



THIRD QUARTER 2004

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Chief Executive Officer



Juan A. Santiago
Chairman of the Board

October 29, 2004

Management's Discussion and Analysis of Financial Condition and Results of Operations

(dollars in thousands)

The following commentary reviews the consolidated financial condition and results of operations of Puerto Rico Farm Credit, ACA (Association) for the three months ended September 30, 2004. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2003 annual report of the Association.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners and farm-related business for financing short and intermediate-term loans and long-term real estate mortgage loans. The Association also maintains a portfolio of purchased loans, originated by other Farm Credit System entities and non-system entities. The Association's predominant local service area (LSA) agricultural commodities were dairy, livestock and fruits which totaled approximately \$118 million or 47.1 percent of all outstanding loan volume at September 30, 2004.

The gross loan volume of the Association at September 30, 2004 was \$250,073, an increase of \$26,752 or 12.0 percent as compared to \$223,321 at December 31, 2003. Net loans, including the allowance for loan losses, also increased during the year, but by \$26,801 or 12.3 percent over the December 31, 2003 amount of \$217,338. The difference of \$49 was the result of a third quarter reduction in the allowance. The improvement in gross loan volume was primarily related to a \$23,390 increase in net participation loans purchased. Additionally, LSA loan volume increased by \$3,362, primarily related to the fruit and livestock industries.

Net loans at September 30, 2004 made up 97.0 percent of total assets, as compared to 97.0 at December 31, 2003. However, this compared to 97.1 percent at September 30, 2003.

As a percentage of gross loans, nonaccrual loans equaled 1.3 percent at September 30, 2004, compared with 1.3 percent and 1.8 percent at December 31 and September 30, 2003, respectively. The year-over-year decrease in the percentage was primarily the result of a partial payment received from the sale of collateral

property related to a large volume account. Due to the substantial increase in loan volume, the overall credit quality of the total portfolio continued to show improvement. Asset quality measures remained favorable due to consistent underwriting standards, the lower interest rate environment and a strong real estate market.

The Association maintained an allowance for loan losses in an amount considered by management as sufficient to absorb the estimated risk inherent in the loan portfolio. The allowance for loan losses decreased by \$49 to \$5,934 at September 30, 2004. The analysis for 2004 has identified less risk as a result of a lower level of nonaccrual loans and improved credit quality. The ratio of allowance to gross loan volume was 2.4 percent at September 30, 2004 and 2.7 percent at December 31, 2003. There were no charge-offs or recoveries during the first nine months of 2004.

In June 2003, the American Institute of Certified Public Accountants' Accounting Standards Executive Committee (AcSEC) issued a proposed Statement of Position (SOP) – Allowance for Credit Losses, which was intended to clarify the methodology for estimating the allowance for credit losses and to enhance financial statement disclosures related to the allowance for credit losses. In January 2004, AcSEC abandoned its proposed SOP and announced that it would focus instead on improving financial statement disclosures regarding the allowance for loan losses.

The Association and the Farm Credit System conducted a study to further refine the guidance for calculating the allowance for loan losses taking into account generally accepted accounting principles, and applicable Farm Credit Administration requirements, as well as the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. The guidance recommended that the Association adopt a methodology for determining the allowance for loan losses based upon the study's findings and review the methodology with its outside auditors to determine if it is in accordance with System and other related guidance. During the fourth quarter of 2004, the Association will finalize and apply the revised methodology to the loan portfolio, and determine an appropriate allowance for loan losses. The resulting reduction in the allowance for loan losses will be significant.

In April 2004, the Farm Credit Administration, the System's regulator, issued an "Informational Memorandum" to System institutions regarding the allowance for loan losses. The memorandum addresses the status of the AICPA's project and the Securities and Exchange Commission and the Federal Financial Institutions Examination Council guidance on the subject. The objective of the Farm Credit Administration's memorandum was to clarify its expectations regarding the analysis and related documentation for the allowance for loan losses. The Farm Credit Administration endorsed the direction provided by these other regulatory agencies and will include the conceptual framework addressed in this guidance in their examination process.

RESULTS OF OPERATIONS

Net income for the nine months ended September 30, 2004 totaled \$1,881, a decrease of \$104 or 5.2 percent as compared to the nine months ended September 30, 2003. The decrease was primarily the result of the difference in the reduction of the allowance for loan losses year over year. Otherwise, higher levels of earning assets generated interest income which more than offset higher non-interest expense.

At September 30, 2004 net interest income was \$4,781, an increase of \$433 or 10.0 percent when compared to the September 30, 2003 total of \$4,348. During the first nine months of 2004, interest income from LSA lending increased by \$149 and participation lending increased by \$683. Interest income from the collection of nonaccrual loans decreased by \$159 for the nine months ended September 30, 2004. As previously discussed, management continues to project reduced levels of interest income from the collection of nonaccrual loans, negatively impacting net interest income comparisons on a year-over-year basis.

Interest expense related to lending activities increased by \$367 for the nine months ended September 30, 2004. This was partially offset by a \$126 increase in the interest credit earned from AgFirst Farm Credit Bank (the Bank) on loanable funds. Thus, net interest expense to the Bank only increased \$241 or 12.4 percent for the nine months ended September 30, 2004.

During the third quarter, management analysis resulted in a reduction of the allowance for loan losses of \$49, resulting in a reversal of provision enhancing income. This compared to the first nine months of 2003 when reductions in the allowance for loan losses resulted in a \$351 enhancement of income.

Noninterest income for the nine months ended September 30, 2004 totaled \$231 a decrease of \$10 or 4.1 percent compared to the first nine months of 2003.

Noninterest expense for the nine months ended September 30, 2004 was \$3,180 compared to \$2,953 at September 30, 2003. The increase of \$227 or 7.9 percent was primarily related to higher salary and benefits costs, as well as various categories of other operating expenses. Other operating expenses increased due to the higher cost of outside consultants/auditors and the cost of the 2004 advertising campaign in support of island ag-products and young/beginning/small farmers. The increase in other operating expenses was partially offset by decreases in other categories. The Farm Credit System Insurance Fund announced a 40 percent decrease in the premium rate assigned to accruing loan volume, beginning July 1, 2004. Through September 30, 2004 the net effect of the reduction was a \$102 favorable variance compared to September 30, 2003, positively impacting net income.

As a result of the 2001 restructuring, a majority of the Association's business has been conducted in the tax-exempt subsidiary or as possession-sourced activity eligible for tax credits. During the first nine months of 2004, like 2003, the Association did not record a provision for income tax expense.

For the three months ended September 30, 2004.

Net income for the third quarter of 2004 was \$794 compared to \$965 for the same quarter of 2003. Net interest income for the three months ended September 30, 2004 totaled \$1,639 compared to \$1,440 for the three months ended September 30, 2003, reflecting increased accruing loan volume.

For the three months ended September 30, 2004, the Association recorded a \$49 provision reversal enhancing income, as compared to \$351 provision reversal during the third quarter of 2003.

Noninterest income for the three months ended September 30, 2004 was \$90, an increase of \$20 from the third quarter of 2003. As discussed in the second quarter financial statement report, this was the result of a timing difference in the recognition of a dividend related to credit life insurance services.

For the third quarter of 2004, noninterest expense increased by \$89 to total \$984 compared to the third quarter of 2003 which totaled \$895. The quarterly increase, like the year-over-year increase, was related to salaries and benefits and other operating expenses.

Key Results of Operations Ratios:

	Annualized for the nine months ended 9/30/04	For the year ended 12/31/03
Return on Average Assets	1.06%	1.28%
Return on Average Stockholders' Equity	5.36%	5.94%
Net Interest Income as a Percentage of Average Earning Assets	2.73%	2.80%

LIQUIDITY AND FUNDING SOURCES

Liquidity

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with the Bank and from income generated by operations. Sufficient liquid funds have been available to meet all financial obligations.

Funding Sources

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate notes are utilized by the Association to fund variable rate loan advances and operating funds requirements. The total notes payable to the Bank at September 30, 2004 was \$201,533 as compared with \$172,671 at December 31, 2003. The increase of \$28,862 or 16.7 percent corresponded to the increase in gross loan volume and the funding of the year-end 2003 dividend.

The Association had no lines of credit outstanding with third parties as of September 30, 2004.

Funds Management

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers variable rate loan products which are competitively priced according to financial market rates. Variable rate loans may be indexed to either the Prime rate or the 90-day London Interbank Offered Rate (LIBOR). The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control interest rate risk associated with the loan portfolio.

CAPITAL RESOURCES

Total stockholders' equity at September 30, 2004 increased 4.0 percent to \$47,704 from December 31, 2003 when total stockholders' equity was \$45,855. The increase was primarily attributable to net income retained as unallocated surplus during the year.

Total capital stock and participation certificates were \$1,003 on September 30, 2004 compared to \$1,022 on December 31, 2003. The decrease of \$19 was the net result of refunding more stock to non-borrowing stockholders than new stockholders purchasing capital stock or participation certificates.

Retained earnings unallocated increased \$1,881 or 4.0 percent to \$48,535 from December 31, 2003 when unallocated retained earnings totaled \$46,654. The increase was net income earned during the first three quarters of 2004.

The Board of directors intends to continue its policy of declaring cash dividends. 2003 was the eleventh consecutive year of paying dividends. At its June 2004 meeting, the Board of Directors voted to eliminate quarterly equity dividend declarations, and to only make an annual dividend declaration in December. The table below sets forth the recent dividends declared:

<u>Year</u>	<u>Type</u>	<u>Amount Declared</u>
2003	Patronage	\$ 1,847
	Equity	153
		<u>\$ 2,000</u>
2002	Patronage	\$ 1,602
	Equity	149
		<u>\$ 1,751</u>

The amount of dividends, as always, will depend on continued strong earnings, the overall financial condition of the Association and other factors.

The Association's regulatory permanent capital ratio at September 30, 2004 was 23.54 percent compared to 25.83 percent at December 31, 2003. The Association's total surplus and core surplus ratios were both 23.00 percent at September 30, 2004. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

Key financial condition ratios were as follows:

	9/30/04	12/31/03
Stockholders' Equity to Assets	18.96%	20.50%
Debt to Stockholders' Equity	4.28:1	3.88:1

Puerto Rico Farm Credit, ACA
Consolidated Balance Sheets

<i>(dollars in thousands)</i>	September 30,		December 31,
	2004	2003	2003
	<i>(unaudited)</i>		
Assets			
Cash	\$ 541	\$ 15	\$ 16
Loans	250,073	223,436	223,321
Less: allowance for loan losses	5,934	6,147	5,983
Net loans	244,139	217,289	217,338
Accrued interest receivable	1,396	1,115	876
Investment in other Farm Credit institutions	4,712	4,712	4,712
Premises and equipment, net	484	511	482
Other property owned	—	23	—
Other assets	389	224	230
Total assets	\$ 251,661	\$ 223,889	\$ 223,654
Liabilities			
Notes payable to AgFirst Farm Credit Bank	\$ 201,533	\$ 173,684	\$ 172,671
Accrued interest payable	352	213	199
Dividend payable	—	55	1,849
Postretirement benefits other than pensions	1,364	1,136	1,188
Minimum pension liability	—	1,295	1,223
Other liabilities	708	753	669
Total liabilities	203,957	177,136	177,799
Commitments and contingencies			
Stockholders' Equity			
Capital stock and participation certificates	1,003	1,017	1,022
Retained earnings unallocated	48,535	47,746	46,654
Accumulated other comprehensive income (loss)	(1,834)	(2,010)	(1,821)
Total stockholders' equity	47,704	46,753	45,855
Total liabilities and stockholders' equity	\$ 251,661	\$ 223,889	\$ 223,654

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

Puerto Rico Farm Credit, ACA
Consolidated Statements of Income

(unaudited)

<i>(dollars in thousands)</i>	For the three months ended September 30,		For the nine months ended September 30,	
	2004	2003	2004	2003
Interest Income				
Loans	\$ 2,526	\$ 2,091	\$ 6,967	\$ 6,293
Interest Expense				
Notes payable to AgFirst Farm Credit Bank	887	651	2,186	1,945
Net interest income	1,639	1,440	4,781	4,348
Provision for (reversal of) loan losses	(49)	(351)	(49)	(351)
Net interest income after provision for (reversal of) loan losses	1,688	1,791	4,830	4,699
Noninterest Income				
Loan fees	68	64	186	188
Fees for financially related services	26	4	32	32
Other noninterest income	(4)	2	13	21
Total noninterest income	90	70	231	241
Noninterest Expense				
Salaries and employee benefits	677	561	2,066	1,906
Occupancy and equipment	67	47	185	153
Insurance Fund premium	(23)	64	84	186
Guarantee fee	48	56	148	172
Other operating expenses	215	167	697	536
Total noninterest expense	984	895	3,180	2,953
Income before income taxes	794	966	1,881	1,987
Provision (benefit) for income taxes	—	1	—	2
Net income	\$ 794	\$ 965	\$ 1,881	\$ 1,985

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

Puerto Rico Farm Credit, ACA

Consolidated Statements of Changes in Stockholders' Equity

(unaudited)

<i>(dollars in thousands)</i>	Capital Stock and Participation Certificates	Retained Earnings Unallocated	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance at December 31, 2002	\$ 1,001	\$ 45,914	\$ (2,038)	\$ 44,877
Net income		1,985		1,985
Pension liability			28	28
Total comprehensive income				2,013
Capital stock/participation certificates issued	74			74
Capital stock/participation certificates retired	(58)			(58)
Cash dividends declared		(153)		(153)
Balance at September 30, 2003	\$ 1,017	\$ 47,746	\$ (2,010)	\$ 46,753
Balance at December 31, 2003	\$ 1,022	\$ 46,654	\$ (1,821)	\$ 45,855
Net income		1,881		1,881
Minimum pension liability adjustment			(13)	(13)
Total comprehensive income				1,868
Capital stock/participation certificates issued	44			44
Capital stock/participation certificates retired	(63)			(63)
Balance at September 30, 2004	\$ 1,003	\$ 48,535	\$ (1,834)	\$ 47,704

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

Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)
(unaudited)

NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

A description of the organization and operations of Puerto Rico Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2003, are contained in the 2003 Annual Report to Stockholders. These unaudited third quarter 2004 consolidated financial statements should be read in conjunction with the 2003 Annual Report to Stockholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the nine months ended September 30, 2004, are not necessarily indicative of the results to be expected for the year ending December 31, 2004.

Certain amounts in prior period consolidated financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on the prior period net income or total capital as previously reported.

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of September 30, 2004, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

Balance at 12-31-02	\$ 6,498
(Reversal of) provision for loan losses	(351)
Recoveries, net of loans charged off	<u>—</u>
Balance at 9-30-03	<u>\$ 6,147</u>
Balance at 12-31-03	\$ 5,983
(Reversal of) provision for loan losses	(49)
Recoveries, net of loans charged off	<u>—</u>
Balance at 9-30-04	<u>\$ 5,934</u>

NOTE 3 – COMMITMENTS AND CONTINGENT LIABILITIES

Actions are pending against the Association in which money damages are sought. However, on the basis of information now at hand, management and legal counsel are of the opinion that the ultimate liability, if any, resulting therefrom, would not be material in relation to the overall financial position of the Association.

NOTE 4 – EMPLOYEE BENEFIT PLANS

The Association participates in a Districtwide defined benefit retirement plan. The costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times each institution's salary expense as a percentage of the District's salary expense. The Association also participates in a Districtwide Thrift Plan.

The Association sponsors a plan providing certain benefits (primarily health care) to its retirees. The following table sets forth the components of net periodic benefit costs of the other postretirement benefits plan for the nine months ended September 30, 2004:

	For the nine months ended September 30,	
	2004	2003
Service cost	\$ 37	\$ 31
Interest cost	127	123
Amortization of net (gain) loss	25	25
Recognized net actuarial (gain) loss	<u>52</u>	<u>44</u>
Net periodic benefit cost	<u>\$ 241</u>	<u>\$ 223</u>

The following is a table of retirement and postretirement benefit expense for the nine months ended September 30, 2004:

	For the nine months ended September 30,	
	2004	2003
Pension	\$ 283	\$ 321
Thrift	48	41
Other postretirement benefits	<u>241</u>	<u>223</u>
Total	<u>\$ 572</u>	<u>\$ 585</u>

As of September 30, 2004, the Association had contributed \$1,690 to the Districtwide defined benefit retirement plan, which was sufficient to meet its accumulated benefit obligation. The contributions eliminated the minimum pension liability with \$185 of the contributions being classified as prepaid retirement expense in Other Assets on the Consolidated Balance Sheet. The Association does not anticipate making additional contributions for the remainder of 2004.