Family First Credit Union

Operations Policy

Asset/Liability Management Policy

Purpose

The Asset-Liability Management (ALM) Policy of Family First Credit Union sets forth the policies, procedures, and guidelines to be followed in the overall management of the credit union's earning assets and liabilities (deposits, loans, and investments) and to control the credit union's risks and financial position. This policy statement formalizes the credit union's commitment to the ALM process.

Earnings must be sufficient to build adequate capital and reserves. To the extent that sources and uses of funds are re-priced at different times, Family First Credit Union can be exposed to severe earnings volatility in a period of rapidly changing market interest rates. The purpose of the ALM policy is to outline steps to balance the saving and borrowing needs of the membership with earnings requirements of the Credit Union. It also addresses risk management parameters by which the credit union must comply to avoid undue interest rate risk and its potential adverse impact on short-term and long-term net margins. The assets and liabilities of Family First Credit Union will be managed to achieve satisfactory and consistent earnings, liquidity, and safety.

ALM Objectives

The objectives of Family First Credit Union ALM process are to ensure the following:

- Stable and consistent financial performance is maintained.
- There is adequate liquidity and funding to meet cash needs.
- There is fair and equitable treatment of both savers and borrowers.
- Various risks are measured and managed on a consistent basis.
- Guidelines are established to meet various regulatory rules and regulations.
- Management of cash, capital and liquidity are coordinated toward the goals set forth in the Strategic Business Plan.

Priorities

Family First Credit Union considers meeting the rate and maturity expectations of its savers as top priority, while maintaining minimal interest rate risk, credit risk, liquidity risk and price risk. The optimum situation is for the credit union to achieve good balance between loans and shares, while maintaining balance sheet concentrations within acceptable limits.

In summary, the following priorities are fundamental in the formulation to strategies under this policy:

- ✓ **Sources of Funds**
  - Primary – Member Deposits
  - Secondary – Retained Earnings
  - Thirdly – Borrowed Funds
- ✓ **Uses of Funds**
  - Primary – Loans to Members
  - Secondary – Investments and cash equivalents
  - Thirdly – Fixed Assets

Investments and cash equivalents are a residual use of funds that primarily are used to meet share withdrawals or loan advances. Safety of principal and interest are always considered the most important criterion of investments. The liquidity characteristics (marketability, collateral, and maturity) are also important in investment decision making. Yield is not a consideration until safety and liquidity are adequately provided for. With regard to fixed assets, Family First Credit Union will generally not commit more than 5% of its total assets to non-earning fixed assets. The credit union may invest up to 7% of its total assets in fixed assets if authorized by both the board of directors and the Department of Banking and Finance, and, after careful evaluation of the credit union's financial position.

Responsibility and Management Oversight

The Board of Directors is accountable to the membership for the formulation and control of the ALM Policy. Management is responsible for the daily accomplishment of established objectives of asset-liability management by committing personnel and necessary technology to respond to changes in deposit, loan, and investment balances and rates.

The Board delegates responsibility for implementing this policy to the ALM Committee (ALCO). The ALCO, made up of the CFO/EVP, CEO/ President, CLO and at least two members of the Board of Directors (in addition to the CEO), must meet quarterly, but may meet more frequently as deemed appropriate by the Chair. Written minutes of all official ALCO meetings will be maintained and distributed to the Board.

The ALCO will review the ALM reports on a quarterly basis. It will be the committee's responsibility to conduct quarterly analysis designed to assess earnings, liquidity adequacy, interest rate risks and measure key risks and ratios to actual performance. In addition, the ALCO will be responsible for generating asset liability strategy recommendations to the Board for its approval. The ALCO will provide the Board with quarterly reports.

Functions of the ALM Committee (ALCO)

The ALCO will meet periodically (at least quarterly) to review and monitor all phases of Family First Credit Union's operations as they relate to the ALM process. ALM reports generated by the credit union's ALM software in conjunction with supplemental reports generated by the accounting department are the basis of the ALM Committee's activities. These reports focus on the credit union's interest rate risk, liquidity risk, credit risk, and key ratios.

The specific functions of the ALCO are:

- **Reporting**
  - The ALCO will review the following at its quarterly meeting:
    - General economic overview and forecasts
    - Interest rate forecasts and spreads
    - Interest Rate Risk measures
    - Credit Risk measures
    - Analysis of net economic value (NEV)
    - Rising and falling GAP ratios
    - Extreme Rate Shock analysis – Interest Rate Risk and NEV
    - Mismatches in the balance sheet
    - Year-to-date operating results
    - Anticipated funding needs
    - Anticipated loan demands
    - Liquidity position and risk measures
    - Net Interest Margin measures
    - Capital position
    - Investment portfolio mix
    - Asset Concentration limits and risk
    - Current loan investments and funding strategies
    - An explanation of any known exceptions to this policy as well as an action plan and timetable to bring the credit union into compliance with such policy limits.

  - The ALCO shall provide a report to the Board of Directors on a quarterly basis, which will include, but is not limited to, the following:
    - Year-to-date operating results and variances
    - Interest income and interest expense statements
    - Net economic value (NEV) analysis
    - Liquidity and Interest Rate Risk Summary
    - Measure key ratios to actual report
    - Measure key risks to actual report
    - Balance sheet concentrations report
    - Investment portfolio and loan activity report
    - Risk exposure based on metrics in Appendix A and others included in the ALM Reports
    - Performance against established standards and against peer data
    - Relevant regulatory developments

Delegated Authority and Management Directives

The Board has given specific directive and delegated authority to the ALCO and senior management regarding liquidity, capital management, investing, loan and dividend pricing, borrowing, interest rate risk exposure and real estate lending.

Directive on Interest Rate Risk (IRR) Management

The ALCO will monitor the credit union's interest rate risk exposure on a quarterly basis. Family First Credit Union's interest rate risk will be evaluated by focusing on the timing with which assets and liabilities are subject to repricing. This repricing arises through changes in loan, investment, and deposit balances, and variable-rate instruments becoming eligible for repricing. Differences in the timing of such repricing are reflected in the projected gap position, as provided by the ALM software. The projected Gap position estimates the future risk position that will emerge with the passage of time.

<u>Short-term Risk Exposure</u>

The ALCO will monitor short-term exposure to earnings utilizing a cumulative six-month repriceable Gap methodology.

Because of the difference between the credit union's interest rate sensitivity and its capacity to change interest rates on assets and liabilities, the rising and falling Gap ratios will be considered. The Gap ratios measure the risk and movement in gross spread in a rising and/or falling rate environment.

A limit in the projected rising 100 bps and falling 100 bps has been set by the Board at +/-25%. Any Gap ratio results outside of +/-25% will be discussed by the ALM Committee and consideration given to adjusting the credit union's interest rates.

<u>Intermediate-term Risk Exposure</u>

The ALCO will monitor the intermediate-term exposure to earnings utilizing net interest income simulation.

A change limit in year one for the projected Net Interest Income (NII) of -5% given a +/- 100bp rate shock, -10% given a +/- 200bp or -15% given a +/- 300bp rate shock has been set by the Board and deemed appropriate for the existing and projected market environments.

A change limit in year two for the projected Net Interest Income (NII) of -10% given a +/- 100bp rate shock, -15% given a +/- 200bp or -20% given a +/- 300bp rate shock has been set by the Board and deemed appropriate for the existing and projected market environments.

Each quarter the ALCO will review and report to the Board the credit union's intermediate-term IRR exposure. At least annually, the ALCO will review, or have a third-party review, the pricing assumptions used in the analysis.

Long-term Risk Exposure

The ALCO will monitor the long-term exposure utilizing a net economic value (NEV) methodology.

NEV measures the implied risk to NII based on the net present value of the cash flow relationship between earning assets and funding structures. The change in NEV from its base value may not exceed -8.3% given a +/- 100bp shock, -16.7% given a +/- 200bp shock or -25% or +/- 300bp shock. Also, the resulting post shock NEV ratio may not fall below 10%.

The change in NEV from its base value may not exceed -40% given a +/- 400bp shock or -45% given a +/- 500 bp shock

Each quarter the ALCO will review and report to the Board its long-term IRR exposure. At least annually, the ALCO will review, or have a third-party review, the assumptions used in each analysis.

Net Interest Margin (NIM)

The ALCO will monitor the net interest margin ratio changes resulting from the rate shock scenarios.

The minimum guideline limit for the NIM ratio is 4.0% given a +/- 100bp shock, +/- 200bp shock or +/- 300bp shock. Each quarter the ALCO will review and report to the Board its NIM ratio results.

Whenever the quarterly assessment measures exceed Board approved limits, the ALCO will report to the Board and review whether any corrective action is warranted. When corrective action is warranted, the ALCO will report to the Board, and record in the ALCO meeting minutes, the plan of action and/or strategies to bring the IRR volatility back into policy compliance. The plan of action will include an estimated time frame for bringing the exceptions back into policy limits. Additionally, as the interest rate and market environments change, the ALCO and the Board will review these limits as needed.

Risk Exposure of Investment Portfolio Activities

Investment durations are limited to the point that 1) recognizes measured prudent relative value to the holding period of the investment, 2) is supported by the credit union's Investment Policy and the prevailing liquidity ratio and cash flow outlook and 3) is supported by the credit union's measured risk exposure limits for both short-term and long-term risk exposure profiles.

The Board directs management to use the investment portfolio to make the necessary day-to-day adjustments in the overall ALM position. By managing the maturity structure of the portfolio in light of ALM goals, policy, and guidelines, significant adjustments can be made, and thus greater control exerted over interest rate risk and liquidity risk. Investment decisions must be consistent with the credit union's investment policy.

The maturity of investments in certificates of deposits and government securities/bonds shall not exceed five years. The total amount of investments in government securities/bonds shall not exceed 15 percent of the investment portfolio.

Directive on Liquidity Risk Management
It is the policy of Family First Credit Union to maintain adequate liquidity levels consistent with prudent financial practices and regulatory requirements. Management will review the credit union's liquidity trends and funding sources on a monthly basis. Specific liquidity requirements are contingent on a variety of factors, including seasonal or cyclical fluctuations in the economy, the desirability of investment income versus loan income, the present as well as the forecasted mix of earning assets, and the availability of funds. The manner in which existing assets and liabilities mature plays a major role in determining the credit union's liquidity position. Corrective action will be taken when necessary.

Directive on Liquidity Risk Management
The target loans to deposits ratio is 75% to 95%.
The target liquidity ratio is 15% to 20%.
If the liquidity ratio approaches the minimum of 15%, the ALCO will prepare a contingency plan which may include, but is not limited to, the following:

- Restructure loans to slow demand (i.e., increase rates, adjust equity requirements, lower maximums)
- Limit certain kinds of loans
- Increase deposits (raise dividend rates, offer certificate specials)
- Seek investments with shorter maturities, and/or

If the liquidity ratio falls below the minimum of 15%, the contingency plan will be presented to the Board monthly until the ratio reaches 15%. Additional action will be taken, which may include, but is not limited to, the following:

- Tighten credit standards and/or increase loan rates
- Reduce lending activities significantly
- Borrow against established line of credit with Catalyst Corporate FCU.

Liquidity ratios and loan/share ratios will be reported to the board monthly.
The demand for loans increases during summer/vacation and in November and December. Management will adjust liquidity during these peek months in the following order:

Primary Sources of Liquidity
1) Due from accounts in other financial institutions
2) Certificates maturing within 30 days
3) Securities and investments maturing with 30 days

4) Access line-of-credit with Catalyst Corporate FCU.

Secondary Sources
1) Certificates with maturities over 30 days
2) Securities with maturities over 30 days,
3) Marketable securities which have depreciated since purchase

Contingency Sources
1. Securities and investments that can be sold in the open market with no loss due from market depreciation.

Authority to Borrow Funds
The President/CEO and EVP/CFO have the authority to access the line-of-credit established with Catalyst Corporate FCU. All other borrowing activities must be approved by the Board.

Directive on Real Estate Loan Risk Management
Family First Credit Union has four primary risks involved with holding real estate loans on its balance sheet:
1. The interest rate involved with holding long-term, fixed-rate investments.
2. The geographic concentration risk of having real estate investments in a single metropolitan area.
3. The liquidity risk of being unable to fund member loan demand and share withdrawals without adversely affecting profitability or capital.
4. The credit risk of borrowers defaulting or not repaying the principal loan balance.

To avoid certain credit and liquidity concentration risks, the following limits are placed on real estate lending activities:
1. Total first-lien residential mortgage loans may not exceed 220% of the Credit Union's equity capital.
2. The amount held in second-lien mortgages (including HELOCs) may not exceed 125% of the credit union's equity capital.
3. Total real estate / mortgage loans may not exceed 250% of the credit union's equity capital.

Directive on Capital Management
The credit union will maintain an equity capital to total asset ratio no lower than 10%. The ALCO is responsible for both monitoring the capital goals quarterly and reporting compliance to the Board. Management will report the capital ratio to the Board on a monthly basis.

Directive on Credit Risk Management

Credit risk includes the risk that some loans may not be repaid, and the Credit Union will suffer losses on these loans. Delinquent loans will be monitored regularly, and asset quality will be evaluated on a monthly basis. The delinquent loan ratio and net loan loss ratio will be reported to Board on a monthly basis.

Monitor Key Ratios and Statistics
In addition to the ratios and statistics related to interest rate risk and liquidity, key ratios that measure other aspects of the credit union's operations will be monitored. Special attention is to be focused on those ratios that relate to the financial goals of the credit union. Ratios and their trends should be evaluated in light of these goals and the stated ALM objectives. Key ratios compared to peer group averages will be reported the Board on a monthly basis.

Analyze Pricing, Strategies, and New Products
When new types of loans, deposits, or pricing strategies for these products are proposed, the potential impact on the credit union's interest rate risk and liquidity position should be examined. A shift in emphasis from fixed-rate loans to variable-rate loans, or vice-versa, has important risk implications. Similarly, the effects of calendar pricing or anniversary repricing of variable-rate loans should be analyzed.

Review and Monitor Competitive Position
Rates charged and paid by competing financial institutions for loans and deposits will be reviewed by management. The purpose of this review process is to:

- Ensure the rates paid on deposits and the rates charged on loans are consistent with local market conditions.
- Ensure the rates paid and charged are fair and equitable to both savers and borrowers.
- Ensure the credit union's profitability and financial strength is not impaired by interest rate and/or dividend policies.

Forecasting Interest Rates – The general policy of Family First Credit Union is not to forecast rates but, rather, to position itself so that it is not significantly affected by rate changes, regardless of the direction and magnitude of the changes.

Other Asset Concentration Limits
The following table sets forth some of the credit union's asset concentration limitations:

Investments in …	**Are limited to …**
Fixed rates assets (investments and loans)	90% of total assets
Total dollars invested in real estate loans	30% of total assets
Investments and loans with maturity dates Beyond 15 years	20% of total assets
Unsecured loans	20% of total assets
CASD SERP	25% of net worth

All other asset concentration limits are identified in the credit union's Concentration Risk Policy and in the Concentration Risk Matrix report. The Concentration Risk Matrix report is reviewed by the ALM Committee and reported to the Board of Directors quarterly.

Back-Testing

Management will monitor the results of the ALM model to the Credit Union's actual results. Back-testing can determine whether differences between forecasted and actual results stem from errors in model setup, model assumptions or other factors. A back-test of the IRR model will be obtained annually after year-end. The back-testing will be performed during the first quarter of each year based on the previous year's results. The back-testing results will be reviewed by the ALM Committee and presented to the Board of Directors.

Independent Review

The ALCO will obtain an independent review (validation) of the credit union's ALM model including the interest rate risk function and liquidity/funds management. The independent review of the ALM model will be performed every eighteen months. The results of the independent review will be reviewed and evaluated by the ALCO. The ALCO will then present the independent review report to the Board of Directors.

Changes

When necessary, the ALCO will recommend changes to the Board to adjust or amend the ALM policy. The policy should be reviewed annually and amended as circumstances warrant. All changes to the policy must be approved by the Board.