

**SAFE CREDIT UNION**  
Folsom, California

**FINANCIAL STATEMENTS**  
December 31, 2019 and 2018

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## INDEPENDENT AUDITOR'S REPORT

Audit Committee  
SAFE Credit Union  
Folsom, California

**Report on the Financial Statements**

We have audited the accompanying financial statements of SAFE Credit Union, which comprise the statements of financial condition as of December 31, 2019 and 2018, and the related statements of net income and comprehensive income, 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 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 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 these financial statements based on our audits. We conducted our audits 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of SAFE Credit Union as of December 2019 and 2018, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Crowe LLP*  
Crowe LLP

Sacramento, California  
March 5, 2020

SAFE CREDIT UNION  
 STATEMENTS OF FINANCIAL CONDITION  
 December 31, 2019 and 2018  
 (Dollar amounts in thousands)

	<u>2019</u>	<u>2018</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 368,623	\$ 101,251
Investments:		
Available-for-sale	35,971	118,496
Other	11,282	10,839
Loans held for sale	13,491	6,199
Loans, net of allowance \$15,869 and \$15,114 as of December 31, 2019 and 2018, respectively	2,454,041	2,462,189
Property and equipment, net	52,467	51,059
Share insurance deposits	25,749	24,195
Goodwill	13,282	13,282
Other intangible assets	522	651
Accrued interest receivable	6,491	6,401
Other assets	<u>103,654</u>	<u>89,167</u>
 Total assets	 <u>\$ 3,085,573</u>	 <u>\$ 2,883,729</u>
 <b>LIABILITIES AND MEMBERS' EQUITY</b>		
Liabilities		
Members' shares	\$ 2,645,522	\$ 2,458,037
Public unit shares	55,166	25,119
Federal Home Loan Bank advances	45,000	100,000
Accrued expenses and other liabilities	<u>29,461</u>	<u>23,823</u>
 Total liabilities	 <u>2,775,149</u>	 <u>2,606,979</u>
 Commitments and contingent liabilities (Note 10)		
Members' equity		
Retained earnings, restricted	310,490	277,656
Accumulated other comprehensive income (loss)	<u>(66)</u>	<u>(906)</u>
 Total members' equity	 <u>310,424</u>	 <u>276,750</u>
 Total liabilities and members' equity	 <u>\$ 3,085,573</u>	 <u>\$ 2,883,729</u>

See accompanying notes.

SAFE CREDIT UNION  
 STATEMENTS OF NET INCOME AND COMPREHENSIVE INCOME  
 For the Years Ended December 31, 2019 and 2018  
 (Dollar amounts in thousands)

	<u>2019</u>	<u>2018</u>
Interest income:		
Interest on loans	\$ 100,026	\$ 86,337
Interest on investments and cash equivalents	<u>6,742</u>	<u>5,569</u>
	<u>106,768</u>	<u>91,906</u>
Interest expense:		
Dividends on members' and public unit shares	16,825	9,797
Interest expense on borrowed and escrowed funds	<u>1,971</u>	<u>2,107</u>
	<u>18,796</u>	<u>11,904</u>
Net interest income	87,972	80,002
Provision for loan losses	<u>8,407</u>	<u>6,598</u>
Net interest income after provision for loan losses	<u>79,565</u>	<u>73,404</u>
Noninterest income:		
ATM and debit card income	21,418	20,278
Account service fees	18,266	16,757
Loan fees	7,355	5,950
Securities and insurance fees	4,638	4,330
Net gain on sale of loans	6,720	2,931
Other noninterest income	<u>3,217</u>	<u>5,658</u>
Total noninterest income	<u>61,614</u>	<u>55,904</u>
Noninterest expenses:		
Salaries and benefits	65,298	60,031
Professional services	17,673	16,149
Office occupancy and operations	12,775	12,999
Other noninterest expense	<u>12,599</u>	<u>11,206</u>
Total noninterest expenses	<u>108,345</u>	<u>100,385</u>
Net income	<u>32,834</u>	<u>28,923</u>
Other comprehensive income:		
Unrealized gain (loss) on investments available-for-sale	<u>840</u>	<u>(150)</u>
Total other comprehensive income (loss)	<u>840</u>	<u>(150)</u>
Comprehensive income	<u>\$ 33,674</u>	<u>\$ 28,773</u>

See accompanying notes.

SAFE CREDIT UNION  
STATEMENTS OF MEMBERS' EQUITY  
For the Years Ended December 31, 2019 and 2018  
(Dollar amounts in thousands)

	<u>Retained Earnings</u>				Accumulated Other Comprehensive Income (Loss)	Total
	<u>Regular Reserve</u>	<u>Other Appropriated</u>	<u>Unappropriated</u>	<u>Total</u>		
Balance, January 1, 2018	\$ 38,700	\$ 210,033	\$ -	\$ 248,733	\$ (756)	\$ 247,977
Net income	-	-	28,923	28,923	-	28,923
Net change in unrealized gain/(loss) on available-for-sale investments	-	-	-	-	(150)	(150)
Appropriations	<u>-</u>	<u>28,923</u>	<u>(28,923)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance, December 31, 2018	38,700	238,956	-	277,656	(906)	276,750
Net income	-	-	32,834	32,834	-	32,834
Net change in unrealized gain/(loss) on available-for-sale investments	-	-	-	-	840	840
Appropriations	<u>-</u>	<u>32,834</u>	<u>(32,834)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance, December 31, 2019	<u>\$ 38,700</u>	<u>\$ 271,790</u>	<u>\$ -</u>	<u>\$ 310,490</u>	<u>\$ (66)</u>	<u>\$ 310,424</u>

See accompanying notes.

SAFE CREDIT UNION  
STATEMENTS OF CASH FLOWS  
For the Years Ended December 31, 2019 and 2018  
(Dollar amounts in thousands)

	<u>2019</u>	<u>2018</u>
Cash Flows from Operating Activities		
Net income	\$ 32,834	\$ 28,923
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of servicing rights	1,117	821
Amortization of investment premiums, net	267	605
Provision for loan losses	8,407	6,598
Depreciation and amortization	3,420	3,730
Amortization of intangibles	129	129
Net loss on disposition of property and equipment	44	13
Change in fair value of loans held for sale	(187)	650
Net gain on sale of loans	(6,720)	(2,931)
Originations of loans held for sale	(349,890)	(155,432)
Proceeds from sale of loans held for sale	349,505	180,586
Net change in:		
Cash surrender value of company-owned life insurance policies	533	1,472
Accrued interest receivable	(90)	(834)
Other assets	(16,137)	(9,381)
Accrued expenses and other liabilities	<u>5,638</u>	<u>(8,513)</u>
<b>Net cash provided by operating activities</b>	<u>28,870</u>	<u>46,436</u>
Cash Flows from Investing Activities		
Proceeds from maturities and payments of available-for-sale investments	83,098	71,935
Net change in other investments	(443)	-
Net change in loans	(259)	(296,702)
Net change in share insurance deposits	(1,554)	(950)
Purchases of property and equipment	<u>(4,872)</u>	<u>(1,538)</u>
<b>Net cash provided by (used) in investing activities</b>	<u>75,970</u>	<u>(227,255)</u>
Cash Flows from Financing Activities		
Net increase in members' shares	187,485	104,303
Net increase in public unit shares	30,047	53
Proceeds from Federal Home Loan Bank advances	45,000	90,000
Repayments on Federal Home Loan Bank advances	<u>(100,000)</u>	<u>(30,000)</u>
<b>Net cash provided by financing activities</b>	<u>162,532</u>	<u>164,356</u>
<b>Increase (decrease) in cash and cash equivalents</b>	267,372	(16,463)
Cash and cash equivalents, beginning of year	<u>101,251</u>	<u>117,714</u>
Cash and cash equivalents, end of year	<u>\$ 368,623</u>	<u>\$ 101,251</u>

See accompanying notes.

SAFE CREDIT UNION  
STATEMENTS OF CASH FLOWS  
For the Years Ended December 31, 2019 and 2018  
(Dollar amounts in thousands)

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	<u>2019</u>	<u>2018</u>
Supplemental Disclosures of Cash Flow Information		
Dividends paid on members' and public unit shares and		
Interest paid on borrowed and escrowed funds	<u>\$ 18,346</u>	<u>\$ 11,571</u>

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See accompanying notes.



SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS**

Nature of operations: SAFE Credit Union (Credit Union) is a state-chartered credit union organized under the provisions of the California Financial Code and California Corporation Code. Participation in the Credit Union is limited to those individuals who qualify for membership, which is defined in the Credit Union's Charter and Bylaws.

The Credit Union provides financial services through its branches in Sacramento and the surrounding counties. Its primary member share products are checking, savings, and term certificate accounts, and its primary lending products are residential real estate, vehicle, and commercial loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. There are no significant concentrations of loans to any one industry or member. However, the members' ability to repay their loans is dependent on the real estate and general economic conditions in the area.

Significant accounting policies: The Credit Union follows the accounting standards set by the Financial Accounting Standards Board (FASB). The FASB establishes generally accepted accounting principles (GAAP) that are followed to ensure consistent reporting of the financial condition, results of operations and cash flows of the Credit Union. References to GAAP issued by the FASB in these notes are to the *FASB Accounting Standards Codification<sup>TM</sup>*, commonly referred to as the Codification or ASC.

Use of estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided and actual results could differ.

Subsequent events: The Credit Union has evaluated subsequent events for recognition and disclosure through March 5, 2020, the date on which the financial statements were available to be issued.

Concentrations of credit risk: Most of the Credit Union's business activity is with its members, many of whom live, work, or worship in the following counties: Amador, Alameda, Butte, Contra Costa, El Dorado, Nevada, Placer, Sacramento, San Joaquin, Solano, Sutter, Yolo, and Yuba. The Credit Union may be exposed to credit risk resulting from these geographic concentrations. Although the Credit Union has a diversified loan portfolio, borrowers' ability to repay loans may be affected by the economic climate of the geographic regions in which borrowers reside. Management continually monitors the Credit Union's operations, including the loan portfolio, for potential impairment and other accounting consequences associated with concentration risk.

Fair value: The Codification defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. 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.

Cash and cash equivalents: For the purpose of the statements of financial condition and cash flows, cash and cash equivalents include cash on hand, amounts due from financial institutions, and highly liquid debt instruments classified as cash that were purchased with maturities of three months or less. Amounts due from financial institutions may, at times, exceed federally insured limits.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

Investments: Debt securities that management has the positive intent and ability to hold to maturity are classified as held-to-maturity and recorded at amortized cost. Securities not classified as held-to-maturity are classified as available-for-sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. Declines in the fair value of individual available-for-sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In determining whether other-than-temporary impairment (OTTI) exists, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) the current liquidity and volatility of the market for each of the individual security categories, (4) the projected cash flows from the specific security type, (5) the financial guarantee and financial rating of the issuer, and (6) the intent and ability of the Credit Union to retain its investment in the issue for a period of time sufficient to allow for any anticipated recovery in fair value. Once a decline in value is determined to be other-than-temporary, and management does not intend to sell the security or it is more likely than not that the Credit Union will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not that the Credit Union will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Other investments primarily consist of Federal Home Loan Bank (FHLB) stock and are classified separately and are stated at cost.

FHLB stock: The Credit Union is a member of the FHLB of San Francisco and, as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. The stock is bought from and sold to the FHLB based upon its \$100 par value. The stock does not have a readily determinable fair value and, as such, is classified as restricted stock, carried at cost and evaluated for impairment. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted, (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance, (c) the impact of legislative and regulatory changes on the customer base of the FHLB, and (d) the liquidity position of the FHLB. Cash dividends are reported as income when received.

Loans held for sale: Mortgage loans originated and intended for sale in the secondary market, for which the fair value option has been elected, are recorded at fair value as of December 31, 2019 and 2018. The fair value includes the servicing value of the loans.

Mortgage loans held for sale are generally sold with servicing rights retained. The carrying value of mortgage loans includes the value of the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

Mortgage derivatives: Interest rate lock commitments (IRLC) for mortgage loans to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. The fair value of the IRLC is recorded at the time the rate is locked based on the underlying mortgage loan and the probability that the mortgage loan will fund within the terms of the rate lock commitment. In order to hedge the change in interest rates resulting from its commitments to fund the loans, the Credit Union enters into forward sale commitments of To Be Announced (TBA) mortgage-backed securities (MBS). The forward sales commitments are typically entered into at the time the interest rate lock commitment is made. The value of the forward sales commitments moves in opposite direction of the value of the interest rate lock commitments and mortgage loans held for sale. Fair values of these mortgage derivatives are estimated based on changes in interest rates from the date of the interest rate lock commitment. The cash flows from these forward sales agreements are classified as operating activities in the statements of cash flows.

Loans, net: The Credit Union grants mortgage, vehicle, commercial, and other consumer loans to members. In addition, the Credit Union purchases participation loans originated by various other credit unions and sells participation loans to other financial institutions. Loans that the Credit Union has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, less an allowance for loan losses and net deferred origination fees and costs. Interest income on loans is recognized over the term of the loan and is calculated using the simple interest method on principal amounts outstanding.

The accrual of interest income on all classes of loans is discontinued at the time the loan is 90 days past due, unless the loan is well-secured and in the process of collection. In addition, interest is not recognized on commercial loans when interest is discontinued and the collection of both principal and interest is considered doubtful. Other personal loans are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if the collection of principal and interest is considered doubtful.

All interest accrued, but not collected, for loans placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all of the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Loan fees and certain direct loan origination costs are deferred, and the net cost is recognized as an adjustment to interest income using the interest method over the estimated life of the loans.

Allowance for loan losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses as of the balance sheet date. The allowance is established through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is likely. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of the underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Credit Union's allowance for loan losses and may require the Credit Union to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

The Credit Union's allowance for loan losses is the amount considered adequate to absorb probable incurred losses in the portfolio based on management's evaluations of the size and current risk characteristics of the loan portfolio as of the balance sheet date. Such evaluations consider prior and potential loss experience, the risk rating, and the levels of impaired and nonperforming loans. A loan is considered impaired when, based on current information and events, it is probable that the Credit Union will be unable to collect the scheduled payments of principal or interest when due according to the original contractual terms of the loan agreement. Specific allowances for loan losses are established for impaired loans on an individual basis as required by the Codification. The specific allowances established for these loans are based on a thorough analysis of the most probable source of repayment, including the present value of the loan's expected future cash flow, the loan's estimated market value, or the estimated fair value of the underlying collateral, less costs to sell.

General allowances are established for loans that can be grouped into pools based on similar characteristics as required by the Codification, and accordingly, they are not included in the separately identified impairment disclosures. The general reserve component of the allowance for loan losses also consists of reserve factors that are based on management's assessment of the following: (1) inherent credit risk, (2) delinquent loan balances, (3) historical losses experienced by the Credit Union during the previous five years, and (4) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

*Residential real estate* – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate, and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends may indicate that the borrowers' capacity to repay their obligations may be deteriorating.

*Commercial* – Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by operating cash flows. Economic trends are closely correlated to the credit quality of these loans. Commercial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

*Vehicle* – Vehicle loans are generally underwritten based on the creditworthiness of the borrowers and are secured by vehicles. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends may indicate that the borrowers' capacity to repay their obligations may be deteriorating.

*Credit card and other consumer loans* – Credit card and other consumer loans are generally unsecured and possess a higher risk of loss than other classes of loans. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends may indicate that the borrowers' capacity to repay their obligations may be deteriorating.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

Troubled debt restructurings: The Credit Union performs a loan-level valuation of those loans identified as troubled debt restructurings. The Credit Union believes that each loan included in the analysis constitutes a troubled debt restructuring when, prior to the restructuring, the borrower experiences financial difficulty and, in response, the Credit Union grants a concession to the borrower, such as a reduction of interest rate, extension of the loan term or other concession that the Credit Union would not otherwise consider. The Credit Union estimates the impairment of the troubled debt restructured loan either by discounting expected future cash flows using the loan's original interest rate or by taking the difference between the loan balance and the collateral value, less selling costs, of the property securing the loan. The amounts are then reserved for as part of the allowance for loan loss account.

Loan servicing: Servicing assets are recognized as separate assets when rights are acquired through the purchase or sale of financial assets. For sales of mortgage loans where servicing is retained, a portion of the cost of originating the loan is allocated to the servicing right based on fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively on 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 the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. The valuation allowance is reported in other assets. If the Credit Union later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans and is included in other noninterest income. The fees are based on a contractual percentage of the outstanding principal, or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income.

Other real estate owned: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in operating expenses.

Property and equipment: Land is carried at cost. Buildings, leasehold improvements, and furniture and equipment are carried at cost, less accumulated depreciation and amortization. Buildings, furniture, and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. The cost of leasehold improvements is amortized using the straight-line method over the lesser of the term of the related lease or the life of the asset.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

Transfers of financial assets: Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Credit Union, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Credit Union does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Company-owned life insurance: The Credit Union has purchased life insurance policies on certain key executives. Company-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. Cash surrender values were \$25,938,000 and \$25,405,000 at December 31, 2019 and 2018, respectively, and are included in other assets on the statements of financial condition. Income earned on these policies, net of expenses, totaled \$533,000 and \$1,472,000 for the years ended December 31, 2019 and 2018, respectively.

National Credit Union Share Insurance Fund (NCUSIF) deposit: The deposit in the NCUSIF is in accordance with National Credit Union Administration (NCUA) regulations, which require the maintenance of a deposit by each federally insured credit union in an amount equal to one percent of its insured members' shares. The deposit would be refunded to the credit union if its insurance coverage were terminated, if it converts its insurance coverage to another source, or if management of the fund were transferred from the NCUA Board.

Goodwill and other intangible assets: Identifiable assets, liabilities, and contingent liabilities in entities acquired are measured at fair value at the date of acquisition. Identifiable intangible assets are recognized if they can be separated or arise from a contractual right and the fair value can be reliably measured. Any excess of the cost of business combination over the fair value of the acquired identifiable assets, liabilities, and contingent liabilities is recognized as goodwill. Goodwill is assessed for impairment at least annually and more frequently if events or changes in circumstance indicate that the carrying value may not be recoverable. Goodwill is the only intangible asset with an indefinite life on the statements of financial condition. Other intangible assets consist of the premium recognized on the value of a book of client investment accounts acquired during 2015, and the intangible asset related to the deposits purchased from another credit union during 2016, both of which are amortized over the estimated life of the asset and evaluated for impairment on at least an annual basis.

Unfunded commitments and related financial instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans, issued to meet member financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded on the balance sheet when they are funded.

Members' shares: Members' shares are the savings deposit accounts of the owners of the Credit Union. Share ownership entitles the members to vote in the annual elections of the Board of Directors and on other corporate matters. Irrespective of the amount of shares owned, no member has more than one vote. Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation.

Dividends on members' shares are based on available earnings at the end of a dividend period and are not guaranteed by the Credit Union. Dividend rates are set by the Credit Union's Board of Directors.

Advertising costs: Advertising costs are expensed as incurred.

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SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

Income taxes: The Credit Union is exempt, by statute, from federal income taxes. The Credit Union is a state-chartered credit union described in Internal Revenue Code (IRC) Section 501(c)(14). As such, the Credit Union is exempt from federal taxation of income derived from the performance of activities that are in furtherance of its exempt purposes. However, the Credit Union is subject to unrelated business income tax.

FASB Codification Topic 740, *Income Taxes*, provides guidance for how uncertain tax positions should be recognized, measured, disclosed and presented in the financial statements. This requires the evaluation of tax positions taken or expected to be taken in the course of preparing the Credit Union's tax returns to determine whether the tax positions are more likely than not to be sustained "when challenged" or "when examined" by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold would be recorded as a tax expense and liability in the current year. For the years ended December 31, 2019 and 2018, management has determined that there are no material uncertain tax positions.

Retirement plans: Employee 401(k) and profit sharing plan expense is the amount of matching and discretionary contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

Comprehensive income: Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the members' equity section of the statements of financial condition.

Fair value of financial instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

Loss contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management was not aware of any loss contingencies that will have a material effect on the financial statements.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or members' equity.

Adoption of New Accounting Standards:

Revenue Recognition: On January 1, 2019, the Credit Union adopted ASU 2014-09 Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively, "ASC 606"), which created a single framework for recognizing revenue from contracts with customers that fall within its scope and revises when it is appropriate to recognize a gain or loss from the transfer of nonfinancial assets. ASC 606 establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this amendment specifies the accounting for some costs to obtain or fulfill a contract with a customer.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

The majority of the Credit Union's revenues come from interest income from loans and securities and other sources, including derivatives, loan fees and leases, all of which are outside of the scope of ASC 606. The Credit Union sources of revenue that do fall within the scope of ASC 606 are presented in Noninterest Income and are recognized as revenue as the Credit Union satisfies its obligation to its member. Services within the scope of ASC 606 include such items as service charges and related fees on deposit accounts, debit and credit card interchange income, wealth management fees, and if applicable, the sale of other real estate owned.

The Credit Union adopted ASC 606 using the modified retrospective method applied to all contracts not completed as of January 1, 2019, and not covered under another accounting pronouncement. Results for reporting periods beginning after January 1, 2109, are presented under ASC 606 while prior period amounts continue to be reported in accordance with legacy GAAP. The adoption of ASC 606 did not result in a change in accounting for any of the in-scope revenue streams identified above; as such, no cumulative effect adjustment was recorded.

A brief description of the Credit Union's revenue streams now accounted for under ASC 606 is as follows:

**Service Charges and Related Fees on Deposit Accounts:** The Credit Union earns fees for account maintenance, transaction-based services and overdraft services. Account maintenance fees, which relate primarily to monthly account maintenance, are generally earned over the course of the statement cycle, representing the period over which the Credit Union satisfies the performance obligation. Transaction-based fees include services such as stop payment charges, official check fees, statement rendering, shared branching services and ATM usage fees. Transaction-based fees are generally recognized at the time the transaction is executed as that is the point in time when the Credit Union fulfills the member request. Overdraft service charges include returned check insufficient funds and overdraft protection fees and are recognized at the point in time that the overdraft occurs. Total revenue recognized in 2019 for service charges and fees on deposit accounts was \$21,185,000.

**Debit and Credit Card Interchange Income:** The Credit Union earns interchange revenue from debit and credit cardholder transactions conducted through various merchant networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. Total revenue recognized in 2019 for interchange income was \$22,820,000.

**Wealth Management Fees:** The Credit Union earns wealth management fees from investment brokerage services provided to its members by third party providers. The Credit Union earns fees for the management of member assets (account management fees) and/or transactions on their accounts (transaction-based fees). Account management fees are predominately recognized monthly on a tiered scale based on total assets under management (AUM). A much smaller percentage of account management fees are recognized quarterly and consist of trail commissions on AUM from various third-party investment providers. Transaction-based revenue is recognized at time of trade. Total revenue recognized in 2019 for wealth management services was \$3,015,000.



**NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (Continued)**

New Accounting Standards That Have Not Yet Been Adopted:

*ASU 2016-02, Leases (Topic 842)*

In February 2016, the FASB amended existing guidance that requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis, and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The new guidance also requires enhanced disclosure about an entity's leasing arrangements. These amendments are effective for the Credit Union for fiscal years beginning after December 15, 2020 and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted for all nonpublic business entities. The adoption of this standard is not expected to have a material effect on the Credit Union's operating results; however, at this time, the impact is being determined and evaluated.

*ASU 2016-13, Financial Instruments – Credit Losses (Topic 326)*

In June 2016, FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables and held-to-maturity debt securities. It also applies to off-balance sheet credit exposures not accounted for as insurance.

The standard will be effective for the December 31, 2023 annual financial statements; however, the Credit Union may early adopt for fiscal years beginning after December 31, 2018. The Credit Union formed a CECL committee that is responsible for the oversight of CECL implementation. Vendor due diligence and selection was performed in 2019, data assessments were performed, and one year of historical data was utilized to run various models accepted under the new standard. The committee continues to assess the data needs for various models that can be deployed with back testing to determine the most accurate and appropriate model to be put into place at time of implementation. The Credit Union expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. The Credit Union expects the adoption will result in a material increase to the allowance for loan losses balance; however, at this time, the impact is being determined and evaluated.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
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**NOTE 2 - INVESTMENTS**

Investments classified as available-for-sale consist of the following (in thousands):

<u>December 31, 2019</u>	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
U.S. Government sponsored agency securities	\$ 15,989	\$ 5	\$ (7)	\$ 15,987
U.S. Government sponsored agency collateralized mortgage obligations, residential	4,769	4	(5)	4,768
U.S. Government sponsored agency Mortgage-backed securities, residential	<u>15,279</u>	<u>20</u>	<u>(83)</u>	<u>15,216</u>
	<u>\$ 36,037</u>	<u>\$ 29</u>	<u>\$ (95)</u>	<u>\$ 35,971</u>

<u>December 31, 2018</u>	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
U.S. Government sponsored agency securities	\$ 91,033	\$ -	\$ (548)	\$ 90,485
U.S. Government sponsored agency collateralized mortgage obligations, residential	5,816	38	(4)	5,850
U.S. Government sponsored agency Mortgage-backed securities, residential	<u>22,553</u>	<u>-</u>	<u>(392)</u>	<u>22,161</u>
	<u>\$ 119,402</u>	<u>\$ 38</u>	<u>\$ (944)</u>	<u>\$ 118,496</u>

There were no proceeds from sales and calls of securities for the years ended December 31, 2019 and 2018.

Investments by maturity as of December 31, 2019 are summarized as follows (in thousands):

	<u>Available-for-Sale</u>		
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Other</u>
No contractual maturity	\$ -	\$ -	\$ 11,282
Less than one year maturity	15,989	15,987	-
U.S. Government sponsored agency collateralized mortgage obligations, residential	4,769	4,768	-
U.S. Government sponsored agency mortgage-backed securities, residential	<u>15,279</u>	<u>15,216</u>	<u>-</u>
	<u>\$ 36,037</u>	<u>\$ 35,971</u>	<u>\$ 11,282</u>

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

**NOTE 2 - INVESTMENTS (Continued)**

Expected maturities of U.S. Government sponsored agency collateralized mortgage obligations and U.S. Government sponsored agency mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations and are therefore classified separately with no specific maturity date. FHLB stock has been classified with no contractual maturity.

Gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position were as follows (in thousands):

	<u>Fair Value Associated With Unrealized Losses Existing for:</u>		<u>Continuous Unrealized Losses Existing for:</u>		<u>Total Unrealized Losses</u>
	<u>Less Than 12 Months</u>	<u>More Than 12 Months</u>	<u>Less Than 12 Months</u>	<u>More Than 12 Months</u>	
<u>December 31, 2019</u>					
Available-for-sale: U.S. Government sponsored agency securities, collateralized mortgage obligations, mortgage-backed securities, residential	\$ 15,183	\$ 10,990	\$ (88)	\$ (7)	\$ (95)

	<u>Fair Value Associated With Unrealized Losses Existing for:</u>		<u>Continuous Unrealized Losses Existing for:</u>		<u>Total Unrealized Losses</u>
	<u>Less Than 12 Months</u>	<u>More Than 12 Months</u>	<u>Less Than 12 Months</u>	<u>More Than 12 Months</u>	
<u>December 31, 2018</u>					
Available-for-sale: U.S. Government sponsored agency securities, collateralized mortgage obligations, mortgage-backed securities, residential	\$ 9,310	\$ 106,166	\$ (18)	\$ (926)	\$ (944)

At December 31, 2019, the investment portfolio included 20 securities, 8 of which have current unrealized losses that have existed for less than one year, and 1 of which has an unrealized loss that has existed for more than one year. All of these securities were considered to be acceptable credit risks. Based upon an evaluation of the available evidence, including recent changes in market interest rates, credit rating information, and information obtained from regulatory filings, management believes the decline in fair value for these securities is temporary. In addition, the Credit Union has the intent and ability to hold these investment securities for a period of time sufficient to allow for an anticipated recovery.

The Credit Union did not have any other-than-temporary impairment in 2019 in available-for-sale securities.

Other investments consist of the following at December 31 (in thousands):

	<u>2019</u>	<u>2018</u>
FHLB stock	\$ 11,225	\$ 10,782
Other investments	<u>57</u>	<u>57</u>
	<u>\$ 11,282</u>	<u>\$ 10,839</u>

The fair value of other investments and FHLB stock is not practical to determine due to restrictions placed on its transferability.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

**NOTE 2 - INVESTMENTS (Continued)**

The Credit Union views its investment in the FHLB stock as a long-term investment, is carried at cost and evaluated for impairment. The Credit Union reviews the FHLB of San Francisco's financial statements when released and based on certain factors, management has concluded that the stock was not impaired at December 31, 2019 or 2018.

Securities totaling \$7,404,000 have been pledged as collateral to secure borrowings using the Discount Window with the Federal Reserve Bank of San Francisco, as disclosed in Note 8. Securities totaling \$28,588,000 are available to be pledged as collateral to secure FHLB advances, as more fully disclosed in Note 8.

**NOTE 3 - LOANS, NET**

Loans consist of the following at December 31 (in thousands):

	<u>2019</u>	<u>2018</u>
Residential real estate	\$ 1,089,709	\$ 1,102,634
Commercial	163,846	170,687
Vehicle	1,083,069	1,077,663
Credit card and other consumer	<u>121,576</u>	<u>114,225</u>
Loans receivable, gross	2,458,200	2,465,209
Deferred net loan origination costs	11,710	12,094
Allowance for loan losses	<u>(15,869)</u>	<u>(15,114)</u>
	<u>\$ 2,454,041</u>	<u>\$ 2,462,189</u>

The following presents, by portfolio segment, the changes in the allowance for loan losses and the recorded investment in loans for the years ended December 31, 2019 and 2018 (in thousands):

	<u>Residential Real Estate</u>	<u>Commercial</u>	<u>Vehicle</u>	<u>Credit Card and Other Consumer</u>	<u>Total</u>
<u>December 31, 2019</u>					
Allowance for loan losses:					
Beginning balance	\$ 6,023	\$ 847	\$ 4,953	\$ 3,291	\$ 15,114
Provision for loan losses	(1,373)	246	6,673	2,861	8,407
Charge-offs	-	(6)	(5,804)	(3,623)	(9,433)
Recoveries	<u>177</u>	<u>89</u>	<u>988</u>	<u>527</u>	<u>1,781</u>
Ending Balance	<u>\$ 4,827</u>	<u>\$ 1,176</u>	<u>\$ 6,810</u>	<u>\$ 3,056</u>	<u>\$ 15,869</u>
 <u>December 31, 2018</u>					
Allowance for loan losses:					
Beginning balance	\$ 5,224	\$ 3,954	\$ 4,047	\$ 3,250	\$ 16,475
Provision for loan losses	533	(960)	4,413	2,612	6,598
Charge-offs	-	(2,165)	(4,660)	(2,982)	(9,807)
Recoveries	<u>266</u>	<u>18</u>	<u>1,153</u>	<u>411</u>	<u>1,848</u>
Ending Balance	<u>\$ 6,023</u>	<u>\$ 847</u>	<u>\$ 4,953</u>	<u>\$ 3,291</u>	<u>\$ 15,114</u>

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

**NOTE 3 - LOANS, NET (Continued)**

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment based on impairment method as of December 31, 2019 and 2018 (in thousands):

<u>December 31, 2019</u>	<u>Residential Real Estate</u>	<u>Commercial</u>	<u>Vehicle</u>	<u>Credit Card and Other Consumer</u>	<u>Total</u>
Allowance for loan losses:					
Ending balance attributable to loans:					
Individually evaluated for impairment	\$ 3,613	\$ 661	\$ 198	\$ 76	\$ 4,548
Collectively evaluated for impairment	<u>1,214</u>	<u>515</u>	<u>6,612</u>	<u>2,980</u>	<u>11,321</u>
Total ending allowance balance	<u>\$ 4,827</u>	<u>\$ 1,176</u>	<u>\$ 6,810</u>	<u>\$ 3,056</u>	<u>\$ 15,869</u>
Loans:					
Loans individually evaluated for impairment	\$ 32,714	\$ 7,802	\$ 1,674	\$ 387	\$ 42,577
Loans collectively evaluated for impairment	<u>1,056,995</u>	<u>156,044</u>	<u>1,081,395</u>	<u>121,189</u>	<u>2,415,623</u>
Total ending gross loans balance	<u>\$ 1,089,709</u>	<u>\$ 163,846</u>	<u>\$ 1,083,069</u>	<u>\$ 121,576</u>	<u>\$ 2,458,200</u>
<u>December 31, 2018</u>	<u>Residential Real Estate</u>	<u>Commercial</u>	<u>Vehicle</u>	<u>Credit Card and Other Consumer</u>	<u>Total</u>
Allowance for loan losses:					
Ending balance attributable to loans:					
Individually evaluated for impairment	\$ 3,997	\$ 58	\$ 191	\$ 35	\$ 4,281
Collectively evaluated for impairment	<u>2,026</u>	<u>789</u>	<u>4,762</u>	<u>3,256</u>	<u>10,833</u>
Total ending allowance balance	<u>\$ 6,023</u>	<u>\$ 847</u>	<u>\$ 4,953</u>	<u>\$ 3,291</u>	<u>\$ 15,114</u>
Loans:					
Loans individually evaluated for impairment	\$ 35,615	\$ 7,407	\$ 1,288	\$ 220	\$ 44,530
Loans collectively evaluated for impairment	<u>1,067,019</u>	<u>163,280</u>	<u>1,076,375</u>	<u>114,005</u>	<u>2,420,679</u>
Total ending gross loans balance	<u>\$ 1,102,634</u>	<u>\$ 170,687</u>	<u>\$ 1,077,663</u>	<u>\$ 114,225</u>	<u>\$ 2,465,209</u>

The allowance for loan losses was considered by the Credit Union as adequate to cover probable incurred losses in the loan portfolio as of the balance sheet date. However, no assurance can be given that the Credit Union, in any particular period, will not sustain loan losses that exceed the allowance, or that subsequent evaluation of the loan portfolio, in light of then-prevailing factors, including economic conditions, credit quality of the assets comprising the portfolio, and the ongoing evaluation process, will not require significant changes in the allowance for loan losses.

The following presents the recorded investment and unpaid principal balance for impaired loans with associated allowance amount, if applicable, as of December 31, 2019 and 2018 (in thousands). The recorded investment in loans includes accrued interest receivable and loan origination fees, net.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

**NOTE 3 - LOANS, NET (Continued)**

<u>December 31, 2019</u>	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
Impaired loans with an allowance:					
Residential real estate	\$ 20,321	\$ 20,072	\$ 3,613	\$ 21,286	\$ 1,072
Commercial	2,841	2,796	661	1,530	259
Vehicle	1,143	1,134	198	942	72
Credit card and other consumer	<u>280</u>	<u>276</u>	<u>76</u>	<u>218</u>	<u>14</u>
	<u>\$ 24,585</u>	<u>\$ 24,278</u>	<u>\$ 4,548</u>	<u>\$ 23,976</u>	<u>\$ 1,417</u>
Impaired loans without an allowance:					
Residential real estate	\$ 12,393	\$ 12,285	\$ -	\$ 12,878	\$ 174
Commercial	4,961	4,929	-	6,075	-
Vehicle	531	529	-	539	-
Credit card and other consumer	<u>107</u>	<u>107</u>	<u>-</u>	<u>85</u>	<u>-</u>
	<u>\$ 17,992</u>	<u>\$ 17,850</u>	<u>\$ -</u>	<u>\$ 19,577</u>	<u>\$ 174</u>
Totals:					
Residential real estate	\$ 32,714	\$ 32,357	\$ 3,613	\$ 34,164	\$ 1,246
Commercial	7,802	7,725	661	7,605	259
Vehicle	1,674	1,663	198	1,481	72
Credit card and other consumer	<u>387</u>	<u>383</u>	<u>76</u>	<u>303</u>	<u>14</u>
	<u>\$ 42,577</u>	<u>\$ 42,128</u>	<u>\$ 4,548</u>	<u>\$ 43,553</u>	<u>\$ 1,591</u>
<u>December 31, 2018</u>	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
Impaired loans with an allowance:					
Residential real estate	\$ 22,251	\$ 21,997	\$ 3,997	\$ 23,574	\$ 1,213
Commercial	218	190	58	4,929	233
Vehicle	741	735	191	706	54
Credit card and other consumer	<u>157</u>	<u>155</u>	<u>35</u>	<u>151</u>	<u>9</u>
	<u>\$ 23,367</u>	<u>\$ 23,077</u>	<u>\$ 4,281</u>	<u>\$ 29,360</u>	<u>\$ 1,509</u>
Impaired loans without an allowance:					
Residential real estate	\$ 13,364	\$ 13,250	\$ -	\$ 13,414	\$ 211
Commercial	7,189	7,147	-	5,825	-
Vehicle	547	544	-	399	-
Credit card and other consumer	<u>63</u>	<u>63</u>	<u>-</u>	<u>61</u>	<u>-</u>
	<u>\$ 21,163</u>	<u>\$ 21,004</u>	<u>\$ -</u>	<u>\$ 19,699</u>	<u>\$ 211</u>
Totals:					
Residential real estate	\$ 35,615	\$ 35,247	\$ 3,997	\$ 36,988	\$ 1,424
Commercial	7,407	7,337	58	10,754	233
Vehicle	1,288	1,279	191	1,105	54
Credit card and other consumer	<u>220</u>	<u>218</u>	<u>35</u>	<u>212</u>	<u>9</u>
	<u>\$ 44,530</u>	<u>\$ 44,081</u>	<u>\$ 4,281</u>	<u>\$ 49,059</u>	<u>\$ 1,720</u>

Interest income recorded on a cash basis was not material during the years ended December 31, 2019 and 2018.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 3 - LOANS, NET (Continued)**

**Troubled Debt Restructurings:**

During the periods ending December 31, 2019 and 2018, the terms of certain loans were modified as troubled debt restructurings. The modifications of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate or an extension of the maturity date.

During the twelve month periods ending December 31, 2019 and 2018, modifications involving an extension of the maturity date were for periods ranging from one month up to 16 years. Modifications involving a reduction of the stated interest rate of the loan included reductions in rate of between 0.25% and 13.90%. The Credit Union has not committed to lend additional amounts as of December 31, 2019 and 2018 to borrowers with outstanding loans that are classified as troubled debt restructurings.

The following tables present loans modified as troubled debt restructurings during the years ended December 31, 2019 and 2018 (dollars in thousands):

<u>December 31, 2019</u>	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investments</u>	<u>Post-Modification Outstanding Recorded Investments</u>
TDRs occurring during the year:			
Residential real estate	2	\$ 41	\$ 41
Commercial	1	19	19
Vehicle	64	937	927
Credit card and other consumer	<u>23</u>	<u>256</u>	<u>257</u>
	<u>90</u>	<u>\$ 1,253</u>	<u>\$ 1,244</u>

The troubled debt restructurings described above resulted in a net increase to the allowance for loan losses of \$59,000 and resulted in charge offs of \$25,000 during the year ending December 31, 2019.

<u>December 31, 2018</u>	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investments</u>	<u>Post-Modification Outstanding Recorded Investments</u>
TDRs occurring during the year:			
Residential real estate	3	\$ 333	\$ 338
Commercial	3	897	897
Vehicle	53	812	811
Credit card and other consumer	<u>6</u>	<u>66</u>	<u>66</u>
	<u>65</u>	<u>\$ 2,108</u>	<u>\$ 2,112</u>

The troubled debt restructurings described above resulted in a net decrease to the allowance for loan losses of \$1,974,000 and resulted in charge offs of \$2,037,000 during the year ending December 31, 2018.

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SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 3 - LOANS, NET** (Continued)

The following tables present loans modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the years ended December 31, 2019 and 2018 (dollars in thousands):

<u>December 31, 2019</u>	<u>Number of Loans</u>	<u>Recorded Investments</u>
TDRs that subsequently defaulted:		
Residential real estate	-	\$ -
Commercial	-	-
Vehicle	10	48
Credit card and other consumer	<u>3</u>	<u>34</u>
	<u>13</u>	<u>\$ 82</u>

The troubled debt restructurings that subsequently defaulted, as described above, resulted in a net increase to the allowance for loan losses of \$1,000 and resulted in charge offs of \$53,000 during the year ending December 31, 2019. The Credit Union has not committed to lend additional amounts as of December 31, 2019 to borrowers with outstanding loans that are classified as troubled debt restructurings.

<u>December 31, 2018</u>	<u>Number of Loans</u>	<u>Recorded Investments</u>
TDRs that subsequently defaulted:		
Residential real estate	1	\$ 39
Commercial	-	-
Vehicle	6	13
Credit card and other consumer	<u>1</u>	<u>4</u>
	<u>8</u>	<u>\$ 56</u>

The troubled debt restructurings that subsequently defaulted, as described above, resulted in a net decrease to the allowance for loan losses of \$10,000 and resulted in charge offs of \$19,000 during the year ending December 31, 2018. The Credit Union has not committed to lend additional amounts as of December 31, 2018 to borrowers with outstanding loans that are classified as troubled debt restructurings.

A loan is considered to be in payment default once it is 60 days contractually past due under the modified terms or charged off.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed in accordance with the Credit Union's internal underwriting policy.



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**NOTE 3 - LOANS, NET** (Continued)

**Credit Quality Indicators:**

Management regularly reviews and risk grades commercial loans in the Credit Union's portfolio. The risk grading system allows management to classify assets by credit quality in accordance with the Credit Union policy. The Credit Union's internal risk grading system definitions are as follows:

- Satisfactory—loans that are protected by the current net worth and paying capacity of the obligor(s) or by the value of the underlying collateral.
- Special Mention—loans with potential weaknesses that require close attention. If left uncorrected, the weaknesses may result in deterioration of the repayment prospects for the asset, or in the future loan credit position.
- Substandard—loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Credit Union will sustain some loss if the deficiencies are not corrected.
- Doubtful—a loan classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include: sale or liquidation actions; other forms of income or assistance; perfecting liens on collateral; and refinancing plans.
- Loss—a loan classified as a loss is considered uncollectible and of such little value that its continuance as a loan is not warranted. This classification does not necessarily mean that the loan has absolutely no recovery or salvage value, but rather, it is not practical or desirable to defer writing off this asset even though partial recovery may occur in the future.

The following presents, by credit quality indicator, the commercial portfolio as of December 31, 2019 and 2018 (in thousands):

	<u>2019</u>	<u>2018</u>
Satisfactory	\$ 158,178	\$ 160,385
Special mention	1,725	5,742
Substandard	3,921	4,521
Doubtful	18	36
Loss	4	3
	\$ 163,846	\$ 170,687

Management reviews the performance of the loan portfolio on a regular basis. Non-commercial loans are evaluated on the basis of performing and nonperforming status. Nonperforming loans are defined as being greater than 60 days past due.

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**NOTE 3 - LOANS, NET (Continued)**

The following presents, by credit quality indicator, the residential real estate, vehicle, and credit card and other consumer loan portfolio as of December 31, 2019 and 2018 (in thousands):

<u>December 31, 2019</u>	<u>Performing</u>	<u>Nonperforming</u>	<u>Total</u>
Residential real estate	\$ 1,085,811	\$ 3,898	\$ 1,089,709
Vehicle	1,079,115	3,954	1,083,069
Credit card and other consumer	<u>120,454</u>	<u>1,122</u>	<u>121,576</u>
	<u>\$ 2,285,380</u>	<u>\$ 8,974</u>	<u>\$ 2,294,354</u>

<u>December 31, 2018</u>	<u>Performing</u>	<u>Nonperforming</u>	<u>Total</u>
Residential real estate	\$ 1,100,088	\$ 2,546	\$ 1,102,634
Vehicle	1,076,116	1,547	1,077,663
Credit card and other consumer	<u>113,322</u>	<u>903</u>	<u>114,225</u>
	<u>\$ 2,289,526</u>	<u>\$ 4,996</u>	<u>\$ 2,294,522</u>

The following represents an aging analysis of the recorded investment of past due loans as of December 31, 2019 and 2018 (in thousands):

<u>December 31, 2019</u>	<u>30-59 Days</u>	<u>60-89 Days</u>	<u>90+ Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loan Receivable, Gross</u>	<u>Loans in Which Interest Has Been Discontinued</u>
Residential real estate	\$ 8,864	\$ 1,209	\$ 2,689	\$ 12,762	\$ 1,076,947	\$ 1,089,709	\$ 2,689
Commercial	40	-	-	40	163,806	163,846	2,273
Vehicle	13,504	2,967	987	17,458	1,065,611	1,083,069	987
Credit card and other consumer	<u>988</u>	<u>415</u>	<u>707</u>	<u>2,110</u>	<u>119,466</u>	<u>121,576</u>	<u>707</u>
	<u>\$ 23,396</u>	<u>\$ 4,591</u>	<u>\$ 4,383</u>	<u>\$ 32,370</u>	<u>\$ 2,425,830</u>	<u>\$ 2,458,200</u>	<u>\$ 6,656</u>

<u>December 31, 2018</u>	<u>30-59 Days</u>	<u>60-89 Days</u>	<u>90+ Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loan Receivable, Gross</u>	<u>Loans in Which Interest Has Been Discontinued</u>
Residential real estate	\$ 742	\$ 39	\$ 2,507	\$ 3,288	\$ 1,099,346	\$ 1,102,634	\$ 2,507
Commercial	118	15	3	136	170,551	170,687	2,641
Vehicle	9,913	965	582	11,460	1,066,203	1,077,663	582
Credit card and other consumer	<u>828</u>	<u>408</u>	<u>495</u>	<u>1,731</u>	<u>112,494</u>	<u>114,225</u>	<u>495</u>
	<u>\$ 11,601</u>	<u>\$ 1,427</u>	<u>\$ 3,587</u>	<u>\$ 16,615</u>	<u>\$ 2,448,594</u>	<u>\$ 2,465,209</u>	<u>\$ 6,225</u>

There were no loans at December 31, 2019 or 2018 that were on accrual status and 90 days or more past due.

SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 4 - LOAN SERVICING**

Mortgage loans serviced for others are not included in the accompanying statements of financial condition. The unpaid principal balances of these loans at December 31 are summarized as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Mortgage loan portfolios serviced for others	\$ <u>980,287</u>	\$ <u>803,675</u>

Custodial escrow balances maintained in connection with the foregoing loan servicing, and included in member shares, were \$4,845,000 and \$4,145,000 at December 31, 2019 and 2018, respectively.

Mortgage servicing rights are recorded within other assets on the statements of financial condition. A summary of the changes in the balance of mortgage servicing rights for the years ended December 31 was as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Balance, beginning of the year	\$ 5,900	\$ 5,321
Servicing assets recognized during the year	2,493	1,399
Amortization of servicing assets	(1,117)	(821)
Change in valuation allowance	<u>(84)</u>	<u>1</u>
Balance, end of year	\$ <u>7,192</u>	\$ <u>5,900</u>
Fair value of mortgage servicing rights	\$ <u>8,955</u>	\$ <u>8,357</u>

The aggregate changes in the valuation allowances for mortgage servicing rights for the years ended December 31 were as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Balance, beginning of the year	\$ -	\$ 1
Additions	84	-
Reductions	<u>-</u>	<u>(1)</u>
Balance, end of year	\$ <u>84</u>	\$ <u>-</u>

The key economic assumptions used in determining the fair value of mortgage servicing rights at December 31 were as follows:

	<u>2019</u>	<u>2018</u>
Prepayment speed	18.85%	15.70%
Weighted-average life (years)	5.45	6.97
Yield to maturity discount rate	9.84%	10.50%

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SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 5 - PROPERTY AND EQUIPMENT, NET**

Property and equipment at December 31 are summarized as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Land	\$ 10,023	\$ 10,023
Building	47,496	46,250
Leasehold improvements	3,088	3,335
Furniture and equipment	<u>37,590</u>	<u>34,807</u>
	98,197	94,415
Accumulated depreciation and amortization	<u>(45,730)</u>	<u>(43,356)</u>
	<u>\$ 52,467</u>	<u>\$ 51,059</u>

Depreciation expense was \$3,410,000 and \$3,721,000 for 2019 and 2018, respectively.

The Credit Union has 24 operating leases, which include branch offices and automated teller machine (ATM) locations. Certain operating leases contain renewal options and provisions requiring the Credit Union to pay property taxes and operating expenses over base time periods. All rental payments are dependent only upon the lapse of time. Minimum rental payments under operating leases with initial or remaining terms of one year or more at December 31, 2019 were as follows (in thousands):

Years Ending December 31, <u>    </u>	
2020	\$1,064
2021	927
2022	851
2023	387
Subsequent Years	<u>1,219</u>
	<u>\$ 4,448</u>

Rental expense for the years ended December 31, 2019 and 2018, for all facilities leased under operating leases, totaled \$1,426,000 and \$1,389,000, respectively.

**NOTE 6 - GOODWILL AND OTHER INTANGIBLE ASSETS**

The Credit Union completed a merger transaction with American River HealthPro Credit Union that became effective on July 1, 2009. This merger was accounted for as a purchase business combination. As the purpose of this merger was to achieve growth and economies of scale among these mutual enterprises, no payment considerations were involved, contingent or otherwise. The goodwill of \$13,282,000 associated with this merger, arising from expected synergies from the combined operations, for the years ended December 31, 2019 and 2018, is subject to an annual impairment test. Management assesses goodwill for impairment at least annually, and has determined that there was no goodwill impairment for 2019 or 2018.

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SAFE CREDIT UNION  
 NOTES TO FINANCIAL STATEMENTS  
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**NOTE 6 - GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)**

In 2015, the Credit Union purchased a book of client investment accounts, which resulted in an intangible asset of \$196,000 as of December 31, 2015. This intangible asset is amortized over a period of 10 years beginning January 2016. During the fourth quarter of 2017, it was determined that the client investment accounts were not performing as originally expected. Analysis indicated that future earnings were less than the carrying amount resulting in an other than temporary impairment write down of \$58,000, which was recorded in other noninterest expense. The remaining amortization period on this intangible was not impacted. The intangible asset balance related to the purchase of client investment accounts was \$75,000 and \$87,000 for the years ended December 31, 2019 and 2018, respectively.

In 2016, the Credit Union purchased \$34,322,000 in member share accounts from another credit union. The purchase consisted of regular shares, money market accounts, certificates, and individual retirement accounts. The purchase resulted in an initial intangible asset of \$817,000. This intangible asset is amortized over a period of 7 years beginning November 2016. The intangible balance related to the purchase of the deposits was \$447,000 and \$564,000 for the years ended December 31, 2019 and 2018, respectively.

**NOTE 7 - MEMBERS' SHARES**

Members' shares at December 31 are summarized as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Regular share accounts	\$ 483,174	\$ 511,873
Share draft accounts	618,740	603,089
Money market accounts	950,735	868,969
Certificate accounts	500,948	383,976
Individual retirement accounts	34,631	33,791
Individual retirement certificate accounts	<u>57,294</u>	<u>56,339</u>
	<u>\$ 2,645,522</u>	<u>\$ 2,458,037</u>

Shares by maturity as of December 31, 2019 are summarized as follows (in thousands):

No contractual maturity	\$ 2,087,280
Zero to one year maturity	274,811
One to two years maturity	193,735
Two to three years maturity	64,263
Three to four years maturity	17,553
Four to five years maturity	7,255
Over five years maturity	<u>625</u>
	<u>\$ 2,645,522</u>

Regular share accounts share draft accounts, money market accounts, and individual retirement accounts have no contractual maturity. Certificate accounts have maturities of six years or less.

The NCUSIF insures members' shares, including individual retirement and Keogh accounts up to \$250,000.

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SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
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**NOTE 7 - MEMBERS' SHARES (Continued)**

The aggregate amount of certificate accounts in denominations of \$250,000 or more at December 31, 2019 and 2018 was \$85,356,000 and \$54,026,000, respectively.

The Credit Union maintains public unit money market and certificate share accounts. These funds are interest bearing and subject to immediate withdrawal for money market accounts or at maturity for certificates. The balance in public unit share accounts was \$55,166,000 and \$25,119,000 at December 31, 2019 and 2018, respectively. The public unit shares are secured by letters of credit as discussed in Note 8.

At December 31, 2019 and 2018, overdraft demand shares reclassified to loans totaled \$1,396,000 and \$1,234,000, respectively.

**NOTE 8 - BORROWINGS ARRANGEMENTS**

Advances from Federal Home Loan Bank at December 31 are summarized as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Overnight advance, with variable rates from 1.12% to 2.53%, averaging 1.68%	\$ -	\$ 10,000
Fixed rate advance, maturing May 2019, rate at 2.45%, contains a prepayment penalty	\$ -	\$ 45,000
Fixed rate advance, maturing May 2021, rate at 3.07%, contains a prepayment penalty in the first year; callable quarterly thereafter	\$ -	\$ 45,000
Fixed rate advance, maturing April 2022, rate at 2.63%, contains a prepayment penalty in the first year; callable quarterly thereafter	\$ 45,000	\$ -

Advances are collateralized by either first mortgage loans under a blanket lien arrangement or by certain investments held in safekeeping by the FHLB. At December 31, 2019, the Credit Union had \$45,000,000 in borrowings collateralized by first mortgage loans.

Based on this collateral and the Credit Union's holdings of FHLB stock, the Credit Union is eligible to borrow up to a total of \$739,000,000 at year-end 2019.

The Credit Union is authorized to use the Discount Window with the Federal Reserve Bank of San Francisco (FRBSF) to borrow money on the terms and security required per the FRBSF's Operating Circular No. 10, effective July 16, 2013, as amended and supplemented from time to time thereafter ("OC-10"). The agreement is reviewed for continuation by the FRBSF and the Credit Union annually.

SAFE CREDIT UNION  
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For the Years Ended December 31, 2019 and 2018

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**NOTE 8 - BORROWINGS ARRANGEMENTS** (Continued)

Payments over the next five years are as follows (in thousands):

Years Ending December 31,		
2020	\$	-
2021		-
2022		45,000
2023		-
2024		-
	<u>\$</u>	<u>45,000</u>

The Credit Union has pledged collateral for public unit shares in the form of letter of credit agreements totaling \$60,500,000. The letters of credit are collateralized by first mortgage loans under a blanket lien arrangement with the FHLB. The letters of credit are as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Maturing March 2020, with an annual maintenance charge of 10 basis points	\$ 27,500	\$ -
Maturing March 2021, with an annual maintenance charge of 10 basis points	\$ 33,000	\$ -

**NOTE 9 - OFF-BALANCE-SHEET ACTIVITIES**

The Credit Union is party to conditional commitments to lend funds in the normal course of business to meet the financing needs of its members. These commitments represent financial instruments to extend credit, which include lines of credit, credit cards, and home equity lines that involve, to varying degrees, elements of credit and interest rate risk in excess of amounts recognized in the financial statements.

The Credit Union's exposure to credit loss is represented by the contractual amount of these commitments. The Credit Union follows the same credit policies in making commitments as it does for those loans recorded in the financial statements.

The Credit Union has approved residential real estate loans in processing that were not yet funded at December 31, 2019 and 2018 of \$1,961,000 and \$2,500,000, respectively.

Unfunded loan commitments under lines of credit are summarized as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Residential real estate	\$ 62,746	\$ 62,382
Commercial	1,539	2,696
Credit card and other consumer	<u>386,517</u>	<u>318,876</u>
	<u>\$ 450,802</u>	<u>\$ 383,954</u>

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SAFE CREDIT UNION  
NOTES TO FINANCIAL STATEMENTS  
For the Years Ended December 31, 2019 and 2018

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**NOTE 9 - OFF-BALANCE-SHEET ACTIVITIES** (Continued)

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. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Credit Union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral obtained to secure borrowing on the lines of credit is based on management's credit evaluation of the member.

Unfunded commitments under revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized, usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Credit Union is committed.

**NOTE 10 - COMMITMENTS AND CONTINGENT LIABILITIES**

The Credit Union is party to various legal actions normally associated with collections of loans and other business activities of financial institutions, the aggregate effect of which, in management's opinion, would not have a material adverse effect on the financial condition or results of operations of the Credit Union.

On August 13, 2019, the Credit Union entered into a non-cancellable Agreement with the City of Sacramento for Naming Rights to the City of Sacramento's Convention Center and Performing Arts District. The agreement calls for the Credit Union to make annual payments over a twenty-five year period beginning in 2019 with total payments of \$22,988,000 to be paid by the Credit Union over the life of the contract. As of December 31, 2019, there was \$22,694,000 remaining to be paid under the Naming Rights Agreement as follows:

Years Ending <u>December 31,</u>	
2020	\$ 1,144
2021	850
2022	850
2023	850
Subsequent Years	<u>19,000</u>
	<u>\$ 22,694</u>

As part of the Naming Rights agreement, the City of Sacramento maintains \$30,000,000 in interest bearing deposits with the Credit Union. These deposits are treated as public unit shares.

**NOTE 11 - EMPLOYEE BENEFITS**

The Credit Union has a defined-contribution 401(k) benefit and profit sharing plan and 457(b) plan that allows substantially all employees to defer a portion of their salary into the plans. The Credit Union is not required to make matching and profit sharing contributions to the plan. Benefit plan and profit sharing plan costs are accrued and funded on a current basis. The Credit Union voluntarily contributed \$3,698,000 and \$3,316,000 to the benefit plans for the years ended December 31, 2019 and 2018, respectively.

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For the Years Ended December 31, 2019 and 2018

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**NOTE 11 - EMPLOYEE BENEFITS** (Continued)

The Credit Union maintains supplemental executive retirement plans to provide certain retirement benefits for key executives. The contributions into the plans are accrued as compensation expense and funded on a current basis. The expense recognized under these plans was \$701,000 and \$617,000 for the years ended December 31, 2019 and 2018, respectively. The Credit Union had \$60,000 accrued under these plans at both December 31, 2019 and 2018.

The Credit Union recognized \$4,399,000 and \$3,933,000 in compensation and benefit expense for all plans for the years ended December 31, 2019 and 2018, respectively.

**NOTE 12 - MEMBERS' EQUITY**

The Credit Union is subject to various regulatory capital requirements administered by the NCUA and the California Department of Business Oversight. 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 financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital guidelines that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under GAAP. The Credit Union's capital amounts and 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 to total assets. Further, credit unions over \$10,000,000 in assets 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 requirements as of December 31, 2019 and 2018 were 5.55 percent and 5.92 percent, respectively. The minimum requirement to be considered "complex" under the regulatory framework is 6 percent. Management believes, as of December 31, 2019 and 2018, that the Credit Union met all regulatory capital adequacy requirements to which it is subject.

Other appropriated retained earnings represent a restriction of retained earnings as established by the Board of Directors.

As of December 31, 2019 and 2018, the NCUA categorized the Credit Union as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized," the Credit Union must maintain a minimum net worth ratio of 7 percent of assets. There were no conditions or events since that notification that management believes have changed the Credit Union's category.

The Credit Union's actual capital amounts and ratios at December 31 were as follows (in thousands):

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NOTES TO FINANCIAL STATEMENTS  
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**NOTE 12 - MEMBERS' EQUITY (Continued)**

	2019		2018	
	Amount	Ratio Requirement	Amount	Ratio Requirement
Amount needed to be classified as adequately capitalized	\$ 185,134	6.00%	\$ 173,024	6.00%
Amount needed to be classified as well-capitalized	215,990	7.00%	201,861	7.00%
Actual net worth	310,490	10.06%	277,656	9.63%

Because the RBNW requirement was less than the net worth ratio, the Credit Union retained its original category. Further, in performing its calculation of total assets, the Credit Union used the quarter-end balance option, as permitted by regulation.

**NOTE 13 - RELATED-PARTY TRANSACTIONS**

In the normal course of business, the Credit Union extends credit to the Board of Directors and executive officers. The aggregate loans to related parties at December 31, 2019 and 2018 were \$2,905,000 and \$1,597,000, respectively. Member shares from related parties at December 31, 2019 and 2018 amounted to \$2,678,000 and \$2,773,000, respectively.

**NOTE 14 - MORTGAGE DERIVATIVES**

The Credit Union is an active participant in the production of mortgage loans that are sold to a government sponsored entity (GSE), such as Fannie Mae. These loans are classified Loans Held for Sale in the Credit Unions Statements of Financial Condition. The value of the Credit Unions IRLCs is exposed to the risk of adverse changes in interest rates between the time of commitment and the time the Credit Union funds the loan at origination. The Credit Union is also exposed to the risk of adverse changes in value after funding the loan up until the time when the loan is delivered to the GSE. Beginning in 2017, to offset this exposure, the Credit Union entered into forward sales commitments to deliver mortgage loans to investors at specified prices in the "To Be Announced" market (TBA securities). These forward sales commitments act as an economic hedge against the risk of changes in the value of both the IRLCs and the funded loans. The Credit Union does not account for these mortgage derivatives as qualifying accounting hedges and therefore accounts for them as economic hedges. The Credit Union records IRLCs and forward sales commitments as derivative instruments at fair value in its Statements of Financial Condition and records changes in the fair value of those mortgage derivative instruments in current earnings.

At December 31, 2019 and 2018, the Credit Union had interest rate lock commitments of \$22,444,000 and \$8,592,000, respectively, and forward sales commitments for the future delivery of residential mortgage loans totaling \$32,500,000 and \$12,100,000, respectively. The fair value of these mortgage derivatives was reflected by a net derivative asset of \$394,000 and \$108,000 at December 31, 2019 and 2018, respectively. Fair values were estimated based on changes in mortgage interest rates from the date of the commitments. Changes in the fair values of these mortgage derivatives are included in net gains on sales of loans.

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**NOTE 14 - MORTGAGE DERIVATIVES** (Continued)

The net gains and losses relating to free-standing derivative instruments used for risk management are summarized below as of December 31 (in thousands):

	<u>Location</u>	<u>2019</u>	<u>2018</u>
Forward commitments related to mortgage loans held for sale	Net (loss) gain on sale of loans	\$ (941)	\$ 694
Interest rate lock commitments	Net gain (loss) on sale of loans	\$ 292	\$ (82)

The following table reflects the amount and fair value of mortgage derivatives included in the Statement of Financial Condition as of December 31 (in thousands):

	<u>2019</u>	<u>2018</u>
Included in other assets:		
Forward commitments related to mortgage loans held for sale	\$ (67)	\$ (61)
Interest rate lock commitments	<u>461</u>	<u>169</u>
Total included in other assets	<u>\$ 394</u>	<u>\$ 108</u>

**NOTE 15 - FAIR VALUE**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other 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.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investments available-for-sale: The fair value of investment securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker-dealers. If listed prices or quotes are not available, fair value is based upon externally developed models that use unobservable inputs due to the limited market activity of the instrument (level 2 inputs).

Loans held for sale: The fair value of loans held for sale is determined based on an evaluation of best execution forward sales contract prices sourced from the TBA market, by agency (level 2 inputs).

Mortgage derivatives: The derivative instruments consist of IRLC and forward sale commitments that trade in liquid markets. IRLCs are valued according to prices obtained from the GSE and based on mandatory delivery for a delivery period that corresponds with the number of days remaining in the IRLC. Loan level pricing adjustments, if applicable based on the characteristics of the loan, are added to the price (level 2

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**NOTE 15 - FAIR VALUE** (Continued)

inputs). Prices for forward commitments are obtained from the purchasing agency based on loans allocated to the commitments. As such, significant fair value inputs can generally be verified and do not typically involve significant management judgement (level 2 inputs).

Fair value on a recurring basis: The following table summarizes assets and liabilities measured at fair value on a recurring basis as of December 31, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

<u>Assets</u>	<u>2019</u>			
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
U.S. Government sponsored agency securities	\$ 15,987	\$ -	\$ 15,987	\$ -
U.S. Government sponsored agency collateralized mortgage obligations, residential	4,768	-	4,768	-
U.S. Government sponsored agency mortgage-backed securities, residential	15,216	-	15,216	-
Loans held for sale, at fair value	13,491	-	13,491	-
Mortgage derivatives	<u>394</u>	<u>-</u>	<u>394</u>	<u>-</u>
	<u>\$ 49,856</u>	<u>\$ -</u>	<u>\$ 49,856</u>	<u>\$ -</u>

<u>Assets</u>	<u>2018</u>			
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
U.S. Government sponsored agency securities	\$ 90,485	\$ -	\$ 90,485	\$ -
U.S. Government sponsored agency collateralized mortgage obligations, residential	5,850	-	5,850	-
U.S. Government sponsored agency mortgage-backed securities, residential	22,161	-	22,161	-
Loans held for sale, at fair value	6,199	-	6,199	-
Mortgage derivatives	<u>108</u>	<u>-</u>	<u>108</u>	<u>-</u>
	<u>\$ 124,803</u>	<u>\$ -</u>	<u>\$ 124,803</u>	<u>\$ -</u>

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**NOTE 15 - FAIR VALUE** (Continued)

Financial Instruments Recorded Using Fair Value Option

The Credit Union has elected the fair value option for mortgage loans held for sale. These loans are intended for sale and the Credit Union believes that the fair value is the best indicator of the resolution of these loans. Interest income is recorded based on contractual terms of the loan and in accordance with the Credit Union's policy on mortgage loans held for investment. None of these loans are 90 days or more past due or non-accrual as of December 31, 2019 and 2018 (in thousands).

	<u>2019</u>	<u>2018</u>
Aggregate fair value	\$ 13,491	\$ 6,199
Contractual balance	13,144	6,038
Gain (loss)	348	161

Fair value on a nonrecurring basis: Certain assets and liabilities are measured at fair value on a nonrecurring basis. The instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). There were no instruments carried on the Statement of Financial Condition as of December 31, 2019 where a nonrecurring change in fair value was recorded.

The following table presents the assets carried on the Statement of Financial Condition as of December 31, 2018, by class and by level within the valuation hierarchy (as described above), for which a nonrecurring change in fair value has been recorded (in thousands):

	<u>2018</u>				<u>Total Losses</u>
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Impaired loans:					
Commercial	\$ 708	\$ -	\$ -	\$ 708	\$ 2,037
Total impaired loans	<u>\$ 708</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 708</u>	<u>\$ 2,037</u>

Impaired Loans: The Credit Union records loans at fair value on a non-recurring basis. The fair value of impaired loans is estimated by either an observable market price (if available) or the fair value of the underlying collateral, if collateral dependent. The fair value of collateral is determined periodically by third party asset valuation models for residential loans and appraisals (by licensed appraisers) for commercial loans. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. Appraisals conducted on collateral securing commercial loans utilize a market, income, or cost approach or some combination of the three and typically contain unobservable market data. Therefore, such appraisals are classified as Level 3 in the fair value hierarchy. Unobservable market data contained in appraisals often includes adjustments to comparable property sales for such items as location, size and quality. Unobservable market data also includes liquidation discounts estimated by appraisers or management. Impaired loans evaluated under the discounted cash flow method are excluded from the fair value table for non-recurring assets. The discounted cash flow method is not a fair value measurement since the discount rate utilized is the loan's effective interest rate, which is not a market rate.

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**NOTE 15 - FAIR VALUE** (Continued)

Appraisals for collateral-dependent impaired loans are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Credit Union. For commercial properties, the Credit Union reviews the assumptions and approaches utilized in the appraisal to determine the reasonableness of the overall resulting fair value. For residential properties, the appraised value is compared to other sources including Broker Price Opinions and Automated Valuation Models to validate the reasonableness of the appraised amount. On an annual basis, the Credit Union obtains an updated appraisal for collateral-dependent impaired loans and compares the actual selling price of collateral that has been sold to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value.

There were no financial instruments measured at fair value on a non-recurring basis at December 31, 2019.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2018 (in thousands):

<u>Description</u>	<u>Fair Value</u>	<u>Valuation Technique</u>	<u>Significant Unobservable Inputs</u>	<u>Weighted Average</u>
Impaired loans:				
Commercial	\$ 708	Appraisal	Comparable sales adjustment	-31% to 33%
			Liquidation value adjustment	-37%