PENFED CREDIT UNION

**2018** Annual Report

# A **stronger** YEAR FOR **US**

A strong year for PenFed means a stronger year for all of us. Increasing assets and record growth in membership bring new opportunities to better serve our members, for deeper investments with higher returns and to serve the communities and causes we love passionately.

As an organization, we champion the achievements of our members because they are the thing that lifts us. A sound financial victory for one of us is a victory for us all. The economic well-being of our members means greater stability and a surer financial foothold for our organization as we move into the future.

We vow never to stop building, to become stronger, and to work diligently toward a prosperous 2019 — and all of the years that follow.

## WHO WE ARE

We are America's member-owned, growth-oriented financial leader providing competitive pricing, digital convenience, and exemplary service to those we serve.

## OUR PURPOSE

PenFed is a member-owned financial cooperative, democratically controlled by its members and for its members. Unlike a bank, all benefits derived from the institution are returned directly to the members through best-in-class rates, superior products, and the peace of mind only the safest financial institutions can provide.

We operate for the purpose of helping our members "Do Better" financially. We achieve this purpose by providing credit and savings at competitive rates and delivering superior financial services to our members located around the world.

We exist to serve those who serve and those who support them. And we provide credit when credit is needed, contributing to the financial strength, growth, and well-being of our nation's defenders.

## OUR MISSION

To provide superior financial services and respond to members' needs in a cost-effective manner.

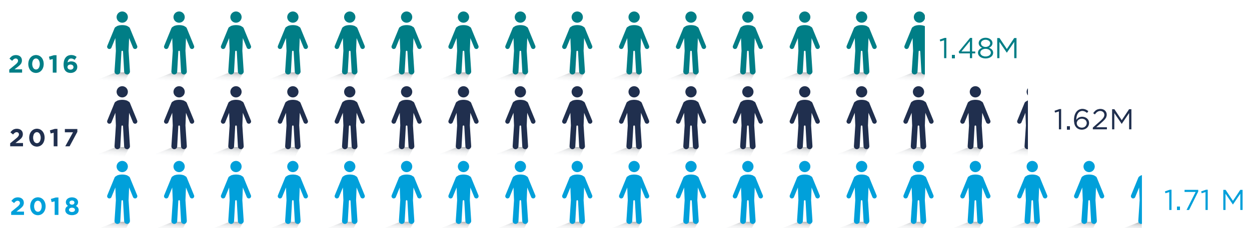
## OUR CORE VALUES

Our core values reflect our overarching beliefs for how we serve our members, operate our credit union, and lead in the financial services industry. We are an organization of strong character and strength, achieved by these shared guiding principles. It is through these values that we will achieve our mission, our vision and our purpose.

We are *collaborative, inspirational,* and *results-driven.* We believe in the power and goodness of our members, our staff, and our leaders, embracing our philosophy: Be kind with no surprises, striving to take perfect care of our members and our employees.

# FINANCIAL HIGHLIGHTS

## TOTAL MEMBERS




## TOTAL ASSETS


## NET INCOME

| $159M | $169M | $179M | $156M |
|---|---|---|---|
| 2015 | 2016 | 2017 | 2018 |

## NET WORTH RATIO

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# LETTER FROM THE chairman

Dear Fellow Members,

This was another great year for PenFed. Our assets grew by $1.6 billion to $24.5 billion, and we added 181,951 new members to reach a high of 1.7 million people. Coincidentally, we continued to build capital for strength and resilience.

In 2018, we launched the Premium Online Savings Account, with no minimum deposit requirements. Our current 2% dividend rate is almost 20 times the national average. We also launched the PenFed Pathfinder Rewards credit card to industry and member acclaim. We lowered our student loan rates to assist college graduates.

PenFed responded to your requests for new features on our mobile platform. We added Bill Pay, enhanced security and provided “show loan application status” and a “pending transactions” view.

We assisted 5,429 families with mortgages and processed over $1 billion in home equity loans. Members who used our Real Estate Rewards program saved about $3.6 million when purchasing their homes.

In our Service Centers, we installed a new phone system to improve the member experience. We also made improvements to branches to better serve you. We opened new branches in Puerto Rico, Nebraska, Texas and New York, and a new service center in San Antonio, Texas.

Through it all, we have continued to give back. In 2018, we donated over $3.52 million to charities. I am immensely proud of our PenFed Foundation’s 2018 accomplishments, including:

— Raising more than $6.2 million to help military families through the Military Heroes Fund and partnerships

— Making homeownership a reality for 186 military families — a record number of grants for this program

— Providing more than $2.25 million across Military Heroes Fund programs to organizations such as Dog Tag Inc., Armed Services Arts Partnership, Friendship Place and US VETS D.C.

— Launching the Veteran Entrepreneur Investment Program to help veteran-owned small businesses, raising $1.4 million

Low rates and low unemployment will challenge the economy in 2019. We have a sound plan and remain committed to providing you the best rates with few fees. Your Board of Directors thanks you for your membership and support; 2019 will be a great year.

Sincerely,

**EDWARD B. CODY**
CHAIRMAN, BOARD OF DIRECTORS

“WE ARE **PROUD** OF WHAT OUR TEAM AND YOU ACCOMPLISHED IN 2018.

AS ALWAYS, OUR **GOAL** IS TO **HELP OUR FELLOW MEMBERS** DO BETTER FINANCIALLY.”

# BOARD OF directors

Mr. Edward B. Cody,
Chairman

Your board members and supervisory committee members are volunteers who serve without compensation. In addition to their service to the credit union, they spend hundreds of hours from their personal lives on credit union business and activities in the interest of our esteemed members.

Mr. Walter P. Fairbanks,
Vice Chairman

Ms. Sandra L. (Sam) Patricola,
Treasurer

Lt Col (USAF Ret.)
John A. Rolando,
Secretary

Col (Ret.)
Ronald P. Hudak

The Honorable
Frederick F.Y. Pang

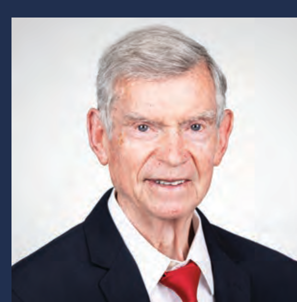
Col (Ret.) James F. Quinn

LTC (USAR)
Philip F. Romanelli

Mr. Alfred E. Rudolph

Col (Ret.)
Robert W. Siegert, III

LTC (Ret.) Ron Spear



LTC (Ret.) Bill R. Vinson,
Director Emeritus

The Honorable
Douglas W. Webster,
Director Emeritus

# president's REPORT

“WE WORK TO EMPOWER OUR MEMBERS TO MAKE MONEY.”

Dear Fellow Members,

As a PenFed member, you have ownership in one of the most robust credit unions in America.

In 2018, our capital grew to a record $2.53 billion. With a net worth ratio of 10.32 percent, PenFed holds $813 million more in capital than required to qualify for the official regulatory rating of “Well Capitalized.” This cushion protects your deposits, and it is so important to us that we conduct a series of stress tests every year. The test results indicate that even in the most adverse economic conditions, your money is protected.

### THE CREDIT UNION DIFFERENCE

The goal of banks is to make money for their stockholders. They charge the most they can on loans and pay out as little as they can on deposits. As a credit union, we have a markedly different mission: we work to empower our members to make money. At PenFed, we are in business to pay our members great rates on deposits and offer great rates on loans.

### THE PENFED DIFFERENCE

At PenFed, everyone is welcome to apply. We serve members from military bases to Main Street, across America and around the world. We have grown to become America’s second–largest federal credit union. Yet we are more. We are a community of people helping people. In 2018, I was humbled and honored to accept the award for Large Business Philanthropist of the Year on behalf of the entire PenFed team: 2,700 people who give more of themselves than they ever ask in return.

### A CALL FOR STORIES THAT INSPIRE

We are inspired by ordinary Americans who give back and succeed in extraordinary ways; so we share stories of inspiration, resilience and service from our employees and members. We invite you to join us on our social channels to enjoy a daily dose of positivity. You can share how you are giving back to your community by emailing us at Stories@PenFed.org.

Thank you for being part of our PenFed community. It is an honor to serve the brave men and women who serve our nation and all who support them.

Very Respectfully,

**JAMES R. SCHENCK**
PRESIDENT & CEO

**You may be familiar with the adage regarding "strength in numbers." Well, nowhere does that phrase ring truer than when discussing the power that we, as an organization, draw from the base of our PenFed members — members just like you.**

We may come from all backgrounds and all walks of life, but the purpose that unites us is the same: financial well-being for ourselves, our communities and our family members.

For membership growth, 2018 was a banner year for PenFed. We experienced an unprecedented number of new members who joined us bringing their resources, expertise and knowledge to our already robust family.

Whether it is preparing for a new baby or preparing for retirement, people learn about PenFed in any number of ways, but they stay with us for one defining reason: because we are with you every step of the way on your financial journey.

### ONE LIFELONG PENFED MEMBER'S STORY

Hudson "Rusty" Byrd discovered PenFed more than two decades ago at the recommendation of his father, a retired Army sergeant. For Mr. Byrd, the decision to join PenFed may have been at his father's suggestion, but the choice to stay with us at almost every life stage was has been far more than just a family affair.

In the late '90s, Mr. Byrd applied for a car loan with PenFed. Two decades later, he is still a member of the PenFed family. Now a senior budget analyst with the State Department, he has continued to use PenFed's services over the years for financial decisions big and small.

# A RECORD-GROWTH YEAR GIVES US STRENGTH IN NUMBERS


"Twenty years ago, I was a single person — no kids. Now, I'm married with three kids. Over that time, I have looked for more ways to work with my money," Mr. Byrd said. "I now have a Money Market Savings Account and a checking account with PenFed. I've used PenFed for purchasing cars, purchasing first homes, refinancing homes — and even for my second home."

*Hudson "Rusty" Byrd and his wife, Leah, at their home, purchased through a PenFed mortgage. "Twenty years ago, I was a single person, no kids. Now, I'm married with three kids. Over that time, I have looked for more ways to work with my money."*

"I LIKE THAT THERE'S A LARGE NUMBER OF PEOPLE THAT ARE PENFED MEMBERS, AND I LIKE **HOW WELL THE MONEY IS MANAGED"**

Over the years, as Mr. Byrd's financial portfolio has grown and his needs have evolved, PenFed has been right there with him.

"I like that there's a large number of people that are PenFed members, and I like how well the money is being managed," Mr. Byrd said. "At the same time, it doesn't feel like a corporation, where things are so financially driven. It's like you get the best of both worlds, the stability and financial tools you associate with a big bank and the customer service and individual care you might get from a credit union."

**Great rates are just the start. When it comes to building a lasting relationship with our members, we must be able to provide service and knowledge for every step in their financial journey.**

As we continue to expand and grow our base of members and portfolio of assets, we know it is paramount that we continue to support those endeavors and our members with a robust customer service experience that includes live support as well as an easy-to-use website and banking app.

### REMARKING ON EXCELLENCE

Our call centers and employees are some of the best in the business. One member recently told us: “I wouldn’t go with anyone else, I’d go to PenFed. They’re polite; they answer all your questions. They’re patient. You establish a relationship with them. It’s a good feeling; I’m not going to lie.”

While we may be receiving some rave reviews, you will not find us content to rest on our laurels. Instead, we are investing where it matters most: in our people. Throughout 2019, you will see even more improvements as we operationalize our call system and begin staffing on our newly acquired call center in San Antonio, Texas.

As a result, you may begin to notice some differences, like reduced call-wait times and faster service overall.

We are also continuing to make significant investments in technology in our ongoing effort to develop online banking tools that set the standard for the credit union industry — rivaling and surpassing those of the big banks.

## A RENEWED COMMITMENT TO our MEMBER SERVICE

WE ANSWERED MORE THAN

# 3.2 MILLION CALLS

IN OUR SERVICE CENTERS

AND OPENED

# 6 NEW BRANCHES

NATIONWIDE

*To help facilitate the growth of our expanding base of members, we are continuing to invest in customer service resources. For example, in 2018, we completed the purchase of a call center in San Antonio, Texas.*

**A record year of growth is not just good news for our base of members. It is great news for our organization on the whole, because it gives us the opportunity to lend greater support for the causes and charities that we love. In 2018, we focused on giving back to our communities. Here are just a few of the places where you made a difference:**

"THE PENFED SPIRIT IS TO GIVE BACK TO THOSE WHO HAVE FOUGHT ON THE FRONT LINES OF OUR FREEDOM."

*JAMES R. SCHENK*
*PRESIDENT & CEO*

- PenFed opened a transportation storefront at the Montgomery County Junior Achievement Finance Park® located in Thomas Edison High School of Technology. The storefront will serve 12,000 students annually, teaching seventh graders about budgeting for and financing a vehicle while visiting the storefront.
- Along with the opening of our newest financial center on the island of Puerto Rico, we launched a financial education program in tandem with our partners called "Tu Dinero, Tu Sueño"("Your Money, Your Dream"). The scalable and proven educational curriculum empowers students to make intelligent decisions with their money and prepares them for success.
- We would also be remiss not to recognize the wonderful work of the PenFed Foundation and its supporters. In 2018, we raised more than $2.5 million at the Night of Heroes Gala. That money goes toward supporting more than 35,000 veterans, active military members and their families each year.

# WORKING together

## SERVING OUR COMMUNITY




*Clockwise from top left:*

*Batter Up: In conjunction with the San Diego Padres, PenFed hosted a benefit for military heroes overseas.*

*Special Delivery: Care packages are delivered to service members, courtesy of PenFed Credit Union and the San Diego Padres.*

*Give the Gifts: PenFed Brand Manager Thomas Alford passes out toys to D.C. Cadets after a successful toy drive.*

*Grand Opening: (l to r) Hon. Frederick F.Y. Pang, Mark Smith, Shirley Dominick, Bruce Kaskold, James Schenck and John Dominick cut the red ribbon.*

*Puppy Love: Pictured are Admiral, fuzzy little service dog in training, and Lisa Jennings, first senior EVP.*

*Hello Hallito: CEO James Schenck is joined by fellow employees to open the PenFed Credit Union Hallito branch.*

"TOGETHER AS A TEAM, WE ARE UNSTOPPABLE."

*JAMES R. SCHENK*
*PRESIDENT & CEO*

**When it comes to serving our communities or servicing our members, it is an aspirational drive always to be doing more — for ourselves and those around us — that fuels us.**

And while we take great pains always to be pushing beyond expectations, we must be doing something right. As we continue to offer our members best-in-class customer service, easy-to-use banking tools, and of course great rates and high returns, the industry has started to take notice.

**THIS YEAR WE WERE FORTUNATE TO BE DISTINGUISHED WITH QUITE A FEW RECOGNITIONS AND AWARDS:**

- PenFed President and CEO James Schenck, 2018 Large Business Philanthropist of the Year | Volunteer Alexandria
- Executive Vice President and President of Mortgage Banking Deborah Ames Naylor, 2nd Place Executive Leader of the Year | Northern Virginia Chamber of Commerce
- Best credit unions | My Bank Tracker
- The best rewards credit cards of 2018 | Kiplinger
- Best credit unions for personal loans | My Bank Tracker
- Best annual no-fee credit cards | The Points Guy
- Best military banks and credit unions | Nerd Wallet
- The most convenient credit unions of 2018 | Magnify Money
- Best savings account | Bank Deal Guy
- Best travel credit cards | Condé Nast Traveler

# WORKING AS one RESULTS IN HONORS AND AWARDS

From consumer publications to trade organizations and industry associations, PenFed was the recipient of a number of awards, accolades and recognitions this year. In 2018, people were abuzz about PenFed products, services and charitable causes.

The proof is in our passion. The PenFed spirit of doing more for our communities and the causes we love goes well beyond the occasional. It is a mantle we carry with us every day. In 2018, PenFed President and CEO James Schenck was awarded Large Business Philanthropist of the Year by Volunteer Alexandria — an award he shares with PenFed and all of its employees.

This same year Executive Vice President and President of Mortgage Banking Deborah Ames Naylor was also recognized in the running for Executive Leader of the Year by the Northern Virginia Chamber of Commerce.

# 2018 supervisory COMMITTEE REPORT

As a matter of introduction, I am Brad Honkus and have been a long time member of PenFed and the Supervisory Committee. Recently, Committee Chair Terry Grafenstine announced her departure from the Supervisory Committee, and I am pleased to assume her responsibilities after having served as the vice chair of the Committee. Terry did an outstanding job as chair and we commend her dedicated service.

In accordance with the Federal Credit Union Act, your Supervisory Committee — appointed by PenFed's Board of Directors — is given the responsibility to provide assurance that the operations of the credit union are carried out in accordance with the Act, the regulations of the National Credit Union Administration (NCUA) and otherwise in a safe and sound manner.

The Supervisory Committee is represented at all Board of Directors meetings and also attends key meetings with Board and executive team members, including PenFed's chief executive officer and first senior vice president. We also meet regularly with PenFed's Audit Services Department, federal regulators and our external auditors to monitor and evaluate internal controls that help ensure that your assets are safeguarded and that PenFed is operating effectively and efficiently. Importantly, the chair of the Supervisory Committee meets quarterly with PenFed's chairman of the Board, chief compliance officer, chief risk officer, chief security officer and chief audit executive to receive firsthand updates from the front line on PenFed's actions to protect its members, safeguard their assets and ensure unwavering support for efforts to protect the nation's financial system and deter and detect terrorist and criminal activities.

This year, the Committee engaged the services of the independent public accounting firm of BDO USA, LLP, to audit the financial statements of the credit union. As noted in this report, BDO issued its opinion that the credit union's financial statements as of and for the year ended December 31, 2018, are presented fairly in all material respects. Importantly, PenFed had no weaknesses or deficiencies in its controls over financial reporting. In other words, PenFed's members can be assured that the Board of Directors, Supervisory Committee, and executive team are fulfilling their fiduciary responsibilities for sound fiscal stewardship of PenFed.

> "PENFED HAD NO WEAKNESSES OR DEFICIENCIES IN ITS CONTROLS OVER FINANCIAL REPORTING."


Based on the activity of our external and internal auditors and examiners, as well as our own observations, we can report that PenFed continues to maintain a high level of financial safety and soundness. PenFed continues to be a leader in the financial services it provides to members and an asset to the global credit union community. All of us on the Supervisory Committee are proud to volunteer our time to serve the members of PenFed as liaisons between you and your credit union.

If ever you need assistance or experience difficulties which cannot be resolved through normal channels, I encourage you to contact us. We are always available to answer questions or review comments regarding credit union activities. The Supervisory Committee is here for your benefit.

**BRAD HONKUS**
CHAIRMAN, SUPERVISORY COMMITTEE

# 2018 audited financial statements

# PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES

## FINANCIAL STATEMENTS AND
## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

**Years Ended December 31, 2018 and 2017**

PENFED
CREDIT UNION

# PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES
## FINANCIAL STATEMENTS AND REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS
**Years Ended December 31, 2018 and 2017**

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1801 Market Street, Suite 1700
Philadelphia, PA 19103

# Report of Independent Certified Public Accountants

Supervisory Committee and Members of
**Pentagon Federal Credit Union**

We have audited the accompanying consolidated financial statements of Pentagon Federal Credit Union (a federally chartered credit union) and subsidiaries, which comprise the consolidated statements of financial condition as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in members' equity, and cash flows for the years then ended, and the related notes to the financial statements.

## MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

## AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on the consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**OPINION**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pentagon Federal Credit Union and subsidiaries as of December 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Philadelphia, Pennsylvania
April 26, 2019

# PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
**(dollars in thousands)**

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 1,179,875 | $ 341,706 |
| Investment securities | | |
| Available-for-sale (cost $1,837,984 and $1,544,195) | 1,797,348 | 1,514,985 |
| Federal Home Loan Bank stock and other | 171,887 | 256,560 |
| Loans, net of allowance of $118,975 and $98,409 | 19,868,271 | 19,415,023 |
| Loans held for sale at fair value | 80,378 | 194,389 |
| Accrued interest receivable | 69,692 | 64,072 |
| NCUSIF deposit | 160,824 | 155,939 |
| Property and equipment, net | 442,295 | 396,134 |
| Other assets | 714,181 | 520,068 |
| Total assets | $ 24,484,751 | $ 22,858,876 |
| **LIABILITIES AND MEMBERS' EQUITY** | | |
| Members' accounts: | | |
| Regular shares | $ 2,498,378 | $ 2,209,802 |
| Checking accounts | 1,734,838 | 1,024,174 |
| Money market shares | 3,337,606 | 4,208,388 |
| Share certificates | 9,162,892 | 8,156,196 |
| IRA shares | 218,018 | 222,522 |
| IRA certificates | 1,930,854 | 1,988,649 |
| Total members' accounts | 18,882,586 | 17,809,731 |
| Borrowed funds | 2,681,000 | 2,361,000 |
| Accrued interest on members' accounts | 12,052 | 9,398 |
| Other liabilities | 452,484 | 386,185 |
| Total liabilities | 22,028,122 | 20,566,314 |
| Members' equity: | | |
| Regular reserves | 90,900 | 90,900 |
| Undivided earnings | 2,435,035 | 2,270,770 |
| Accumulated other comprehensive loss | (69,306) | (69,108) |
| Total members' equity | 2,456,629 | 2,292,562 |
| Total liabilities and members' equity | $ 24,484,751 | $ 22,858,876 |

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

## PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES
### CONSOLIDATED STATEMENTS OF INCOME
**(dollars in thousands)**

| | Years Ended December 31, 2018 | Years Ended December 31, 2017 |
|---|---|---|
| Interest income | | |
| Loans | $ 877,804 | $ 778,253 |
| Investment securities | 57,819 | 51,780 |
| Total interest income | 935,623 | 830,033 |
| Interest expense | | |
| Members' accounts | 264,623 | 222,618 |
| Borrowed funds | 75,239 | 72,528 |
| Total interest expense | 339,862 | 295,146 |
| Net interest income | 595,761 | 534,887 |
| Provision for loan losses | 157,441 | 136,345 |
| Net interest income after provision for loan losses | 438,320 | 398,542 |
| Non-interest income | | |
| Fees and charges | 56,661 | 50,880 |
| Credit card and debit card interchange | 25,879 | 26,004 |
| Gains on sales of loans | 22,263 | 28,124 |
| Gains on sales of investment securities | 87 | 4,914 |
| Other | 57,370 | 59,837 |
| Total non-interest income | 162,260 | 169,759 |
| Non-interest expense | | |
| Compensation and benefits | 227,096 | 193,120 |
| Office operations | 80,885 | 64,189 |
| Loan servicing | 32,160 | 31,362 |
| Occupancy | 23,802 | 22,059 |
| Education and promotional | 27,115 | 31,056 |
| Professional and outside services | 20,954 | 16,770 |
| Other | 32,540 | 31,123 |
| Total non-interest expense | 444,552 | 389,679 |
| Net income | $ 156,028 | $ 178,622 |

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

## PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES
### CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
**(dollars in thousands)**

| | Years Ended December 31, | |
|---|---|---|
| | **2018** | **2017** |
| Net income | $ 156,028 | $ 178,622 |
| Other comprehensive income(loss): | | |
| Change in net unrealized gains (losses) on investment securities during the year | (11,512) | 1,503 |
| Adjustment for realized gains on investment securities included in consolidated statements of income | 87 | 4,914 |
| Change in unrealized net gains on cash flow hedges | 4,453 | 3,164 |
| Amounts reclassified into interest expense on the consolidated statements of income | (4,219) | - |
| Change in unrealized pension and postretirement liabilities | 7,654 | (7,522) |
| Adjustment for realized pension and postretirement costs recorded to compensation and benefits on the consolidated statements of income | 3,339 | 3,659 |
| Other comprehensive (loss) income, net of reclassification adjustments | (198) | 5,718 |
| Comprehensive income | $ 155,830 | $ 184,340 |

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

# PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY
**Years Ended December 31, 2018 and 2017**
**(dollars in thousands)**

| | Regular Reserves | Undivided Earnings | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|
| Balance, January 31, 2017 | $ 90,900 | $ 2,072,384 | $ (74,826) | $ 2,088,458 |
| Net income | - | 178,622 | - | 178,622 |
| Equity from Credit Union mergers | - | 19,764 | - | 19,764 |
| Other comprehensive income, net of reclassification adjustments | - | - | 5,718 | 5,718 |
| Balance, December 31, 2017 | 90,900 | 2,270,770 | (69,108) | 2,292,562 |
| Net income | - | 156,028 | - | 156,028 |
| Equity from Credit Union mergers | - | 8,237 | - | 8,237 |
| Other comprehensive loss, net of reclassification adjustments | - | - | (198) | (198) |
| Balance, December 31, 2018 | $ 90,900 | $ 2,435,035 | $ (69,306) | $ 2,456,629 |

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

# PENTAGON FEDERAL CREDIT UNION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CASH FLOWS
**(dollars in thousands)**

| | Years Ended December 31, 2018 | 2017 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 156,028 | $ 178,622 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 157,441 | 136,345 |
| Depreciation and amortization | 42,052 | 29,192 |
| Net amortization of premiums and accretion of discounts | 10,230 | 8,194 |
| Gains on sales of loans | (22,263) | (28,124) |
| Gains on sales of investment securities | (87) | (4,914) |
| Loans originated and sold | (925,599) | (1,901,610) |
| Proceeds from sales of loans held for sale | 1,130,798 | 2,019,582 |
| Bargain gains from mergers | (3,038) | (21,042) |
| Changes in: | | |
| Accrued interest receivable | (5,620) | (12,627) |
| Other assets- Credit Union owned life insurance | 24,665 | (57,487) |
| Other assets | (209,141) | (32,483) |
| Other liabilities | 85,418 | 74,065 |
| Net cash provided by operating activities | 440,884 | 387,713 |
| Cash flows from investing activities: | | |
| Proceeds from maturities of investment securities | 245,664 | 161,574 |
| Purchases of investment securities | (573,820) | (522,715) |
| Decrease (increase) in Federal Home Loan Bank stock and other | 84,673 | (42,294) |
| Proceeds from sales of investment securities | 60,740 | 164,160 |
| Net increase in loans | (601,699) | (846,700) |
| Purchase of property and equipment | (79,145) | (82,429) |
| Cash from mergers | 56,976 | 113,975 |
| Entity value equity from mergers | (8,237) | (19,764) |
| Increase in NCUSIF deposit | (3,081) | (9,494) |
| Net cash used in investing activities | (817,929) | (1,083,687) |
| Cash flows from financing activities: | | |
| Repayment of borrowings | (8,765,000) | (24,295,217) |
| Proceeds from borrowings | 9,085,000 | 24,434,000 |
| Increase in members' accounts, net | 895,214 | 520,111 |
| Net cash provided by financing activities | 1,215,214 | 658,894 |
| Net increase (decrease) in cash and cash equivalents | 838,169 | (37,080) |
| Cash and cash equivalents at beginning of year | 341,706 | 378,786 |
| Cash and cash equivalents at end of year | $ 1,179,875 | $ 341,706 |
| Additional cash flow information: | | |
| Interest paid | $ 336,528 | $ 293,830 |
| Transfers of loans, net to other real estate owned | 4,063 | 3,087 |
| Noncash investing activities: | | |
| Fair value of assets acquired in mergers[1] | $ 191,916 | $ 685,237 |
| Fair value of liabilities assumed in mergers[1] | 180,641 | 644,431 |

***1 – See Note 2 for details of assets acquired and liabilities assumed***

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

## NOTE 1 – NATURE OF BUSINESS AND ORGANIZATION

Pentagon Federal Credit Union (the "Credit Union") is headquartered in McLean, Virginia and was organized and chartered on March 25, 1935 as a federal credit union under the provisions of the Federal Credit Union Act of 1934 for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes. The principal common bond shared by the Credit Union's members is their affiliation with the United States defense sector. Participation in the Credit Union is limited to those individuals who qualify for membership as defined in its charter and bylaws.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Financial Statements Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") and predominant practices within the banking industry. The consolidated financial statements and accompanying notes to the financial statements include the accounts of Pentagon Federal Credit Union and its wholly owned subsidiaries, PenFed Realty, LLC - which provides real estate brokerage services to the Credit Union's members and the general public, PenFed Title, LLC - which provides real estate settlement title services to the Credit Union's members, and DigMed, LLC – which provides advertising services to the Credit Union and the general public. All significant intercompany accounts and transactions have been eliminated.

### Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make certain estimates and assumptions that affect the amounts reported in the financial statements and in the accompanying notes. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change include the determination of the allowance for loan losses, determination of fair value for financial instruments, business combinations accounting and related adjustments, and employee benefit plan obligations and expenses.

(dollars in thousands)

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Business Combinations and Acquisitions

The Credit Union accounts for mergers under the applicable provisions of Accounting Standards Codification ("ASC") 805, "Business Combinations" and the operations of the merged entities are included with the Credit Union's consolidated balances as of the effective dates of each acquisition. Under this guidance, the assets acquired and liabilities assumed for each credit union merger are recorded at their respective fair values at the effective date of the merger. If the fair value of the acquired liabilities exceeds the fair value of the acquired assets, then goodwill is recorded; however, if fair value of assets acquired exceeds the fair value of liabilities assumed and entity value acquired, then the difference is recognized in the Credit Union's statements of income in other non-interest income- as a bargain purchase gain.

There were two credit union mergers in 2018, which are detailed below.

### 2018 Business Combinations – Mergers

| *Fair Value of Assets Acquired* | Merger A | Merger B | 2018 Total |
|---|---|---|---|
| Cash | $ 3,154 | $ 53,822 | $ 56,976 |
| Investment securities | 19,333 | 17,183 | 36,516 |
| Loans | 16,155 | 68,973 | 85,128 |
| Property & equipment | 300 | 8,768 | 9,068 |
| Other | 907 | 3,321 | 4,228 |
| Total Assets Acquired | $ 39,849 | $ 152,067 | $ 191,916 |
| *Fair Value of Liabilities Assumed* | | | |
| Other liabilities | $ 1,000 | $ 2,000 | $ 3,000 |
| Member accounts | 35,589 | 142,052 | 177,641 |
| Total Liabilities Assumed | $ 36,589 | $ 144,052 | $ 180,641 |
| *Net Equity Acquired from Mergers* | $ 3,260 | $ 8,015 | $ 11,275 |
| Entity Value | $ 2,142 | $ 6,095 | $ 8,237 |
| Residual Bargain Gain | 1,118 | 1,920 | 3,038 |
| | $ 3,260 | $ 8,015 | $ 11,275 |

The two mergers in 2018 had aggregate total assets of approximately $191.9 million, with total liabilities of approximately $180.6 million, and a resulting addition to equity of approximately $8.2 million and a bargain purchase gain recognized in non-interest income - other of approximately $3.0 million.

(dollars in thousands)

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Business Combinations and Acquisitions – Continued

There were six credit union mergers in 2017, which are detailed below.

### 2017 Business Combinations – Mergers

| *Fair Value of Assets Acquired* | Merger A | Merger B | Merger C | Merger D | Merger E | Merger F | 2017 Total |
|---|---|---|---|---|---|---|---|
| Cash | $ 30,734 | $ 45,581 | $ 6,093 | $ 392 | $ 17,883 | $ 13,292 | $ 113,975 |
| Investment securities | 668 | 24,476 | 749 | 64,089 | 464 | 3,200 | 93,646 |
| Loans | 62,808 | 141,105 | 3,203 | 92,023 | 90,607 | 40,511 | 430,257 |
| Property & equipment | 694 | 8,326 | 37 | 804 | 5,880 | 1,716 | 17,457 |
| Other | 4,430 | 9,630 | 294 | 7,547 | 3,982 | 4,019 | 29,902 |
| Total Assets Acquired | $ 99,334 | $ 229,118 | $ 10,376 | $ 164,855 | $ 118,816 | $ 62,738 | $ 685,237 |
| *Fair Value of Liabilities Assumed* | | | | | | | |
| Other liabilities | $ 3,196 | $ 2,119 | $ 100 | $ 3,099 | $ 3,000 | $ 1,000 | $ 12,514 |
| Member accounts | 91,164 | 219,224 | 10,076 | 147,418 | 106,164 | 57,871 | 631,917 |
| Total Liabilities Assumed | $ 94,360 | $ 221,343 | $ 10,176 | $ 150,517 | $ 109,164 | $ 58,871 | $ 644,431 |
| *Net Equity Acquired from Mergers* | $ 4,974 | $ 7,775 | $ 200 | $ 14,338 | $ 9,652 | $ 3,867 | $ 40,806 |
| Entity Value | $ 2,292 | $ 4,364 | $ 100 | $ 7,730 | $ 3,303 | $ 1,975 | $ 19,764 |
| Residual Bargain Gain | 2,682 | 3,411 | 100 | 6,608 | 6,349 | 1,892 | 21,042 |
| | $ 4,974 | $ 7,775 | $ 200 | $ 14,338 | $ 9,652 | $ 3,867 | $ 40,806 |

The six mergers in 2017 had aggregate total assets of approximately $685.2 million, with total liabilities of approximately $644.4 million, and a resulting addition to equity of approximately $19.8 million and a bargain purchase gain recognized in non-interest income – other of approximately $21.0 million.

In September 2018, the Credit Union purchased certain net tangible assets totaling $0.2 million and assumed certain advertising operations of DigMed LLC, dba White64, an advertising company in the Washington, D.C. area, for a purchase price of approximately $3.0 million and $1.7 million in contingent payments for this transaction. The effects of this transaction on the consolidated statements of cash flow were included in the respective line items. The remaining disclosures for this 2018 asset acquisition were omitted due to materiality.

**(dollars in thousands)**

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Goodwill and Intangibles

Total Goodwill was approximately $23.2 million and $18.7 million at December 31, 2018 and 2017, respectively, and is a component of other assets. Additions in 2018 were mostly the result of the acquisition of DigMed, LLC.

| | Carrying Value Goodwill December 31, 2018 |
|---|---|
| **Goodwill at beginning of year** | $ 18,707 |
| Goodwill additions during the year | 4,449 |
| Adjustments | - |
| **Goodwill at end of year** | $ 23,156 |

| | Carrying Value Goodwill December 31, 2017 |
|---|---|
| **Goodwill at beginning of year** | $ 18,707 |
| Goodwill additions during the year | - |
| Adjustments | - |
| **Goodwill at end of year** | $ 18,707 |

The Credit Union has total intangibles from acquisitions at December 31, 2018 and 2017, of $12.8 million and $12.1 million, respectively. Net additions to acquisition intangibles were related to the mergers, which had total additions of $2.8 million and $9.1 million for 2018 and 2017, respectively. The acquisition intangibles in both 2018 and 2017 relate mostly to core deposit intangibles, which represent the estimated fair value of the relationships within the members' share deposits acquired. The remaining disclosures for the 2018 and 2017 asset acquisitions, goodwill, and other acquisition intangibles were omitted due to materiality.

| | Carrying Value Intangibles December 31, 2018 |
|---|---|
| **Intangibles at beginning of year** | $ 12,056 |
| Intangible additions during the year | 2,787 |
| Amortization and adjustments | (2,030) |
| **Intangibles at end of year** | $ 12,813 |

| | Carrying Value Intangibles December 31, 2017 |
|---|---|
| **Intangibles at beginning of year** | $ 4,498 |
| Intangible additions during the year | 9,132 |
| Amortization and adjustments | (1,574) |
| **Intangibles at end of year** | $ 12,056 |

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand, shares in other credit unions, and demand deposits in other financial institutions. Amounts due from financial institutions may, at times, exceed federally insured limits.

### Investment Securities

Investment securities that management has the ability and intent to hold to maturity are classified as held-to-maturity and carried at cost, adjusted for amortization of premiums and accretion of discounts using the interest method. Other investment securities are classified as available-for-sale and are carried at fair value. Unrealized gains and losses on investment securities available-for-sale are excluded from earnings and reported in accumulated other comprehensive loss in members' equity. Purchase premiums and discounts are recognized in interest income using the interest method over the term of the securities purchased. Gains and losses on dispositions of investment securities are computed using the specific identification method. Credit Union management evaluates investments for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as the intent and ability of the Credit Union to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Federal Home Loan Bank-Atlanta stock and other securities have no readily available markets and thus do not have a quoted market value. Therefore, Federal Home Loan Bank stock and other securities are carried at cost or cash value. The Federal Home Loan Bank-Atlanta stock totaled approximately $128 million and $115 million at year-end 2018 and 2017, respectively. Other securities also includes a Charitable Donation Account, in which any revenues and/or gains are used to support charities as allowed under credit union regulations. The Charitable Donation Account totaled approximately $0 and $109 million at year-end 2018 and 2017, respectively. During 2018 and 2017, Federal Home Loan Bank stock and other securities were not impaired.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Loans and Allowance for Loan Losses

At origination, loans which management intends to hold until maturity are stated at the amount of unpaid principal, net of deferred loan origination costs/fees and the allowance for loan losses, while loans that management has a strategic intent to sell are designated as Loans Held for Sale (see below). Interest on loans is recognized over its term using the level yield method, except for credit cards where interest is calculated on an average balance detailed in the member's monthly statement. Loan fees and certain direct loan origination costs are deferred, and the net fee/cost is recognized as an adjustment to interest income over the term of the loans using the level yield method, except for credit cards - which are amortized on a straight-line basis.

The allowance for loan losses is maintained at a level that, in management's judgment, is adequate to absorb probable losses inherent in the loan portfolio. The allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, and trends in historical loss experience, in addition to specific impaired loans and economic conditions and trends (qualitative factors). Loans are typically charged off at 180 days or more delinquent consistent with regulatory guidance, with consideration of collateral valuations as deemed collectable. The loan portfolio is comprised primarily of large groups of smaller balance homogeneous loans that are collectively evaluated for impairment. First trust and home equity real estate loans that are generally 90 days or more past due are individually evaluated for impairment when certain impairment indicators, for example increased delinquency, documented member hardships, initiation of foreclosure activities and other factors, are present; if not, the loans are collectively considered in the general allowance for loan loss. Modified loans classified as troubled debt restructurings are identified and measured individually for impairment. Troubled debt restructurings are modified loans that include a concession to a member who is experiencing financial difficulty. The allowance is increased by a provision for loan losses (charged to expense) and the allowance is reduced by loan related charge-offs, net of recoveries. Changes in the estimated allowance are charged to the provision for loan losses. Due to the nature of uncertainties related to any estimation process, management's estimate of credit losses inherent in the loan portfolio may change in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Interest accrued is discontinued on loans when management believes, after considering economic factors, business conditions, and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful, or after three months of nonpayment, whichever occurs first. Credit Card loans that are contractually past due 90 days or more have not been put on nonaccrual status as they are typically charged off at 180 days (per regulatory guidelines). Uncollectible interest previously accrued is reversed against interest income. The Credit Union generally places impaired loans in nonaccrual status and recognizes interest income on a cash basis as payments are received. Income is subsequently recognized when cash payments are received until, in management's judgment, the borrower's ability to make periodic payments is resumed, in which case the loan is returned to an accrual status.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Loans Held for Sale

At origination, loans are classified as either mortgage loans held for investment or loans held for sale, based on management's strategy, intent, and ability to hold or sell these loans. Interest income on loans held for sale is recognized in loan interest income as earned. The Credit Union follows the fair value method for loans held for sale in accordance with "ASC 825 Financial Instruments" and recognizes changes in fair value as adjustments to gains on sales of loans in non-interest income. This option is generally irrevocable. The Credit Union elected the Fair Value Option for loans held for sale because they are hedged using derivatives, and the historical accounting practice resulted in volatility in earnings. Loans held for sale are sold with the mortgage servicing rights retained by the Credit Union, and are generally sold without recourse, subject to customary representations and warranties. The Credit Union recognizes the sale of loans or other financial assets when the transferred assets are legally isolated from the Credit Union's creditors, the Credit Union has relinquished control over the financial assets, and the appropriate other accounting criteria are met for recognition of a sale of an asset. At December 31, 2018 and 2017, the Credit Union had $80,378 and $194,389, respectively, of loans held for sale, which were committed for sale prior to the respective year-end periods. The Credit Union had outstanding commitments to sell loans of $38 million and $136 million at December 31, 2018 and 2017, respectively (see Note 13 – Derivative Instruments). The Credit Union accounts for these loan sale commitments, as well as the related derivatives used to economically hedge loans held for sale, at fair value.

### Mortgage Servicing Rights

Mortgage servicing rights are recognized as separate assets when mortgage loans are sold in the secondary market and the right to service these loans is retained for a fee. The Credit Union services for others approximately $6.2 billion in loan balances at both December 31, 2018 and 2017. These rights are recognized at fair value determined by a valuation model that calculates the present value of estimated future net servicing income. The valuation model utilizes assumptions that market participants would use in estimating future net servicing income, such as contractual servicing fee income, costs to service, discount rates, ancillary income, prepayment speeds, and default rates. This model is highly sensitive to changes in certain assumptions. If actual experience differs from the anticipated rates used in the Credit Union's model, this difference could result in a material change in the value of mortgage servicing rights.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Mortgage Servicing Rights – Continued

The Credit Union uses assumptions and estimates within the fair value method for capitalized mortgage servicing rights. These assumptions include prepayment speeds and discount rates commensurate with the risks involved and comparable to assumptions used by market participants to value and bid servicing rights available for sale in the market. Specifically, at year-end 2018 and 2017, the Credit Union utilized assumptions in conditional prepayment rates of 10.0% and 10.3%, respectively, and also utilized a discount rate of 10.1% in both 2018 and 2017, in determining the fair value of capitalized mortgage servicing rights. At December 31, 2018 and 2017, the mortgage servicing rights balance was $67,548 and $64,398, respectively. During 2018 and 2017, the Credit Union sold mortgage loans with proceeds from sales of loans totaling $1,130,798 and $2,019,582, respectively, and recognized net gains on sales of loans totaling $22,263 and $28,124, respectively, which were recorded as non-interest income.

### Other Real Estate Owned

The Credit Union records real estate acquired through foreclosure ("real estate owned") at fair value on the date of acquisition, plus certain capitalized costs, net of estimated disposal costs, resulting in a new cost basis. Carrying costs such as interest and maintenance are expensed as incurred. After foreclosure, updated fair values are obtained, after which the real estate owned is carried at the lower of its carrying value or its fair value less estimated costs to sell. The balances of such assets are included in other assets in the consolidated statements of financial condition. Due to changing market conditions (and the fair value and disposal cost assumptions for real estate owned), the amounts ultimately realized from the sale of real estate owned may differ from the amounts reflected in the consolidated financial statements. At December 31, 2018 and 2017, the Credit Union had real estate owned (in other assets designation) with gross balances of $3,625 and $3,939, respectively, and related valuation allowance balances of $487 and $650, respectively. Additions to the valuation allowance were $524 and $789 for 2018 and 2017, respectively.

### Property and Equipment

Property and equipment are stated at cost, including interest capitalized during the period of construction, less accumulated depreciation and amortization. Purchased software, as well as internally developed software for the Credit Union's internal-use, is capitalized when the software is placed in service. Depreciation and amortization are recognized using the straight-line method over the estimated useful lives of the assets. Land is stated at cost. Expenditures for maintenance and repairs are charged to operations as incurred. The cost and related accumulated depreciation are eliminated from the accounts when assets are disposed. Any resulting gain or loss is reflected in the results of operations. Leasehold improvements are amortized over the lesser of the estimated economic life of the improvements or the remaining term of the lease.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Members' Accounts

Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Interest on members' share and savings accounts is based on available earnings at the end of an interest period and is not guaranteed by the Credit Union. Interest rates are set by the Credit Union's Board of Directors, based on an evaluation of current and future market conditions.

### Members' Equity

The Credit Union is required by regulation to maintain statutory reserves ("regular reserves"); representing a regulatory restriction of members' equity and thus these regular reserves are not available for the payment of interest on share accounts. Other appropriated members' equity amounts may be established or transferred at the discretion of the Board of Directors.

### National Credit Union Share Insurance Fund ("NCUSIF") Deposit

The NCUSIF deposit is in accordance with National Credit Union Administration ("NCUA") regulations, requiring the maintenance of a deposit by each insured credit union in an amount equal to one percent of its insured shares. The deposit would be refunded to the Credit Union if: (1) the insurance coverage is terminated; (2) the Credit Union converts to insurance coverage from another source; or (3) the operations of the fund are transferred from the NCUA Board.

### Advertising Costs

Advertising costs are included in education and promotional expense and are expensed as incurred. Advertising expense for 2018 and 2017 was $27,115 and $31,056, respectively, of which $16,705 and $11,808 in 2018 and 2017, respectively, was paid to a related party.

### Income Taxes

The Credit Union is exempt from federal and state income taxes in accordance with Section 122 of the Federal Credit Union Act.

### Comprehensive (Loss)/Income

Accounting principles generally require revenue, expenses, gains, and losses to be included in Net Income. Certain changes in assets and liabilities, such as unrealized gains and losses on investment securities, gains and losses on cash flow hedge derivatives, and pension related adjustments are reported as a separate component of members' equity in the consolidated statements of financial condition.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Fair Value of Assets and Liabilities

Fair value is a market-based measurement, not an entity-specific measurement, and the hierarchy gives the highest priority to quoted prices in active markets. Fair value measurements are disclosed by level within the fair value hierarchy. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

Valuation techniques are to be consistent with the market approach, the income approach, and/or the cost approach. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset/liability or unobservable, meaning those that reflect the entity's own assumptions developed based on the best information available in the circumstances.

The fair value hierarchy is as follows:

Level 1 - Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations have certain assumptions and projections, which require significant management judgment or estimation in determining the fair value assigned to such assets or liabilities.

### Derivative Instruments

A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index, or referenced interest rate. These instruments include interest rate swaps, caps, floors, collars, financial forwards and futures contracts, and when-issued securities, as examples. The Credit Union can use derivatives to manage economic risk related to securities, mortgage servicing rights and mortgage banking operations, share deposits, debt, and other funding sources.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Derivative Instruments – Continued

Derivative financial instruments are classified primarily as either (1) a hedge of an exposure to changes in the fair value of a recorded asset or liability ("fair value hedge"), (2) a hedge of an exposure to changes in the cash flows of a recognized asset, liability or forecasted transaction ("cash flow hedge") or, (3) derivatives not designated as accounting hedges (such as economic hedging for loans held for sale). The fair value of derivatives in a gain or loss position are included in other assets or other liabilities.

Changes in the fair value of derivatives not designated as cash flow hedges are recognized in current period earnings. The Credit Union has netting agreements within its derivatives agreements, but presents gross assets and liabilities in the consolidated statements of financial condition. At inception and at least quarterly during the life of the hedge, the Credit Union documents its analysis of actual and expected hedge effectiveness for cash flow hedges. This analysis includes techniques such as regression analysis and hypothetical derivatives to demonstrate that the hedge has been, and is expected to be, highly effective in offsetting corresponding changes in the fair value or cash flows of the hedged item. For a cash flow hedge, changes in the fair value of the derivatives that have been highly effective are recognized in accumulated other comprehensive loss until the related cash flows from the hedged item are recognized in earnings. If the cash flow hedge ceases to be highly effective, the Credit Union discontinues hedge accounting and recognizes the changes in fair value in current period earnings. If a derivative that qualifies as a fair value or cash flow hedge is terminated or de-designated, the realized or then unrealized gain or loss is recognized in income over the life of the hedged item (fair value hedge) or in the period in which the hedged item affects earnings (cash flow hedge). Immediate recognition in earnings is required upon sale or extinguishment of the hedged item (fair value hedge) or if it is probable that the hedged cash flows will not occur (cash flow hedge).

### Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (Topic 606) which requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in amounts that reflect the consideration to which the entity expects to be entitled in exchange for those goods and services. The ASU is effective for annual reporting periods beginning after December 15, 2018. The adoption of the guidance in Topic 606 will be applied retrospectively and will not have a material impact on the Credit Union's financial statements or disclosures.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Recent Accounting Pronouncements – Continued

The following ASUs are integral to Topic 606 and may be adopted either retrospectively or on a modified retrospective basis to new contracts and existing contracts, with remaining performance obligations as of the effective date.

- ASU 2015-14, *Deferral of the Effective Date*
- ASU 2016-08, *Principle versus Agent Considerations*
- ASU 2016-10, *Identifying Performance Obligations and Licensing*
- ASU 2016-12, *Narrow-Scope Improvements and Practical Expedients*
- ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*

The Credit Union evaluated revenue streams aligned with the classifications reported on the consolidated statements of income. For those revenue streams subject to the provisions of Topic 606, the Credit Union evaluated those revenue streams which include fees and charges, credit card and debit card interchange, and other non-interest income. The adoption of these integral ASU's on January 1, 2019, will not have a material impact on the Credit Union's financial statements or disclosures.

In January 2016, the FASB issued ASU 2016-01, amends Sub-Topic 825-10 *Financial Instruments-Overall*. This update amends certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Specifically, among other amendments, this update eliminates the disclosure of fair value of financial instruments that are at amortized cost, while requiring separate presentation of financial assets and liabilities by measurement category on the balance sheet or in the notes to financial statements. These amendments are effective for the annual periods beginning after December 15, 2018. The implementation of Sub-topic 825-10 will not have a material effect on the Credit Union's consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, Clarifying the Definition of a Business, effective for annual reporting periods beginning after December 15, 2018. The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similarly identifiable assets; if so, the set of transferred assets and activities is not a business. The adoption of ASU 2017-01 will not have a material effect on the Credit Union's consolidated financial statements.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Recent Accounting Pronouncements – Continued

In March 2017, the FASB issued ASU 2017-07, *Compensation- Retirement Benefits* (Topic 715). This guidance requires the Credit Union records its retirement related service cost components as compensation expense, while all other components of retirement related costs are required to be separately presented in the consolidated statements of income (in other income or other expenses) from the compensation expense, among other requirements. This guidance is effective for fiscal years beginning after December 15, 2018. The adoption of Topic 715 will not have a material effect on the Credit Union's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases* (Topic 842). The new guidance requires lessees to recognize assets and liabilities related to certain operating leases on the balance sheet. The new guidance also requires additional disclosures by lessees and contains targeted changes to accounting by lessors. This guidance is effective for fiscal years beginning after December 15, 2019. The implementation of ASU No. 2016-02 is not expected to have a material effect on the Credit Union's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments* (Topic 230). The guidance addresses how certain cash receipts and cash payments are presented and classified in the statements of cash flows. This guidance is effective for fiscal years beginning after December 15, 2019. The adoption of this standard is not expected to have a material effect on the Credit Union's consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities (Topic 815). This derivatives and hedging guidance simplifies certain documentation required for hedging activities while also simplifying assessment requirements. This guidance also expands the risk management activities that qualify for hedge accounting. Additionally, the guidance eliminates the concept of separately recording hedge ineffectiveness, and expands disclosure requirements of the impact of hedging relationships. This guidance is effective for fiscal years beginning after December 15, 2019 and early adoption is permitted. The Credit Union elected early adoption of this ASU effective January 1, 2018, which has expanded the Credit Union's use of fair value hedging to include the last-of-layer method. The last-of-layer method permits reporting entities to designate the portion of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge. Upon adoption, recorded amounts using the last-of-layer method are not material to the consolidated financial statements. The Credit Union has modified the notes to the consolidated financial statements in accordance to the new guidance.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED**

**Recent Accounting Pronouncements – Continued**

In January 2017, the FASB issued ASU 2017-04, *Intangibles - Goodwill and Other* (Topic 350). The new guidance simplifies the subsequent measurement of goodwill which eliminates Step 2 from the goodwill impairment test. Instead, under the amendments in this ASU, an entity should perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. This guidance is effective for annual goodwill impairment tests in fiscal years beginning after December 15, 2021. Early adoption is permitted for annual goodwill impairment tests performed on testing dates after January 1, 2017. The Credit Union is evaluating the impact of the adoption of ASU 2017-04.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement* (Topic 820) which modifies the disclosure requirements on fair value measurements. This guidance is effective beginning after December 15, 2019 and early adoption is permitted. The Credit Union is evaluating the impact to the notes to the financial statements upon adoption of the new standard.

In August 2018, the FASB issued ASU 2018-15, *Intangibles – Goodwill and Other – Internal-Use Software* (Subtopic 350-40) which helps entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (hosting arrangement) by providing guidance for determining when the arrangement includes a software license. The update applies to entities that are customers in a hosting arrangement that is a service contract. This guidance is effective for annual reporting periods beginning after December 15, 2020. The Credit Union is evaluating the impact from the adoption of the new standard.

In June 2016, the FASB issued new guidance for Credit Losses (ASU 2016-13). The new guidance replaces the incurred loss impairment methodology with an expected credit loss methodology. Financial assets measured at amortized cost will be presented at the net amount expected to be collected by using an allowance for credit losses. Purchased credit deteriorated loans will receive an allowance account for expected credit losses at the acquisition date that represents a component of the purchase price allocation. Credit losses relating to AFS securities will be recorded through an allowance for expected credit losses, with such allowance limited to the amount by which fair value is below amortized cost. An allowance will be established for estimated credit losses on HTM securities. This guidance is effective for fiscal years beginning after December 15, 2021. The Credit Union is evaluating the effect of this ASU will have on our consolidated financial statements.

**(dollars in thousands)**

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

### Recent Accounting Pronouncements – Continued

In August 2018, the FASB issued ASU 2018-14, *Compensation-Retirement Benefits-Defined Benefit Plans-General* (Subtopic 715-20) which modifies the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The ASU removes disclosures that no longer are considered cost beneficial, clarify the specific requirements of disclosures and add disclosure requirements identified as relevant. The guidance is effective for fiscal years beginning after December 15, 2021 with early adoption permitted. The Credit Union is currently evaluating the effect of the disclosures required by the ASU.

## NOTE 3 – INVESTMENT SECURITIES

The amortized cost and fair values of investment securities available-for-sale, with gross unrealized gains and losses, are summarized as follows:

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Amortized | Gross Unrealized | | Fair |
| | Cost | Gains | Losses | Value |
| **Securities available-for-sale** | | | | |
| Federal agency securities-bonds | $ 115,980 | $ - | $ (3,943) | $ 112,037 |
| Government agency bonds | 244,541 | 575 | (8,530) | 236,586 |
| Mortgage backed securities | 1,411,883 | 1,055 | (27,895) | 1,385,043 |
| Other | 65,580 | - | (1,898) | 63,682 |
| Total securities available-for-sale | $ 1,837,984 | $ 1,630 | $ (42,266) | $1,797,348 |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Amortized | Gross Unrealized | | Fair |
| | Cost | Gains | Losses | Value |
| **Securities available-for-sale** | | | | |
| Federal agency securities-bonds | $ 115,974 | $ - | $ (4,032) | $ 111,942 |
| Government agency bonds | 239,380 | 354 | (5,826) | 233,908 |
| Mortgage backed securities | 1,130,412 | 4 | (18,593) | 1,111,823 |
| Other | 58,429 | - | (1,117) | 57,312 |
| Total securities available-for-sale | $ 1,544,195 | $ 358 | $ (29,568) | $1,514,985 |

(dollars in thousands)

## NOTE 3 – INVESTMENT SECURITIES, CONTINUED

The table below presents available-for-sale securities in a gross unrealized loss position, and whether such securities have been in a gross unrealized loss position for less than 12 months, or 12 months or greater.

| | December 31, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | | 12 Months or Greater | | |
| | Number of Investments | Fair Value | Gross Unrealized Losses | Number of Investments | Fair Value | Gross Unrealized Losses |
| **Securities Available for Sale** | | | | | | |
| Federal agency securities-bonds | - | $ - | $ - | 9 | $ 112,037 | $ (3,943) |
| Government agency bonds | 2 | 31,338 | (470) | 20 | 155,772 | (8,060) |
| Mortgage backed securities | 28 | 227,056 | (1,628) | 116 | 929,002 | (26,267) |
| Other | 1 | 9,915 | (23) | 5 | 53,768 | (1,875) |
| **Total securities available for sale in a gross unrealized loss position** | **31** | **$ 268,309** | **$ (2,121)** | **150** | **$ 1,250,579** | **$ (40,145)** |

| | December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | | 12 Months or Greater | | |
| | Number of Investments | Fair Value | Gross Unrealized Losses | Number of Investments | Fair Value | Gross Unrealized Losses |
| **Securities Available for Sale** | | | | | | |
| Federal agency securities-bonds | 1 | $ 9,851 | $ (149) | 8 | $ 102,091 | $ (3,883) |
| Government agency bonds | 3 | 24,534 | (209) | 17 | 150,237 | (5,617) |
| Mortgage backed securities | 57 | 534,715 | (4,941) | 59 | 571,692 | (13,652) |
| Other | 1 | 14,867 | (127) | 4 | 42,445 | (990) |
| **Total securities available for sale in a gross unrealized loss position** | **62** | **$ 583,967** | **$ (5,426)** | **88** | **$ 866,465** | **$ (24,142)** |

The Credit Union evaluates investments for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Each security in a loss position is evaluated for OTTI. Consideration is given to the length of time and the extent to which the fair value has been less than cost and the financial condition and near-term prospects of the issuer. This evaluation also includes recent experience regarding principal and interest payments received, and whether it is more likely than not that these securities would be required to be sold before the anticipated recovery of the amortized cost. The Credit Union does not have a requirement to sell these securities and further anticipates these losses to recover with changes in market conditions or when these securities mature. The unrealized losses for 2018 and 2017 related predominately to current and prior year additions, and were the result of changes in interest rates after these securities were purchased, and thus are not an indication of impairment.

(dollars in thousands)

## NOTE 3 – INVESTMENT SECURITIES, CONTINUED

The contractual maturities at December 31, 2018 and 2017 are detailed in the following table (actual maturities may differ from contractual maturities as certain security issuers have the right to call or prepay obligations without penalty):

| | December 31, 2018 | |
|---|---|---|
| Investment securities available-for-sale | Amortized Cost | Fair Value |
| Due in one year or less | $ - | $ - |
| Due after one year through five years | 216,570 | 209,646 |
| Due after five years through ten years | 435,315 | 425,488 |
| Due after ten years | 1,186,099 | 1,162,214 |
| Total investment securities available-for-sale | $ 1,837,984 | $ 1,797,348 |

| | December 31, 2017 | |
|---|---|---|
| Investment securities available-for-sale | Amortized Cost | Fair Value |
| Due in one year or less | $ - | $ - |
| Due after one year through five years | 109,528 | 107,420 |
| Due after five years through ten years | 404,081 | 394,503 |
| Due after ten years | 1,030,586 | 1,013,062 |
| Total investment securities available-for-sale | $ 1,544,195 | $ 1,514,985 |

Total sales of securities were $60.7 million and $164.2 million for 2018 and 2017, respectively, with gross gains of $115 thousand and gross losses of $28 thousand for 2018, and gross gains of $7.3 million and gross losses of $2.4 million for 2017.

(dollars in thousands)

## NOTE 4 – LOANS, NET

Major classifications of loans to members are summarized as follows:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| First trust mortgages | $ 11,193,301 | $ 11,325,715 |
| Term home equity | 736,832 | 729,511 |
| Equity lines of credit | 1,500,258 | 1,495,091 |
| Total real estate loans | 13,430,391 | 13,550,317 |
| Credit card loans, primarily unsecured | 1,724,668 | 1,736,551 |
| Vehicle loans | 3,383,632 | 3,317,253 |
| Unsecured consumer loans and other | 1,320,253 | 801,694 |
| Total vehicle and other loans | 4,703,885 | 4,118,947 |
| Net unamortized deferred fees and costs | 128,301 | 107,617 |
| Total loans, net of fees and costs | 19,987,245 | 19,513,432 |
| Less allowance for loan losses | (118,975) | (98,409) |
| Loans, net | $ 19,868,270 | $ 19,415,023 |

Loans are comprised of real estate loans (1st & 2nd trust loans collateralized by real estate), unsecured credit card loans, vehicle loans and other loans (comprised mostly of unsecured lines of credits to members and student loans, among others). The overall risk within the real estate portfolios is supported by the collateral held and thus these values are monitored within current market trends for real estate. The overall risk within consumer and credit card loans is tied to trends in unemployment, broad economic trends, and consumer spending, to name a few. The Credit Union monitors performance of these portfolios against these trends and adjusts its lending strategies within established risk tolerance strategies.

The Credit Union holds deeds of trust/mortgages on underlying real estate to collateralize all first trust mortgage, term home equity, and equity line of credit loans. Approximately 30% of real estate loans at December 31, 2018 and 31% at December 31, 2017 are collateralized by residential real estate located in the District of Columbia metropolitan area.

Nonperforming loans include nonaccrual loans in addition to credit card loans that are contractually past due 89 days or more as to interest or principal, but have not been put on nonaccrual status (per regulatory guidelines).

**(dollars in thousands)**

## NOTE 4 – LOANS, NET, CONTINUED

At December 31, 2018 and 2017, nonperforming loans were as follows:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Nonaccrual loans-- real estate loans | $ 14,653 | $ 14,260 |
| Nonaccrual loans-- vehicle and other loans | 51,129 | 36,483 |
| Total nonaccrual loans | 65,782 | 50,743 |
| Credit card loans contractually past due 89 days or more and still accruing | 34,416 | 30,866 |
| Total nonperforming loans | $ 100,198 | $ 81,609 |
| Total nonperforming loans as % of net loans receivable | 0.51 % | 0.44 % |

In addition, the following tables provide past due and aging information for the loan portfolio at 2018 and 2017 year end, as follows:

| December 31, 2018 | 30-59 days Past Due | 60-89 days Past Due | >89 days Past Due | Total Past Due | Current | Total |
|---|---|---|---|---|---|---|
| First trust mortgages | $ 4,281 | $ 2,114 | $ 10,177 | $ 16,572 | $11,305,030 | $11,321,602 |
| Term home equity | 1,171 | 873 | 1,899 | 3,943 | 732,889 | 736,832 |
| Equity lines of credit | 2,722 | 1,599 | 2,577 | 6,898 | 1,493,360 | 1,500,258 |
| Credit card loans | 15,456 | 9,468 | 34,416 | 59,340 | 1,665,328 | 1,724,668 |
| Vehicle loans | 35,174 | 13,412 | 33,034 | 81,620 | 3,302,012 | 3,383,632 |
| Unsecured consumer/other | 8,805 | 6,216 | 18,095 | 33,116 | 1,287,137 | 1,320,253 |
| Total loans | $ 67,609 | $ 33,682 | $ 100,198 | $ 201,489 | $19,785,756 | $19,987,245 |

| December 31, 2017 | 30-59 days Past Due | 60-89 days Past Due | >89 days Past Due | Total Past Due | Current | Total |
|---|---|---|---|---|---|---|
| First trust mortgages | $ 5,589 | $ 3,508 | $ 9,088 | $ 18,185 | $11,415,147 | $11,433,332 |
| Term home equity | 1,859 | 1,009 | 2,836 | 5,704 | 723,807 | 729,511 |
| Equity lines of credit | 3,131 | 1,302 | 2,337 | 6,770 | 1,488,321 | 1,495,091 |
| Credit card loans | 13,809 | 9,938 | 30,866 | 54,613 | 1,681,938 | 1,736,551 |
| Vehicle loans | 28,814 | 9,713 | 22,960 | 61,487 | 3,255,766 | 3,317,253 |
| Unsecured consumer/other | 6,960 | 4,644 | 13,522 | 25,126 | 776,568 | 801,694 |
| Total loans | $ 60,162 | $ 30,114 | $ 81,609 | $ 171,885 | $19,341,547 | $19,513,432 |

(dollars in thousands)

## NOTE 4 – LOANS, NET, CONTINUED

The amount of interest income that would have been recognized on nonperforming loans under the original contractual terms of these loans was approximately $8.0 million and $4.6 million for the years ended December 31, 2018 and 2017, respectively. The actual interest income recognized on nonperforming loans was approximately $5.2 million and $2.4 million in 2018 and 2017, respectively, and thus the foregone interest lost was approximately $2.8 million and $2.2 million for December 31, 2018 and 2017, respectively. During 2018 and 2017, interest income recognized on impaired loans was approximately $0.2 million for each year.

Restructured loans are troubled debt restructurings where the Credit Union has granted a concession to a member who is experiencing financial difficulty. The following table provides a summary of restructured loans outstanding in accruing and nonaccrual status:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Restructured loans-- | | |
| First trust mortgages | $ 26,561 | $ 24,750 |
| Term home equity | 5,163 | 4,801 |
| Equity lines of credit | 3,683 | 6,131 |
| Credit card loans | - | - |
| Vehicle loans | 179 | 103 |
| Unsecured consumer loans and other | 4,314 | 4,853 |
| Total restructured loans-- current | 39,900 | 40,638 |
| Restructured loans-- nonaccrual | | |
| First trust mortgages | 744 | - |
| Term home equity | - | 104 |
| Equity lines of credit | 362 | 352 |
| Credit card loans | - | - |
| Vehicle loans | - | - |
| Unsecured consumer loans and other | 138 | 218 |
| Total restructured loans-- nonaccrual | 1,244 | 674 |
| Total restructured loans | $ 41,144 | $ 41,312 |

The total new restructured loans for 2018 and 2017 were $7.2 million and $2.3 million, respectively, involving mostly concessions in rate and/or extension of maturity to members experiencing financial difficulties. There were not any restructured loan defaults in 2018 and 2017. The Credit Union had 420 and 446 in the number of restructured loans at year-end December 31, 2018 and 2017 respectively. The remaining disclosures related to restructured loans for the years presented were omitted due to lack of materiality.

(dollars in thousands)

## NOTE 4 – LOANS, NET, CONTINUED

Changes in the allowance for loan losses for 2018 and 2017 were as follows:

| December 31, 2018 | 1st Trust Mortgages | Term Home Equity | Equity Lines | Credit Cards | Vehicle Loans | Unsecured and Other | Total |
|---|---|---|---|---|---|---|---|
| Balance, beginning of year | 3,578 | 2,149 | 3,513 | 40,570 | 19,856 | 28,722 | 98,388 |
| Provision for loan loss | 896 | (132) | 737 | 80,615 | 25,704 | 49,642 | 157,462 |
| Loan losses charged to allowance | (1,154) | (575) | (965) | (91,989) | (24,875) | (39,010) | (158,568) |
| Recoveries credited to allowance | 31 | 365 | 152 | 14,642 | 1,429 | 5,073 | 21,694 |
| Balance, end of year | 3,351 | 1,807 | 3,437 | 43,839 | 22,115 | 44,427 | 118,975 |

| December 31, 2017 | 1st Trust Mortgages | Term Home Equity | Equity Lines | Credit Cards | Vehicle Loans | Unsecured and Other | Total |
|---|---|---|---|---|---|---|---|
| Balance, beginning of year | 3,558 | 2,063 | 2,647 | 33,984 | 3,104 | 13,724 | 59,080 |
| Provision for loan loss | 873 | 866 | 791 | 71,928 | 29,287 | 32,600 | 136,345 |
| Loan losses charged to allowance | (879) | (1,084) | (299) | (70,173) | (14,149) | (18,487) | (105,070) |
| Recoveries credited to allowance | 25 | 304 | 375 | 4,852 | 1,614 | 885 | 8,054 |
| Balance, end of year | 3,578 | 2,149 | 3,513 | 40,591 | 19,856 | 28,722 | 98,409 |

The Credit Union’s allowance for loan loss evaluation is predominately based on a collective review for impairment, except for loans reviewed individually for impairment on a monthly basis-such as nonaccrual real estate loans and restructured loans. Factors considered in the review for impairment included (but are not limited to) the review of payment history, updated credit status, collateral value, and economic factors, among others.

(dollars in thousands)

## NOTE 4 – LOANS, NET, CONTINUED

At December 31, 2018 and 2017, the allowance for loan loss balances included the following relative to the method for determining the allowance for loan losses:

| | Allowance for Loan Losses | | Loans, Net | |
|---|---|---|---|---|
| December 31, 2018 | Individually Evaluated for Impairment | Collectively Evaluated for Impairment | Individually Evaluated for Impairment | Collectively Evaluated for Impairment |
| First trust mortgages | $ 2,642 | $ 1,241 | $ 29,648 | $ 11,291,954 |
| Term home equity | 920 | 677 | 10,362 | 726,470 |
| Equity lines of credit | 785 | 2,614 | 1,564 | 1,498,694 |
| Credit card loans | - | 43,839 | - | 1,724,668 |
| Vehicle loans | - | 12,314 | - | 3,383,632 |
| Unsecured consumer loans and other | 284 | 53,659 | 4,631 | 1,315,622 |
| Total | $ 4,631 | $ 114,344 | $ 46,205 | $ 19,941,040 |

| | Allowance for Loan Losses | | Loans, Net | |
|---|---|---|---|---|
| December 31, 2017 | Individually Evaluated for Impairment | Collectively Evaluated for Impairment | Individually Evaluated for Impairment | Collectively Evaluated for Impairment |
| First trust mortgages | $ 2,775 | $ 1,366 | $ 27,269 | $ 11,406,063 |
| Term home equity | 1,256 | 641 | 12,966 | 716,545 |
| Equity lines of credit | 964 | 2,421 | 1,419 | 1,493,672 |
| Credit card loans | - | 40,591 | - | 1,736,551 |
| Vehicle loans | - | 10,056 | - | 3,317,253 |
| Unsecured consumer loans and other | 182 | 38,158 | 5,174 | 796,520 |
| Total | $ 5,177 | $ 93,233 | $ 46,828 | $ 19,466,604 |

**(dollars in thousands)**

## NOTE 4 – LOANS, NET, CONTINUED

In 2018 and 2017, net loan balance additions to impairments totaled $11,132 and $6,316, while net charge offs and removals totaled $1,948 and $9,644, respectively. The average total outstanding impaired loan balance in 2018 and 2017 was $46.2 million and $43.3 million, respectively. As of December 31, 2018 and 2017, there were no impaired loans that did not have a related allowance. During the year ended December 31, 2018, the Credit Union recorded- based on the appraised value of the underlying collateral- net reduction/recoveries of $545 on impaired loans and net reductions/recoveries of $163 related to write-downs of foreclosed real estate. During 2017, the Credit Union had net increases/provisions of $265 on impaired loans and net reductions/recoveries of $428 related to write-downs of foreclosed real estate. Remaining disclosures related to impaired loans were omitted due to lack of materiality.

## NOTE 5 – PROPERTY AND EQUIPMENT, NET

Property and equipment are summarized as follows:

| | Estimated useful life | December 31, 2018 | December 31, 2017 |
|---|---|---|---|
| Land | | $ 41,680 | $ 39,612 |
| Buildings and improvements | 5 to 50 years | 264,821 | 253,295 |
| Furniture and fixtures | 3 to 8 years | 44,898 | 41,408 |
| Computer equipment | 3 to 5 years | 70,643 | 54,665 |
| Computer software | 3 to 10 years | 217,244 | 163,182 |
| Leasehold improvements | 1 to 5 years | 12,932 | 11,171 |
| | | 652,218 | 563,333 |
| Accumulated depreciation | | (209,923) | (167,199) |
| Property and equipment, net | | $ 442,295 | $ 396,134 |

Depreciation and amortization expense for the years ended December 31, 2018 and 2017, was approximately $42,052 and $29,192, respectively, and is included in occupancy expense.

(dollars in thousands)

## NOTE 5 – PROPERTY AND EQUIPMENT, NET, CONTINUED

Future minimum rental commitments within non-cancelable leases as of December 31, 2018 were as follows:

| | | |
|---|---|---|
| 2019 | $ | 6,991 |
| 2020 | | 5,189 |
| 2021 | | 4,589 |
| 2022 | | 3,732 |
| 2023 | | 2,562 |
| Thereafter | | 1,601 |
| | $ | 24,664 |

Rent expense was $7,000 for each year ended 2018 and 2017, and was recorded in the consolidated statements of income as occupancy expense within non-interest expense.

## NOTE 6 – MEMBERS' ACCOUNTS

Share and deposit amounts up to $250 per ownership interest are federally insured through the National Credit Union Share Insurance Fund. Individual deposit account balances exceeding $250 at December 31, 2018 and 2017, totaled $2,206,999 and $1,983,870, respectively.

At December 31, 2018, scheduled maturities of IRA certificates and certificates of deposit on members' accounts are as follows:

| | | |
|---|---|---|
| 2019 | $ | 7,224,376 |
| 2020 | | 1,444,455 |
| 2021 | | 746,567 |
| 2022 | | 500,670 |
| 2023 | | 862,437 |
| Thereafter | | 315,241 |
| | $ | 11,093,746 |

**(dollars in thousands)**

## NOTE 6 – MEMBERS' ACCOUNTS, CONTINUED

Interest expense on members' accounts for the 2018 and 2017 year end are as follows:

| | December 31, | |
|---|---|---|
| | 2018 | 2017 |
| Regular shares | $ 5,070 | $ 5,894 |
| Money market shares | 30,586 | 18,719 |
| Share certificates | 184,039 | 153,617 |
| IRA shares | 114 | 115 |
| IRA certificates | 44,814 | 44,273 |
| | $ 264,623 | $ 222,618 |

## NOTE 7 – BORROWED FUNDS

Borrowed funds are summarized as follows:

| | December 31, | |
|---|---|---|
| | 2018 | 2017 |
| Federal Home Loan Bank advances | $ 2,681,000 | $ 2,361,000 |
| Other borrowings | - | - |
| | $ 2,681,000 | $ 2,361,000 |

The Credit Union borrowed funds from the Federal Home Loan Bank of Atlanta ("FHLB") secured by a blanket lien on the Credit Union's first trust mortgage portfolio. Other borrowings are comprised of aged participation loan agreements accounted for as secured borrowings, with additional disclosures being omitted due to immateriality. Accrued interest payable on borrowings was $8.8 million and $8.1 million for year-end 2018 and 2017, respectively.

(dollars in thousands)

## NOTE 7 – BORROWED FUNDS, CONTINUED

The scheduled maturities of and applicable interest rates (fixed rate terms) for FHLB borrowed funds at December 31, 2018 are as follows:

| Years Ending December 31 | Interest Rate | December 31, 2018 Amount |
|---|---|---|
| 2019 | 2.62% | $ 50,000 |
| 2019 | 2.64% | 50,000 |
| 2019 | 2.68% | 50,000 |
| 2020 | 3.13% | 240,000 |
| 2020 | 1.94% | 300,000 |
| 2021 | 1.71% | 150,000 |
| 2021 | 1.71% | 150,000 |
| 2021 | 2.40% | 150,000 |
| 2021 | 1.52% | 100,000 |
| 2022 | 1.51% | 100,000 |
| 2022 | 3.06% | 150,000 |
| 2022 | 3.16% | 100,000 |
| 2023 | 2.93% | 130,000 |
| 2023 | 2.62% | 130,000 |
| 2023 | 3.09% | 135,000 |
| 2024 | 2.99% | 350,000 |
| 2024 | 2.81% | 80,000 |
| 2024 | 5.80% | 33,000 |
| 2024 | 6.05% | 33,000 |
| 2024 | 4.08% | 100,000 |
| 2026 | 4.67% | 50,000 |
| 2031 | 4.94% | 50,000 |
| | | $ 2,681,000 |
| Weighted Average % | | 2.75% |

## NOTE 8 – EMPLOYEE BENEFIT PLANS

### Overview of Plans

The Credit Union sponsors a trustee, noncontributory, defined-benefit pension plan (the "Plan") covering eligible employees. Benefits under the Plan are primarily based on years of service and the employees' compensation during the last five years of employment. The Credit Union's policy is to make annual contributions to the Plan equal to the amount required to maintain the Plan in sound condition and to satisfy minimum funding requirements. Eligibility requirements of the Plan were modified in December 2006 to exclude employees hired or rehired after December 31, 2006 from participating in the Plan.

The Credit Union also sponsors a defined benefit postretirement plan. Eligibility requirements of the defined benefit postretirement plan were modified in December 2012 to exclude employees hired or rehired on or after December 1, 2012 from participating. The plan covers eligible employees providing medical, life insurance and sick leave benefits. The plan is contributory for retirees who retired after January 1, 1995. For these retirees, effective April 1, 2006, retiree medical contributions were set at 70% for retirees age 65 or above, and 90% for retirees age 55 to 65. Effective April 1, 2007, the plan includes an increase in the contribution level for retirees age 65 and above to 90% of the premium. The 70% and 90% contribution provisions do not apply to employees who retired before January 1, 1995, for whom the Credit Union pays 100% of the premiums.

In accordance with ASC 715, "Compensation-Retirement Benefits" the funding status of each benefit plan is reflected as an asset or liability in the consolidated statements of financial position. ASC 715 requires an employer to recognize the overfunded or underfunded status of defined benefit pension and other postretirement plans, measured solely as the difference between the fair value of plan assets and the benefit obligation, as an asset or liability on the balance sheet. Unrecognized actuarial gains and losses, unrecognized prior service costs, and unrecognized transition obligation remaining from the adoption of earlier pronouncements in ASC 715 are included as a component of accumulated other comprehensive income or loss.

Actuarial gains and losses and prior service costs and credits that arise during a period, are included in other comprehensive income to the extent they are not included in net periodic pension cost (a component of compensation and benefits expense).

(dollars in thousands)

## NOTE 8 – EMPLOYEE BENEFIT PLANS, CONTINUED

The following table sets forth changes in the benefit obligations and plan assets:

| | Retirement Plan | | Postretirement Benefits | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| **Change in benefit obligation** | | | | |
| Benefit obligation at beginning of year | $ 150,552 | $ 124,730 | $ 2,495 | $ 3,063 |
| Service cost | 4,933 | 4,991 | 144 | 54 |
| Interest cost | 4,895 | 5,000 | 139 | 95 |
| Plan participants' contributions | - | - | 324 | 341 |
| Amendments | - | - | 2,049 | - |
| Actuarial (gain) loss | (20,360) | 17,290 | (1,072) | (629) |
| Business combinations | - | 2,113 | - | - |
| Benefits paid/Settlements | (7,456) | (3,572) | (649) | (429) |
| Benefit obligation at end of year | $ 132,564 | $ 150,552 | $ 3,430 | $ 2,495 |
| **Change in plan assets** | | | | |
| Fair value of assets at beginning of year | $ 106,629 | $ 94,928 | $ - | $ - |
| Actual return on plan assets | (7,042) | 12,698 | - | - |
| Business combinations | - | 2,575 | - | - |
| Employer contribution | 10,000 | - | 325 | 88 |
| Plan participants' contributions | - | - | 324 | 341 |
| Benefits paid/Settlements | (7,456) | (3,572) | (649) | (429) |
| Fair value of assets at end of year | $ 102,131 | $ 106,629 | $ — | $ — |
| Funded Status | $ (30,433) | $ (43,923) | $ (3,430) | $ (2,495) |

**(dollars in thousands)**

## NOTE 8 – EMPLOYEE BENEFIT PLANS, CONTINUED

The amounts recognized in the Credit Union's consolidated statements of financial condition at December 31, 2018 and 2017 are presented in the following table:

| | Retirement Plan | | Postretirement Benefits | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| **Amounts recognized in the consolidated statements of financial condition consist of:** | | | | |
| Accrued benefit liability | $ (30,433) | $ (43,923) | $ (3,430) | $ (2,495) |
| Accumulated other comprehensive loss (income) | 38,024 | 50,041 | (1,585) | (2,609) |
| Net amount recognized | $ 7,591 | $ 6,118 | $ (5,015) | $ (5,104) |
| Noncurrent assets | $ - | $ - | $ - | $ - |
| Current liabilities | - | - | (169) | (155) |
| Noncurrent liabilities | (30,433) | (43,923) | (3,261) | (2,340) |
| Net amount recognized | $ (30,433) | $ (43,923) | $ (3,430) | $ (2,495) |
| **Amounts recognized in accumulated other comprehensive loss consist of:** | | | | |
| Net actuarial loss (gain) | $ 38,024 | $ 50,063 | $ (2,957) | $ (2,034) |
| Prior service cost (credit) | - | (22) | 1,372 | (575) |
| **Total** | $ 38,024 | $ 50,041 | $ (1,585) | $ (2,609) |

The following table presents the weighted average assumptions used in the accounting for the plans:

| | Retirement Plan | | Postretirement Benefits | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| **Weighted-average assumptions to determine benefit obligations at measurement date** | | | | |
| Discount rate | 4.05% | 3.45% | 4.20% | 3.45% |
| Expected long-term rate of return on plan assets | 6.00% | 6.00% | N/A | N/A |
| Rate of compensation increase | 4.00% | 4.00% | N/A | N/A |
| Current year healthcare cost trend rate[1] | N/A | N/A | 8.00% | 6.00% |
| **Percentage of the fair value of total plan assets held in each major category of plan assets** | | | | |
| Equity securities | 58% | 53% | N/A | N/A |
| Debt securities | 42% | 47% | N/A | N/A |
| Other securities | 0% | 0% | N/A | N/A |

[1] The healthcare cost trend rate is assumed to decrease annually until it reaches an ultimate rate of 5% in 2023.

## NOTE 8 – EMPLOYEE BENEFIT PLANS, CONTINUED

The Credit Union's target asset allocation at December 31, 2018 and 2017 was 40% to 60% for debt securities (Level 1 and Level 2) and 60% to 40% for equity securities (Level 1). The valuation methodologies used for the Plan's financial instruments are similar to those detailed in Note 12. The Credit Union's investment policy includes various guidelines and procedures designed to ensure assets are invested in a manner necessary to meet expected future benefits earned by participants. The investment guidelines consider a broad range of economic conditions. Central to the policy are target allocation ranges (as shown above) by major asset categories. The objectives of the target allocation are to maintain investment portfolios that diversify risk through prudent asset allocation parameters, achieve asset returns that meet or exceed the Plan's actuarial assumptions, and achieve asset returns that are competitive with like institutions employing similar investment strategies. The investment policy is reviewed and administered by the Pension Committee (the "Committee") appointed by the Board of Directors of the Credit Union. The Committee's responsibilities include, but are not limited to, oversight of the investment management's decisions. The investment policy is established and administered in a manner to comply at all times with applicable government regulations.

The Credit Union's expected long-term return on plan assets assumption is based on a periodic review and modeling of the plan's asset allocation and liability structure over a long-term horizon. Expectations of returns for each asset class are the most important assumptions used in the review and modeling and are based on comprehensive reviews of the historical data and economic/financial market theory. The expected long-term rate of return on assets was selected from within the reasonable range of rates determined by (a) historical real returns, net of inflation, for the asset classes covered by investment policy, and (b) projections of inflation over the long-term period during which benefits are payable to plan participants.

(dollars in thousands)

## NOTE 8 – EMPLOYEE BENEFIT PLANS, CONTINUED

The following table sets forth for the years indicated, the amount of periodic benefit cost recognized in earnings, showing all contributing components; the amounts in accumulated other comprehensive loss expected to be recognized as components of net periodic benefit cost over 2018; and the weighted average assumptions used to determine net periodic cost:

| | Retirement Plan | | Postretirement Benefits | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| **Net periodic benefit cost** | | | | |
| Service cost | $ 4,933 | $ 4,991 | $ 144 | $ 54 |
| Interest cost | 4,895 | 5,000 | 139 | 95 |
| Expected return on plan assets | (4,687) | (4,739) | - | - |
| Amortization of prior service cost (credit) | (22) | (25) | 102 | (63) |
| Recognized net actuarial loss | 3,408 | 3,888 | (149) | (141) |
| Net periodic benefit cost | $ 8,527 | $ 9,115 | $ 236 | $ (55) |
| **Other changes in plan assets and benefit obligations recognized in other comprehensive income** | | | | |
| Net actuarial (gain) loss | $ (8,631) | $ 9,331 | $ (1,072) | $ (629) |
| Less- recognized actuarial gain (loss) | (3,408) | (3,888) | 149 | 141 |
| Prior service cost (credit) | - | - | 2,049 | - |
| Business combinations | - | (462) | - | - |
| Less- recognized prior service (cost) credit | 22 | 25 | (102) | 63 |
| Total recognized in other comprehensive (income) loss | $ (12,017) | $ 5,006 | $ 1,024 | $ (425) |
| Total recognized in net benefit cost and other comprehensive (income) loss | $ (3,490) | $ 14,121 | $ 1,260 | $ (480) |
| **Amounts expected to be recognized into net periodic cost from accumulated other comprehensive loss in the coming year** | | | | |
| Loss (Gain) recognition | $ 2,880 | $ 4,015 | $ (196) | $ (141) |
| Prior service cost (credit) recognition | - | (22) | 102 | (63) |
| **Weighted-average assumptions used to determine net periodic cost** | | | | |
| Discount rate | 3.45 % | 3.90 % | 3.45 % | 3.90 % |
| Expected return on plan assets | 5.50 % | 6.00 % | N/A | N/A |
| Rate of compensation increase | 4.00 % | 4.00 % | N/A | N/A |
| Corridor | 10.00 % | 10.00 % | 10.00 % | 10.00 % |
| Average future service period | 9.10 | 9.22 | 13.84 | 13.18 |

**(dollars in thousands)**

## NOTE 8 – EMPLOYEE BENEFIT PLANS, CONTINUED

The estimated benefit payments and contributions for fiscal years 2019 through 2028 are as follows:

| Estimated Future Benefit Payments | Retirement Plan | Postretirement Benefits |
|---|---|---|
| 2019 | $ 7,262 | $ 169 |
| 2020 | 7,398 | 167 |
| 2021 | 7,488 | 155 |
| 2022 | 7,925 | 153 |
| 2023 | 8,981 | 165 |
| 2024-2028 | 47,852 | 822 |
| **Estimated Contributions for 2019** | $ - | $ 169 |

The Credit Union estimates that it will not make any contributions to the retirement plan in 2019. For measurement purposes, a 6.5% annual rate of increase in the per capita cost of covered health care benefits was assumed for the 2019 year. The rate is assumed to decrease annually until it reaches 5.0% in 2024 and remains at that level thereafter. Assumptions for health care cost trend rates have a significant effect on the amounts reported for the postretirement benefits plan.

A 1% change in assumed health care cost trend rates would have the following effects:

| | 2018 | 2017 |
|---|---|---|
| **1-percentage point increase in healthcare cost trend** | | |
| Effect on total of service and interest cost components | $ 70 | $ 19 |
| Effect on accumulated postretirement benefit obligation | 566 | 221 |
| **1-percentage point decrease in healthcare cost trend** | | |
| Effect on total of service and interest cost components | $ (51) | $ (15) |
| Effect on accumulated postretirement benefit obligation | (432) | (184) |

### 401(k) Plan

The Credit Union has a 401(k) plan that provides for contributions by employees and the employer, with the employer contributions consisting of a 100% matching of the employees' contributions up to the first 4% of the employees' salaries, subject to federal limitations. The Plan is available to substantially all employees of the Credit Union. The expense related to this plan for 2018 and 2017 was $5,605 and $4,594, respectively.

(dollars in thousands)

## NOTE 9 – CAPITAL REQUIREMENTS

The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's consolidated financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting principles. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth (as defined in the regulations) to total assets (as defined). Credit unions are also required to calculate a Risk-Based Net Worth ("RBNW") requirement, which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNW ratio was 5.67% and 5.81% at December 31, 2018 and 2017, respectively. The minimum ratio to be considered complex under the regulatory framework is 6%. Management believes at December 31, 2018 and 2017, the Credit Union meets all capital adequacy requirements to which it is subject. At December 31, 2018, the most recent call reporting period, NCUA categorized the Credit Union as "well capitalized" under the prompt corrective action regulatory framework. To be categorized as "well capitalized," the Credit Union must maintain a minimum net worth ratio of 7% of assets and meet any applicable RBNW requirement. Management believes that there are no conditions or events since that notification that would change the Credit Union's category.

The Credit Union's actual capital amounts and ratios are presented below:

| | Actual | | To Be Adequately Capitalized Under Prompt Corrective Action Provisions | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2018 | | | | | | |
| Net Worth to Total Assets | $ 2,525,936 | 10.3% | ≥ $ 1,469,085 | ≥ 6.0% | ≥ $ 1,713,933 | ≥ 7.0% |
| December 31, 2017 | | | | | | |
| Net Worth to Total Assets | $ 2,361,671 | 10.3% | ≥ $ 1,371,533 | ≥ 6.0% | ≥ $ 1,600,121 | ≥ 7.0% |

In performing its calculation of total assets, the Credit Union used the quarter-end balance option, as permitted by regulation. Because the RBNW requirement for the Credit Union is less than the actual net worth ratio, the Credit Union is not considered "complex" under the RBNW requirements.

(dollars in thousands)

## NOTE 10 – FINANCIAL INSTRUMENTS-COMMITMENTS WITH OFF-BALANCE SHEET RISK

The Credit Union is party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These commitments include financial instruments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the consolidated financial statements.

The Credit Union's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual notional amount of those instruments. The Credit Union uses the same credit policies in making commitments as it does for on-balance-sheet instruments.

A summary of the Credit Union's commitments at December 31, 2018 is as follows:

| | Fixed Rate | Variable Rate | Total Contract or Notional Amount |
|---|---|---|---|
| Thrifty credit services lines of credit | $ 553,026 | $ - | $ 553,026 |
| Second trust mortgages | 26,491 | 3,232,847 | 3,259,338 |
| Credit cards | - | 8,258,996 | 8,258,996 |
| First trust mortgages | 489,531 | 108,803 | 598,334 |
| | $ 1,069,048 | $ 11,600,646 | $ 12,669,694 |

Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. As it relates to first trust mortgage commitments, these commitments to originate loans to be held for investment as well as loans intended to be sold. For details on commitments to sell loans - see Note 13.

The Credit Union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Credit Union upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include real estate and other tangible personal property. In the majority of cases, lines of credit established for credit card and thrifty credit service accounts are unsecured.

(dollars in thousands)

## NOTE 11 – RELATED PARTY TRANSACTIONS

Members of the Board of Directors ("the Board"), Supervisory Committee, and executive officers of the Credit Union have outstanding loans and deposits at the Credit Union.

At December 31, 2018, the aggregate balances included 133 loans totaling $7,963, and member account balances (deposits) totaling $11,389 for 30 individuals. At December 31, 2017, the aggregate balances included 131 loans totaling $6,990 and member account balances (deposits) totaling $9,679 for 34 individuals.

The following table provides additional information regarding related party loan transactions:

| | December 31, 2017 | Disbursements | Repayments | December 31, 2018 |
|---|---|---|---|---|
| First trust mortgages | $ 6,055 | $ 1,581 | $ 579 | $ 7,057 |
| Equity lines of credit | 15 | 261 | 2 | 274 |
| Term home equity | 348 | - | 90 | 258 |
| Vehicle loans | 214 | 76 | 81 | 209 |
| Credit card loans | 280 | 51 | 167 | 164 |
| All other loans | 78 | 1 | 78 | 1 |
| | $ 6,990 | $ 1,970 | $ 997 | $ 7,963 |

(dollars in thousands)

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Accounting standards define fair value as the exchange price that would be received on the measurement date to sell an asset or the price paid to transfer a liability in the principal or most advantageous market available to the entity in an orderly transaction between market participants, with a three level valuation input hierarchy (see Note 2 – Fair Value of Assets and Liabilities).

Fair Value on a Recurring Basis- the following table summarizes financial assets measured at fair value on a recurring basis as of December 31, 2018 and 2017, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Total | (Level 1) | (Level 2) | (Level 3) |
| Federal agency securities-bonds | $ 112,037 | $ - | $ 112,037 | $ - |
| Government agency bonds | 236,586 | - | 236,586 | - |
| Mortgage backed securities | 1,385,043 | - | 1,385,043 | - |
| Other securities | 63,682 | - | 63,682 | - |
| Loans held for sale | 80,378 | - | 80,378 | - |
| Mortgage servicing rights | 67,548 | - | - | 67,548 |
| Derivative instruments | 9,071 | - | 9,071 | - |
| | $ 1,954,345 | $ - | $ 1,886,797 | $ 67,548 |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Total | (Level 1) | (Level 2) | (Level 3) |
| Federal agency securities-bonds | $ 111,942 | $ - | $ 111,942 | $ - |
| Government agency bonds | 233,908 | - | 233,908 | - |
| Mortgage backed securities | 1,111,823 | - | 1,111,823 | - |
| Other securities | 57,312 | - | 57,312 | - |
| Loans held for sale | 194,389 | - | 194,389 | - |
| Mortgage servicing rights | 64,398 | - | - | 64,398 |
| Derivative instruments | 9,014 | - | 9,014 | - |
| | $ 1,782,786 | $ - | $ 1,718,388 | $ 64,398 |

There were no transfers between levels.

(dollars in thousands)

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS, CONTINUED

The table below presents the reconciliation for the years ended December 31, 2018 and 2017, for all Level 3 assets that are measured at fair value on a recurring basis.

| | Fair Value Measurements Using Significant Unobservable Inputs | |
|---|---|---|
| | December 31, 2018 | December 31, 2017 |
| **Mortgage servicing rights at beginning of year** | $ 64,398 | $ 57,721 |
| Fair value adjustment | (6,404) | (8,540) |
| Purchases and issuances | 9,554 | 15,217 |
| Transfers in and/or out of Level 3 | - | - |
| **Mortgage servicing rights at end of year** | $ 67,548 | $ 64,398 |

| | Weighted-Average Mortgage Servicing Rights Assumptions | |
|---|---|---|
| | December 31, 2018 | December 31, 2017 |
| Prepayment Speed (CPR) | 10.0 | 10.3 |
| Projected Life (Years) | 6.1 | 6.0 |
| Discount Rate | 10.10 % | 10.08 % |

| | Hypothetical Effect on Mortgage Servicing Rights Fair Value | |
|---|---|---|
| | 2018 | 2017 |
| Dec. 31 Mortgage Servicing Rights Fair Value | $ 67,548 | $ 64,398 |
| Change in Fair Value from: | | |
| -100 bp decline in 10 year US Treasury | (5,189) | (5,950) |
| -200 bp decline in 10 year US Treasury | (10,275) | (13,108) |
| +100 bp decline in 10 year US Treasury | 4,858 | 6,391 |
| +200 bp decline in 10 year US Treasury | 7,486 | 9,614 |

(dollars in thousands)

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS, CONTINUED

Fair Value on a Non-Recurring Basis- certain assets and liabilities are measured at fair value on a non-recurring basis that are subject to fair value adjustments in certain circumstances; such as loans with evidence of impairment and other real estate owned. Specifically, impaired loans and other real estate owned is recorded at the lower of the principal balance of the loan or fair value of the property (based on appraised values) less estimated selling expenses (which approximate 8%). There are no other material adjustments to appraised values based on unobservable inputs. Certain assumptions and unobservable inputs are currently being used by the appraisers of collateral for other real estate owned, therefore, qualifying these assets as Level 3. These methodologies may result in a significant portion of the fair value being derived from unobservable data. During 2018 and 2017, there were no transfers between levels. The following table presents the assets and liabilities carried on the consolidated statements of financial condition by caption and by level within the valuation hierarchy as described above for which a non-recurring change in fair value has been recorded.

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Loans, net- identified as impaired | $ 41,574 | $ - | $ - | $ 41,574 |
| Other real estate owned, net | 3,139 | - | - | 3,139 |
| | $ 44,713 | $ - | $ - | $ 44,713 |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| Loans, net- identified as impaired | $ 41,652 | $ - | $ - | $ 41,652 |
| Other real estate owned, net | 3,289 | - | - | 3,289 |
| | $ 44,941 | $ - | $ - | $ 44,941 |

**(dollars in thousands)**

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS, CONTINUED

The fair values of the Credit Union's financial instruments are summarized as follows:

| | December 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | $ 1,179,875 | $ 1,179,875 | $ 341,706 | $ 341,706 |
| Investment securities | 1,969,235 | 1,969,235 | 1,771,545 | 1,771,545 |
| Loans, net | 19,868,271 | 19,705,680 | 19,415,023 | 19,369,976 |
| Loans held for sale | 80,378 | 80,378 | 194,389 | 194,389 |
| Mortgage servicing rights | 67,548 | 67,548 | 64,398 | 64,398 |
| Derivative instruments | 9,071 | 9,071 | 9,014 | 9,014 |
| | $ 23,174,378 | $ 23,011,787 | $ 21,796,075 | $ 21,751,028 |
| Financial liabilities: | | | | |
| Members' accounts | $ 18,882,586 | $ 18,676,921 | $ 17,809,731 | $ 17,875,709 |
| Borrowed funds | 2,681,000 | 2,700,237 | 2,361,000 | 2,400,596 |
| Derivative instruments | 5,573 | 5,573 | 444 | 444 |
| | $ 21,569,159 | $ 21,382,731 | $ 20,171,175 | $ 20,276,749 |

The specific estimation methods and assumptions used can have a substantial impact on the resulting fair values of financial instruments. Following is a brief summary of the significant methods and assumptions used in the above table (for Derivative Instruments- see Note 13). Changes to such assumptions could significantly affect those fair values.

Cash and cash equivalents- The carrying amounts of cash and cash equivalents approximate their fair value based on the short-term nature of the assets.

Investment securities- For marketable, fixed-maturity securities, fair values are based on quoted market prices or dealer quotes. For other securities held, fair value equals quoted market price, if available. If a quoted market price is not available, fair values are estimated using quoted market prices for similar securities or by discounting expected future cash flows using a current market rate applicable to the yield, credit quality, and maturity of the investments. Federal Home Loan Bank stock and other securities are redeemable at par and thus the carrying values approximate the fair value.

Loans, net and loans held for sale- The fair value of loans, net is estimated by discounting the future cash flows using the current interest rates at which similar loans would be made to borrowers/members with similar credit ratings and for similar maturities. The fair value of loans held for sale is based on quoted market prices within loan sale commitments.

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS, CONTINUED

Mortgage servicing rights- The fair value of mortgage servicing rights is determined by a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as contractual servicing fee income, costs to service, discount rates, ancillary income, prepayment speeds, and default rates.

Members' accounts- The fair value of regular shares, IRA shares, money market shares, and checking accounts is the amount payable on demand at the reporting date. The fair value of share certificates and IRA certificates is estimated by discounting future cash flows using the rates currently offered for deposits of similar maturities.

Borrowed funds- The fair value of borrowed funds is estimated by discounting the future cash flows using current market rates for similar maturities.

## NOTE 13 – DERIVATIVE INSTRUMENTS

The Credit Union utilizes derivative instruments to manage interest rate risk that affects its ongoing business operations. Interest rate swaps are used to hedge the variability in interest cash flows due to changes in a benchmark interest rate associated with floating rate assets and liabilities. Similarly, interest rate caps are used to manage the maximum exposure to variable rate obligations that are tied to a benchmark interest rate.

ASC 815-10 requires that an entity recognize all derivative instruments as either assets or liabilities at fair value in the consolidated statements of financial condition. In accordance with ASC 815-10, the Credit Union designates derivatives into either cash flow hedges, a hedge of an exposure to changes in cash flows or a recognized asset, liability or forecasted transaction, or fair value hedges, a hedge of an exposure to changes in the fair value of a recorded asset or liability.

(dollars in thousands)

## NOTE 13 – DERIVATIVE INSTRUMENTS, CONTINUED

### Cash Flow Hedges

Interest rate swaps with a total notional amount of $500 million as of December 31, 2018 and 2017, are designated as cash flow hedges of certain share deposit accounts and are highly effective. Interest rate caps with a total notional amount of $100 million and $0 million as of December 31, 2018 and 2017, are designated as cash flow hedges of certain share deposit accounts and are highly effective. The Credit Union expects the interest rate swaps and interest rate caps to remain highly effective during their remaining terms.

| Derivatives in ASC 815 Cash Flow Hedging Relationships | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion) | | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income | |
|---|---|---|---|---|---|
| | 2018 | 2017 | | 2018 | 2017 |
| Interest rate contracts | 4,453 | 3,164 | Interest Expense | 4,219 | - |
| **Total** | **4,453** | **3,164** | **Total** | **4,219** | **-** |

### Fair Value Hedges

Interest rate swaps are used as fair value hedges on designated closed mortgage portfolios under a last-of-layer expected to be remaining at the end of the hedging relationship. Gain and losses on these interest rate swaps as well as the offsetting loss or gain on the hedged closed mortgage portfolio are recognized in current earnings. The Credit Union includes the gain or loss on the closed loan portfolio in the same consolidated financial statements line item – interest income, loans - as the offsetting loss or gain on the related interest rate swaps.

(dollars in thousands)

## NOTE 13 – DERIVATIVE INSTRUMENTS, CONTINUED

### Fair Value Hedges – Continued

The following amounts were recorded on the balance sheet related to cumulative basis adjustments for fair value hedges as of December 31:

| Line Item in the Statements of Financial Position in Which the Hedged Item Is Included | Carrying Amount of the Hedged Assets/(Liabilities) | | Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Assets/(Liabilities) | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Loans receivable - (a) | 705,903 | - | 4,813 | - |
| **Total** | **705,903** | **-** | **4,813** | **-** |

| | | |
|---|---|---|
| Amortized cost basis of closed portfolios used in the last of layer designation (included in the totals above) | 701,090 | |
| Cumulative basis adjustments associated with last of layer relationships | | 4,813 (a) |
| Amount of the designated hedged items | 225,000 | |

(a) Amount excludes the insignificant gain from partial termination of two last of layer designations.

### Mortgage Banking Derivatives

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. The Credit Union's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from commitments to fund the loans. These mortgage banking derivatives are not designated in hedge relationships. At December 31, 2018, the Credit Union had approximately $67 million of interest rate lock commitments and $118 million of forward commitments for the future delivery of residential mortgage loans. At December 31, 2017, the Credit Union had approximately $215 million of interest rate lock commitments and $330 million of forward commitments for the future delivery of residential mortgage loans. Changes in the fair value of these mortgage banking derivatives are included in gains on sales of loans.

**(dollars in thousands)**

## NOTE 13 – DERIVATIVE INSTRUMENTS, CONTINUED

### Mortgage Banking Derivatives – Continued

Changes to the fair value of our mortgage servicing rights arise from changes in interest rates and are economically hedged using interest rate floors, swaps, and forward commitments. The Credit Union had notional amounts outstanding of $270 million and $40 million as of December 31, 2018 and 2017, respectively, to hedge the fair value of mortgage servicing rights. Changes in the fair value of these hedges are recognized in current earnings.

The following table displays the fair value and the location of derivative instruments as of December 31:

| | Asset Derivatives | | | | Liability Derivatives | | | |
|---|---|---|---|---|---|---|---|---|
| | 2018 | | 2017 | | 2018 | | 2017 | |
| | Consolidated Statements of Financial Condition | Fair Value | Consolidated Statements of Financial Condition | Fair Value | Consolidated Statements of Financial Condition | Fair Value | Consolidated Statements of Financial Condition | Fair Value |
| **Derivatives designated as hedging instruments under ASC 815** | | | | | | | | |
| Interest rate contracts | Other assets | 7,767 | Other assets | 7,534 | Other liabilities | (4,816) | Other liabilities | - |
| **Total derivatives designated as hedging instruments under ASC 815** | | 7,767 | | 7,534 | | (4,816) | | - |
| **Derivatives not designated as hedging instruments under ASC 815** | | | | | | | | |
| Interest rate commitments | Other assets | (477) | Other assets | 1,480 | Other assets | - | Other assets | - |
| Forward loan commitments | Other liabilities | - | Other liabilities | - | Other liabilities | (757) | Other liabilities | (60) |
| Interest rate contracts | Other assets | 1,781 | Other assets | - | Other liabilities | - | Other liabilities | (384) |
| **Total derivatives not designated as hedging instruments under ASC 815** | | 1,304 | | 1,480 | | (757) | | (444) |
| **Total derivatives** | | **9,071** | | **9,014** | | **(5,573)** | | **(444)** |

**(dollars in thousands)**

## NOTE 14 – SUBSEQUENT EVENTS

The following subsequent events took place after the balance sheet date, but before the issuance of these consolidated financial statements.

### Merger with Progressive Credit Union

On January 1, 2019 the Credit Union completed a merger with Progressive Credit Union (Progressive), a New York state chartered credit union. The merger was approved by NCUA as an emergency merger on November 29, 2018, whereby the Credit Union, upon merger and in consideration for the assets acquired and liabilities assumed of Progressive, assumed Progressive's open field of membership charter for its exclusive use.

The following table summarizes the amounts of assets acquired and liabilities assumed at the merger date.

| **Provisional Fair Value of Assets Acquired** | | **January 1, 2019** |
|---|---|---|
| Cash | $ | 33,619 |
| Investment securities | | 5,171 |
| Loans | | 164,017 |
| Property and equipment | | 4,618 |
| Goodwill and intangible | | 108,942 |
| Other assets | | 25,293 |
| Total Assets Acquired | $ | 341,660 |
| **Provisional Fair Value of Liabilities Assumed** | | |
| Borrowed Funds | $ | 85,199 |
| Member accounts | | 238,359 |
| Other liabilities | | 5,391 |
| Total Liabilities Assumed | $ | 328,949 |
| **Net Equity Acquired from Mergers** | $ | 12,711 |
| Entity Value | $ | - |
| Residual Bargain Gain | | 12,711 |
| | $ | 12,711 |

## NOTE 14 – SUBSEQUENT EVENTS, CONTINUED

### Merger with Progressive Credit Union - Continued

The provisional fair value of loans of $164 million was estimated using discounted projected cash flows that considered contractual principal and interest payments, prepayments of principal, defaults and recoveries. The contractual principal amount due was $376 million.

The intangible asset is attributable to the value derived from the contractual right of the Credit Union to use the open field of membership charter. The provisional fair value of $108 million was estimated using discounted cash flow approach.

### Merger with McGraw-Hill Federal Credit Union

On March 11, 2019, the members of McGraw-Hill Federal Credit Union (McGraw-Hill) approved a voluntary merger with the Credit Union effective May 1, 2019. As of December 31, 2018, McGraw-Hill had $426 million of assets and $382 million of liabilities.

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