known for as a scholar. Before he became chairman he wrote a seminal paper on how monetary policy should operate in a circumstance like today when short-term rates get to be near zero. So he was totally prepared. He wrote the playbook and he's carried it out.

OUTLOOK: Do you expect Bernanke to step down in 2014?

LM: Yes, I expect he will leave under any circumstances.

OUTLOOK: So if Bernanke steps down, is it safe to assume that Barack Obama would be looking for someone cut from Bernanke's mold for the new Fed chairman?

LM: Absolutely. The president is going to look for somebody who sees the responsibility of the Fed, even given their limited tools, to continue to make what progress is possible to keep the economy growing, unemployment rates falling, and be creative and aggressive as Bernanke has been.

Now, that's not easy. We may be coming close to the end of the line, where there's literally nothing more that the Fed can do. But that's the kind of person that Obama will look for.

Democrats are advocates to the nth degree for the Fed's dual mandate – balancing between controlling inflation and maintaining full employment.

OUTLOOK: Who do you think Obama would nominate to succeed Bernanke?

LM: The overwhelming likelihood is Janet Yellen, the current vice chairman of the Federal Reserve. Janet is one of the more dovish members on the Federal Open Markets Committee. If she were chairman today she would have encouraged even more “simulative” policies than Bernanke has carried out.

OUTLOOK: How would Mitt Romney have approached monetary policy if he had been elected president?

LM: Governor Romney called for more restrictive policy – for the Fed not to be that aggressive. Romney stated publicly he would not re-nominate Bernanke when his second term expires. Anyone he put in the chairman's role would have been more hawkish than Janet Yellen, and by a considerable margin. They would likely have wanted to tighten more quickly and be less aggressive in responding to departures from full employment than Bernanke has been and Yellen would be.

OUTLOOK: How firmly is the difference between monetary “hawks” and “doves” rooted in political ideology?

LM: The reality has been that Republicans are more concerned about inflation, and Democrats are more concerned about full employment. Republicans are the ones who are pushing a single mandate in Congress – they believe the Fed should only focus on keeping inflation in check. The Democrats are advocates to the nth degree for the dual mandate – balancing between controlling inflation and maintaining full employment.

The Fed was politicized in a way that has never happened before in the presidential election.

OUTLOOK: *The Fed chairman is nominated by the president and then confirmed by the Senate. How much deference, traditionally, is the president given during the confirmation process?*

LM: In the old days, the president got deference. But those are the old days – long ago. We just have to go back for precedent to the confirmation hearings when Obama re-nominated Bernanke in 2010. Bernanke had a very, very difficult time, and he got rough treatment.

OUTLOOK: *Could we see a highly politicized confirmation process for Bernanke's replacement?*

LM: Yes. The Fed was politicized in a way that has never happened before in the presidential election. The Fed has become one of the political issues.

OUTLOOK: *What do you foresee in terms of the direction of the overall economy in the year ahead? With the election out of the way – but many key policy issues unresolved – are you optimistic or pessimistic for 2013 and beyond?*

LM: I am optimistic that growth will strengthen and that the unemployment rate will continue to fall, though any further decline in the unemployment rate might not come until 2014. So that is not really “optimistic.” Indeed, I am pessimistic about how long it will take for the economy to reach “full employment.” That could be at least four years! This challenge is compounded by the fact that an ultimate budget agreement will impose a long period of fiscal drag and, as a result, make it difficult to achieve the degree of growth that would be needed to achieve a faster return to full employment. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 10/31/12. 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

2012	GDP	CPI	Funds	2-year	10-year
Q4	1.90%	2.20%	0.15%	0.28%	1.70%
2013	GDP	CPI	Funds	2-year	10-year
Q1	1.80%	2.00%	0.15%	0.28%	1.71%
Q2	2.30%	2.00%	0.15%	0.30%	1.75%
Q3	2.70%	2.20%	0.15%	0.31%	1.80%
Q4	2.80%	2.10%	0.16%	0.40%	1.85%

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	0.32%	0.32%	0.46%	0.80%	1.22%	1.71%
0.25	0.26%	0.32%	0.51%	0.88%	1.30%	1.79%
0.50	0.33%	0.35%	0.56%	0.97%	1.38%	1.86%
0.75	0.34%	0.38%	0.63%	1.06%	1.47%	1.94%
1.00	0.37%	0.41%	0.71%	1.15%	1.56%	2.01%
1.50	0.43%	0.50%	0.89%	1.35%	1.74%	2.16%
2.00	0.53%	0.63%	1.09%	1.57%	1.91%	2.32%
2.50	0.72%	0.86%	1.34%	1.79%	2.10%	2.46%
3.00	0.92%	1.09%	1.59%	2.01%	2.30%	2.60%
4.00	1.45%	1.58%	2.06%	2.39%	2.63%	2.85%
5.00	1.98%	2.12%	2.48%	2.68%	2.91%	3.06%

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

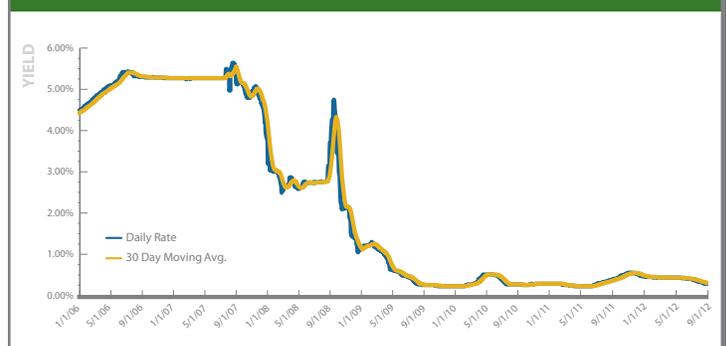
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	5	9	12	11
180	5	13	20	19
365	14	28	41	38

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.

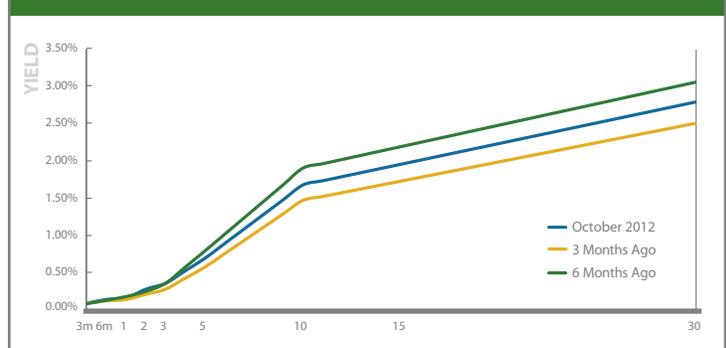
3-MONTH LIBOR



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





About CoBank

CoBank is a \$90 billion 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. 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.

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.

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 Reports Third Quarter Financial Results

CoBank this month announced financial results for the third quarter of 2012.

Third-quarter net income rose 28 percent to \$217.7 million, compared with \$169.9 million in the same quarter last year. Net interest income for the quarter was \$305.1 million, compared with \$252.0 million a year ago. Average loan volume for the quarter was \$70.3 billion, compared to \$47.6 billion for the same period in 2011.

For the first nine months of 2012, net income increased 24 percent to \$700.5 million from \$562.7 million for the same period in 2011. Net interest income increased 12 percent to \$925.2 million. Total loan volume for the bank at quarter end was \$69.9 billion.

The bank's results reflected the benefits of its merger with U.S. AgBank, which closed on January 1, 2012. Through the merger, the bank acquired U.S. AgBank's assets and liabilities, including approximately \$20 billion in wholesale loans to 25 Farm Credit associations. The transaction increased average loan volume as well as net interest income, net income and other key measures of financial performance.

Year-to-date results also include the impact of \$44.6 million in refunds from the Farm Credit System Insurance Corporation received in the second quarter.



Robert B. Engel

"We're pleased with CoBank's performance through the first three quarters of the year," said Robert B. Engel, president and chief executive officer. "Our customers count on us to maintain the financial strength and flexibility required to meet their credit needs no matter what conditions are like in the market. The merger with U.S. AgBank was undertaken with that goal in mind and is now delivering significant benefits for the bank and its customers across all the industries we serve."

The performance of the bank's individual operating segments has varied considerably in 2012 due to the merger as well as external economic and market conditions. Average agribusiness loan volume for the first nine months of 2012 has declined by approximately 9 percent owing to lower prices for grains and other commodities earlier in the year and reduced inventory financing at agricultural cooperatives. At the same time, the bank saw a 9 percent increase in lending to rural infrastructure customers, driven

by increased lending activity in the power supply industry and increased market penetration in the electric distribution industry. Loans to Farm Credit associations have increased primarily due to the merger.

Overall credit quality in CoBank's loan portfolio continues to be strong. At quarter end, 1.03 percent of the bank's loans were classified as adverse assets, down from 1.25 percent at December 31, 2011. Nonaccrual loans increased during the third quarter to \$168.5 million from \$106.9 million at June 30, 2012, largely due to credit concerns involving a limited number of communications and rural energy customers. During the third quarter, the bank recorded a \$10.0 million provision for loan losses, increasing the provision to \$20.0 million for the first nine months of the year. The provision for loan losses in the first nine months of 2011 was \$50.0 million.



David P. Burlage

“From a credit quality standpoint, CoBank continues to benefit from the addition of U.S. AgBank's portfolio of high quality loans to Farm Credit associations, as well as relatively strong conditions in the U.S. rural economy,” said David P. Burlage, CoBank's chief financial officer. “That said, we do expect moderate declines in credit quality over the next few quarters as the effects of this year's drought on crop yields and commodity prices impact various customer segments, including grain and farm supply cooperatives and customers in the dairy and livestock industries.”

The bank's allowance for credit losses now totals \$549.5 million, or 1.79 percent of non-guaranteed loans outstanding excluding loans to Farm Credit associations. “CoBank's strong allowance serves as an important source of protection against credit losses for the bank and its customer-owners,” Burlage said. Capital and liquidity levels at CoBank remain strong and well above regulatory minimums. As of September 30, 2012, shareholders' equity totaled \$6.4 billion, and the bank's permanent capital ratio was 16.13 percent, compared with the 7.00 percent minimum established by the Farm Credit Administration (FCA), the independent regulator for the Farm Credit System. At quarter end, CoBank's cash and investments totaled \$18.8 billion, and days liquidity totaled 193 days. The bank recorded \$2.0 million in impairment losses on investment securities during each of the quarters ended September 30, 2012 and 2011.

As previously announced, CoBank completed a series of preferred stock transactions subsequent to quarter end that enhanced its capital position. The bank redeemed \$363.3 million of cumulative perpetual preferred stock and issued \$400.0 million in new non-cumulative perpetual preferred stock. The transactions will lower CoBank's dividend costs by approximately \$1.8 million per year, despite the higher principal amount outstanding, and the newly issued preferred stock will receive better capital treatment under FCA regulations.

"We're pleased we were able to complete these transactions successfully, and we continue to monitor the markets closely for additional opportunities to strengthen our capital position and reduce costs," Burlage said.

Engel noted that CoBank is now firmly on track to record its 13th consecutive year of net income growth, despite overall market conditions that remain volatile and highly uncertain. "As we approach the end of 2012, the level of downside risk in the global economy remains very high," Engel said. "Around the world, political issues are at the forefront, exerting outsized influence over the pace and direction of economic growth. At CoBank we are focused on what we can control: maintaining the financial strength of our business for the long term, and delivering on our value proposition to customers every day." ■