

Section X

ASSET / LIABILITY

Reviewed: March 2019

Approved: March 20, 2019

**Red Crown Federal Credit Union
Policy Manual
Section X - Asset/Liability**

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A. Statement of General Policy

1. To be successful, Red Crown Federal Credit Union must be able to produce consistent earnings and growth and achieve a return on capital sufficient to provide a capital base capable of supporting future asset growth. Through sound and dynamic asset/liability management, Red Crown intends to realize solid operating results produced by management of the entire balance sheet and income/expense statements.
2. The purpose of Red Crown's asset/liability management (ALM) policy is to guide the management and the board in the decisions regarding loans, investments, dividends, operating expense control, and member service pricing policies. This policy will be reviewed annually to ensure it is appropriate for the current size, complexity and risk profile of the credit union.
3. In conjunction, the ultimate goal of the policy is to establish and review operating policies/procedures that will ensure that spreads and pricing policies are sufficient over the full interest cycle to allow Red Crown to build and maintain sufficient levels of capital, after accounting for operating expenses, loan and investment losses, and other non-operating losses.
4. Secondly, the ALM operating procedures of Red Crown must assure that sufficient levels of liquidity are available to satisfy the credit demands and deposit flows of its members.
5. Further, it is the philosophy of Red Crown to avoid undue interest rate risk. Some risk is inherent as part of credit union operations. It is the policy of Red Crown to manage and control the amount of risk it assumes. Red Crown, therefore, has implemented risk measurement and management procedures to ensure the level of Interest Rate Risk (IRR) stays at or below the policy limits set by the Board of Directors.

B. Committees and Responsibilities

1. Board of Directors

- a. The Board of Directors has ultimate responsibility for implementing and assuring adherence to this policy by the management of Red Crown.
- b. The Board of Directors will, not less than quarterly, review the funds management activities of Red Crown. This review will include: The minutes of the quarterly ALCO meeting held since the last Board meeting; a summary of Red Crown's most recent rate sensitivity analysis, reflecting intervals as determined appropriate by the ALCO committee; an analysis of Red Crown's liquidity position; and an analysis of Red Crown's financial results for the period just ended compared to the budget.

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- c. Annually, the Board of Directors will also review and approve Red Crown's annual budget and strategic plan. The Board of Directors will also review and approve any other data, analysis, and transactions, as may be appropriate, in view of their overall responsibility for the funds management activities of Red Crown or as indicated in the minutes of the ALCO meeting(s).

2. Asset/Liability Management Committee

- a. The primary responsibilities of the ALCO are to review and recommend revisions for products, policies and procedures of Red Crown to ensure prudent Asset / Liability management. Composition of the committee, at a minimum, will include four (4) Board appointed volunteers, *and the CFO*.
- b. The responsibility for implementing the decisions and directives of the ALCO rests with the President/CEO of the Credit Union. It is anticipated that he/she will delegate one or more specific duties assigned to him/her by the ALCO to the CFO/Controller or other staff.

C. Meetings of the ALCO

1. All meetings of the ALCO will be documented in writing. ALCO meetings will be held quarterly, prior to the Board meeting, or when necessary as called by the Chairman of the Committee. The Committee will be accountable to the Board of Directors.
2. As part of the regular quarterly meeting, the ALCO will review monthly and year-to-date spreads, operating expenses, non-interest income, operating profitability (ROA), rate sensitivity ratios, funds flow, asset and liability mixes, loan and dividend rates, monthly investment activity and maturities, asset quality, liquidity trends, and capitalization. The committee also will review local and national economic forecasts and their possible effects on Red Crown's spreads in coming months. The ALCO will report periodically to the Board and, when warranted, recommend to the Board changes regarding Red Crown's loans, investments, dividends, operating-expense controls, and pricing structure.

D. Liquidity

1. Liquidity represents the ability to accommodate, in the most efficient manner possible, decreases in deposits and/or the runoff of other liabilities, as well as the funding of increases in Red Crown's loan portfolio. Red Crown is deemed to have adequate liquidity when it can obtain sufficient cash promptly and at a reasonable rate (cost) to meet all cash flow demands.

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- a. Determination of the adequacy of Red Crown's liquidity position depends upon an analysis of Red Crown's:
 - i. Historical funding requirements;
 - ii. Current liquidity position;
 - iii. Current and anticipated asset quality;
 - iv. Current and anticipated earnings capacity;
 - v. Anticipated future funding needs; and
 - vi. Alternative sources of funds.

 - b. In order to provide funds to satisfy liquidity needs, Red Crown can:
 - i. Liquidate liquid assets;
 - ii. Increase short-term borrowing and/or issue additional short-term deposit liabilities;
 - iii. Decrease holdings of non-liquid assets;
 - iv. Increase liabilities of a term nature; and
 - v. Increase capital funds.
2. Sufficient cash levels will be maintained and investment maturities will be laddered in order to maintain an adequate level of liquidity.

 3. Forecasting future events is essential to adequate ALM planning. Sound financial management can help buffer negative changes in Red Crown's economic climate and accentuate positive ones. However, forecasting future events is a very subjective undertaking and is fraught with potential error. Accordingly, management must also develop contingency plans in case its projections are wrong. Effective contingency planning involves identifying minimum and maximum liability needs and weighing the alternative courses of action designed to meet those needs.

Since projections and alternatives change from day to day, management should be able to define at any time what alternatives are available for both minimum and maximum liability needs on a least-cost basis.

E. Asset Management

1. It is Red Crown's policy that primary sources of liquidity will be from the maintenance of assets having short maturities and cash flows in such a manner that safe and prudent level of liquidity is maintained.

2. Investments
 - a. The objectives of the investment portfolio are to (1) provide liquidity (2) provide for interest rate risk management, and (3) provide additional profit;

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- b. Security purchases will be consistent with separate written investment policies and strategies.
- 3. Loans
 - a. The maximum amount of loans outstanding shall be limited to 100% of deposits and borrowings. The maximum amount Of real estate backed assets, including mortgage-backed securities, will not exceed 40% of deposits and borrowings.
 - b. The Board of Directors seeks to keep the amount of assets classified as substandard, doubtful or loss by the regulatory authorities at less than 15% of capital;
 - c. Loan originations will be consistent with separate written loan policies.

F. Liability Management

- 1. The primary source of funding for Red Crown will be core deposits generated from members within our field of membership. It will be our goal to maintain a favorable mix of core deposits attempting to build a deposit base comprised of transactional and limited transaction accounts as opposed to relying on more expensive share certificates. This will be accomplished by implementing effective marketing, pricing and product strategies allowing us to compete effectively in our marketplace.
- 2. While it is our preference to avoid deposit concentrations, we will attempt to prudently accommodate our members. When deposit concentrations do occur, the ALCO will monitor the impact on the Credit Union's liquidity needs and on our financial strategies.
- 3. We will accept public deposits as an accommodation to local governmental entities. The level and terms of public deposits will be assessed and monitored regularly.
- 4. Red Crown will maintain a line of credit for short-term funding needs from the Federal Home Loan Bank, **and access to the Federal Discount Window**. The credit line is secured and is tested **annually** to confirm availability.

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G. Interest Rate Risk

1. It is the policy of Red Crown to measure and manage its rate sensitivity position to ensure the long-term financial stability of the credit union. In addressing this challenge, the ratios of rate sensitive assets (RSA) to rate sensitive liabilities (RSL) and gap (RSA minus RSL) to equity, as well as gap to total assets will be reviewed quarterly. More importantly, however, special emphasis is to be placed on the change in net interest income that will result from fluctuations in interest rates, changing account volumes, and time. IRR exposures will be projected over at least a two year period. Both static and dynamic simulations will be used in order to provide the ALCO and senior management a complete and comparative description of the exposure. Periodically, the credit union will conduct stress test scenarios which include but not limited to the following:
 - a. Instantaneous and significant changes in the level of interest rates.
 - b. Stress tests of 400 basis point rate shocks.
2. In using simulation, the credit union will consider the impact of parallel and non-parallel rate shocks; prepayment rates on loans and mortgage securities; interest rate caps and floors; and other imbedded options. Model assumptions will be reviewed and results will be back-tested on an annual basis. Functionality of the model will be independently verified as management deems necessary.
3. Before implementation of new business activities or strategies, simulation modeling will be utilized to run “what if” analyses to determine the effect on Red Crown’s risk profile.
4. The ALCO will review the credit union’s IRR exposure each quarter for material changes and compliance with the limits set forth below, ***and make any necessary adjustments to our portfolio.***

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INTEREST RATE RISK LIMITS – NET INTEREST INCOME (12 MONTH HORIZON)

<u>1 Year Change in Market Rates</u>	<u>Net Interest Change as a % of NII</u>
+300 bps	> - 25%
+200 bps	> - 20%
+100 bps	> - 10%
-0-	> - 10%
-100 bps	> - 10%
-200 bps	> - 20%
-300 bps	> - 25%

INTEREST RATE RISK LIMITS – ECONOMIC VALUE (CAPITAL AT RISK)

<u>Change in Interest Rates</u>	<u>Change in Fair Value of Equity</u>
+300 bps	> - 30%
+200 bps	> - 20%
+100 bps	> - 10%
-100 bps	> - 10%
-200 bps	> - 20%
-300 bps	> - 30%

H. Liquidity Management

Liquidity risk is the risk that the credit union does not have sufficient access to funds to maintain an adequate cash flow to maintain everyday business at all times; or does not have the ability to raise or borrow funds at a reasonable cost at all times. Failure to manage liquidity can result in an inability to meet operating cash needs and commitments such as member withdrawals. It is ALCO's responsibility to establish and monitor liquidity risk strategies. Liquidity will be measured and reported utilizing various static measurements. ALCO will review and utilize the Liquidity Risk Ratios Report quarterly to determine that liquidity levels do not fall below or exceed board approved ratios.

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Red Crown's liquidity plan is structured in phases (levels) depending upon the nature of the anticipated balance sheet changes and on the acceptability of the risk incurred as a result of such change. Certain events are triggering events that can cause changes in the levels of Red Crown's liquidity (from normal to severe liquidity constraints) and minimum actions to be taken by management at various levels. ***Red Crown uses Key Ratios to monitor Liquidity Risk. These are maintained in the Liquidity Risk Ratios report.***

1. Level 1 - 0 to 1 ratio exceeds benchmarks- Normal Operating Conditions
 - a. Report current liquidity position to ALCO
 - b. Monitor available sources of liquidity
 - c. Review alternative funding sources annually
 - d. Monitor member share withdraws and borrowing trends
 - e. Monitor investment maturities
 - f. Optimize the use of pledged collateral

2. Level 2 - 2 ratios exceed benchmarks- Activity Relatively Normal
 - a. Report current liquidity position to ALCO
 - b. Monitor available sources of liquidity
 - c. Ensure alternative funding sources availability
 - d. Monitor large member share withdraws and borrowing trends
 - e. Monitor short-term investment maturities and portfolio sale opportunities
 - f. Optimize the use of pledged collateral

3. Level 3 - 3 to 4 ratios exceed benchmarks-Activate Liquidity Contingencies
 - a. Present potential funding plan to ALCO
 - b. Report current liquidity position to ALCO monthly.
 - c. Monitor portfolio sale opportunities
 - d. Develop lists of assets that could be sold
 - e. Determine projected duration of liquidity crisis
 - f. Access external sources of funds as needed
 - g. Contact additional sources of fund to ensure availability and costs
 - h. Extend sources of liquidity maturities and prepare to restrict member borrowings.

4. Level 4 - 5 or more benchmarks exceeded-Liquidity Sources Restricted
 - a. Present funding plan to ALCO for approval
 - b. Report liquidity position to ALCO and the Board of Directors as necessary
 - c. Restrict member borrowings as necessary
 - d. Access external sources of funds as needed
 - e. Identify other possible assets or investments to be sold
 - f. Reassure members and work with regulatory agencies as needed.

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The directives outlined here will be implemented through, and in conjunction with, the lending and investment policies of Red Crown.

I. Contingency Funding Plan

1. The ALCO will determine the order of implementing the funding sources after reviewing and prioritizing their respective impact on the credit union's earnings, relative cost impact, and rate-risk exposure. The credit union's available funding amounts under each collateralized borrowing facility may be dependent upon the credit union's available eligible collateral values required.
 - a. Alternative funding includes an established line of credit with the Federal Home Loan Bank. The limit is determined quarterly according to pledged collateral available. Red Crown has also established access to the Federal Reserve Discount Window *and tested annually*.
 - b. Issue non-member deposits - The credit union has established a deposit agreement with a third party vendor program and may issue non-member deposits from their partner financial institutions, or directly with an acceptable financial institution with a maturity term of up to 5 years. Use of non-member deposits shall not exceed 20% of the credit unions total shares per regulation 701.32.
2. Liquidity crises which may develop because of serious industry-wide problems or significant deterioration of Red Crown's reputation and public confidence require a more structured and far reaching resolution. Should such a funding and liquidity problem develop, the ALCO, with oversight from the Board of Directors, will implement a contingency funding plan which will consider actions including:
 - a. Communications with regulatory agencies;
 - b. Formulation of communications plans with members, employees and the media;
 - c. Formulation of communication plans with large depositors and borrowers;
 - d. Assessment of asset pledging positions and market liquidation values;
 - e. Orderly liquidation of short term assets;
 - f. Availability of funds through borrowing arrangements;
 - g. Operational issues such as lobby traffic;
 - h. Disposition of long maturity assets;
 - i. Increased long term borrowing sources.

J. Capital Adequacy

Red Crown will strive to maintain a Net Worth to Total Assets Ratio of not less than 7%. The ALCO and management shall use their best efforts to ensure that Red Crown's capital position is maintained at levels which will afford the credit union "Well Capitalized" status as defined by NCUA regulation §702.102.

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K. Provision for Exceptions

1. In those situations where it seems prudent to act in a manner that is contrary to this policy, and where it is impossible for the entire committee to convene, the President, after contacting two other committee members, may act for the complete Committee, provided that all actions taken in the absence of the complete Committee will be reported in full at the next regularly scheduled Committee meeting.
2. All funds management activities predating the adoption of this policy and not in conformance with its various sections will not be considered as exceptions of this policy. Management will make a concerted effort to bring the funds management activities of Red Crown into compliance with the various guidelines and provisions of this policy as quickly as possible, subject to sound financial practices.
3. This policy is intended to be flexible to deal with rapidly changing conditions; therefore, this policy can be amended by the unanimous vote of the members of the ALCO. Any and all modifications to this policy are to be reported to the Board of Directors at its next regularly scheduled meeting.