

Sample National Bank ASSET/LIABILITY MANAGEMENT POLICY

I. GOAL

- A. The assets and liabilities of _____ Bank of _____ shall be managed in order to maximize shareholder value, to enhance profitability and increase capital, to serve customer and community needs, and to protect the institution from any disastrous financial consequences arising from changes in interest rate risk. These objectives shall be pursued within the framework of written loan, capital, and investment policies. The Board of Directors believes that accepting some level of interest rate risk is necessary in order to achieve realistic profit goals. The responsibility of managing the asset/liability management procedures will be directed by the Asset/Liability Management Committee (ALCO).

II. ALCO ORGANIZATION AND RESPONSIBILITY

- A. The composition of the ALCO Committee of _____ Bank of _____ shall consist of Mr./Ms. _____, Mr./Ms. _____, and Mr./Ms. _____. Mr./Ms. _____ shall serve as Chairman of the Committee. The Committee shall meet once a month or more frequently when necessary to discuss asset/liability management issues. The ALCO is responsible for recommending to the Board of Directors prudent asset/liability management policies and procedures that enable the bank to achieve its goals while operating in full compliance with all state and federal laws, rules, and regulations.

The Board of Directors will review reports and procedures to ensure adherence with this policy statement. As necessary, the Board will modify or grant exceptions to the policy for recommended action that are in the best interest of the institution.

III. OBJECTIVES

- A. The assets and liabilities shall be managed to attempt to achieve the following minimum objectives:
1. A return on assets above _____ %.
 2. A return on equity above _____ %.
 3. An equity capital-to-assets ratio above _____ %.
 4. A risk-based capital ratio of _____ %.

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Revised July 14, 1997

IV. DUTIES

A. At its quarterly meeting the ALCO shall review the following:

1. Local and national economic forecasts
2. Interest rate forecasts and spreads including a consensus interest rate forecast for the Bank developed by Bank management
3. Internal cost of funds (recent pricing)
4. Mismatches in the balance sheet
5. Year-to-date operating results
6. Anticipated funding needs
7. Anticipated loan demands
8. Liquidity position
9. Maturity distribution of certificates of deposit of \$100,000
10. (GAP) Rate Sensitivity measures
11. Net Interest Margin/Interest Rate Risk Measures
12. Simulation
13. Capital Positions
14. Ratio of loan loss reserves to outstanding risk loans
15. Tax position
16. Fed funds position
17. Investment portfolio
18. Current loan investment and funding strategies
19. An explanation of any known exceptions to this policy as well as an action plan and timetable to bring the bank into compliance with such policy limits.

V. REPORTING REQUIREMENTS

A. The ALCO shall provide the following to the Board of Directors on a quarterly basis:

1. Average daily balance sheet
2. Interest income and interest expense statements
3. Non-interest income and non-interest expense statements
4. Interest spread statement and GAP Report
5. Relevant ratios (detailed above)
6. Net interest change analysis attributable to dollar volumes, earning, paying and market rates as well as time (simulation) compared to policy limits.
7. Investment portfolio and loan activity report
8. A summary approximating investment portfolio values
9. Duration analysis to approximate investment portfolio values for different rate scenarios (annual)
10. Projected flow of funds analysis
11. Recommended Asset/Liability Management plan including a quarterly strategy for the management of interest rate risk and liquidity risk
12. Assessment of performance against the prior quarter's strategy

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- D. The Bank will offer a full array of money market, savings, and NOW accounts, and certificates of time deposits to customers of our Bank with interest rates paid subject to market conditions.
- E. Maturities of both greater than \$100,000 and less than \$100,000 certificates of deposit will normally average _____ months in the aggregate with the majority of new deposits written for _____ months with a minimum _____ month(s) and a maximum of _____ months. As interest rate forecasts dictate, maturities on liabilities will be lengthened or shortened to maximize the net interest margin while complying with the ranges detailed above.
- F. The minimum acceptable rate differential between average liability cost and average asset yield on new business will be _____ basis points.

VIII. LOANS

- A. Loan commitments will be consistent with separate written loan policies. The maximum amount of loans outstanding shall not exceed _____ times the gross capital funds (capital, surplus, undivided profits reserves for loan losses, and capital debentures). The maximum amount of loans outstanding shall be limited to _____ % of deposit levels.
- B. Loan relationships will be pursued if management can demonstrate that such loans will produce a minimum of a _____ basis point spread over current funding costs.
- C. The Board of Directors seeks to keep the amount of assets classified as substandard, doubtful, or loss by the regulatory authorities at less than _____ % of gross capital funds. Furthermore, loan loss reserves shall amount to at least _____ % of the non-government guaranteed loans outstanding.

IX. INVESTMENTS

- A. Security purchases will be consistent with separate written investment policies and strategies. The objectives of the investment portfolio are to (1) provide liquidity (2) provide for interest rate risk management, and (3) provide additional profit.

X. INTEREST RATE RISK

- A. It is the policy of the Bank to measure and manage its rate sensitivity position to ensure the long-run earning power of the bank. In addressing this challenge, the ratios of rate sensitive assets (RSA) to rate sensitive liabilities (RSL) and gap (RSA minus RSL) to equity, as well as gap to total assets will be reviewed based on 30, 60, 90, 180, and 365-day, 1-2 year, and greater than 2 year definitions. More importantly, however, special emphasis is to be placed on the change in net interest income that will result from possible fluctuations in interest rates, changing account

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volumes, and time. In particular, changes in interest income resulting from increasing (+100 b.p. to +300 b.p.), decreasing (-100 b.p. to -300 b.p.) and constant rate scenarios will be evaluated via simulation.

- B. In an effort to measure risk to market value of equity, the Bank will review all long-term fixed rate assets. The Bank will review price volatility of the investment portfolio using duration analysis and specifically look at the estimated depreciation in market value if interest rates rise 300 b.p. in comparison to the Bank's equity capital. In addition, the Bank will compare long term assets to short term volatile liabilities.

XI. RATE SENSITIVE ASSETS

- A. Rate sensitive assets (RSA) are any loans or investments that can be repriced either up or down in interest rate within a given time frame. The following represent some examples of assets that would be considered rate sensitive:

1. Federal Funds sold
2. Securities purchased under agreement to resell
3. All loans maturing within a given time frame
4. All securities maturing within a given time frame
5. Principal payments on all securities that are to be received using current prepayment speed assumptions
6. Principal payments on all loans that are to be received (including the impact of expected prepayments if deemed to be significant)
7. All loans with floating interest rates, and when the floating rate can change (with respect to caps and floors) as well as the repricing characteristics of the underlying index
8. All securities with floating interest rates, and when the floating rate can change (with respect to caps and floors) as well as the repricing characteristics of the underlying index.
9. Special attention shall be paid to any assets having embedded options (calls, prepayments, repricing, etc)

XII. RATE SENSITIVE LIABILITIES

- A. Rate sensitive liabilities (RSL) are interest paying deposits or other liabilities that can be repriced (as dictated historically) either up or down in interest rates within a given time frame. The following represent some examples of rate sensitive liabilities:

1. Fed Funds purchased
2. Securities sold under agreement to repurchase
3. Certificates of deposits or other liabilities that are maturing
 - a. A portion of a portion of demand deposits and MMDA accounts are **not** considered core deposits. Bank's management believes that 60% of interest bearing deposit accounts should normally be considered rate sensitive and 40% should normally be considered core or fixed rate.

- b. A portion of savings and NOW accounts are **not** considered core deposits. Bank's management believes that 60% of interest bearing deposit accounts should normally be considered rate sensitive and 40% should normally be considered core or fixed rate.

Items Section 3 (a) and (b) refer to FDICIA Section 305 (Core Deposit Reporting).

4. Other liabilities such as debentures, term loans, and other floating rate deposits that can be repriced
5. Deposit accounts will be rate sensitive only if historical trends dictate

XIII. GAP MANAGEMENT

A. The Bank's gap and interest rate exposure is compiled and reviewed on a _____ basis. The GAP reports will be used to measure risk to net interest income arising from the repricing of assets and liabilities over time. The Bank will focus on net repricing imbalances (RSA - RSL) in the 90, 180, and 365-day cumulative time frames, while measuring the risk based upon the size of the repricing balances, how long the repricing imbalances remain open, and potential movements in interest rates. While the GAP reports will be used to indicate the timing and sources of interest rate risk, it is understood that maintaining a balanced position for all time periods in a GAP report does not ensure immunity from interest rate risk. The Bank will take into account the following limitations of GAP reporting:

1. Interest rates on assets and liabilities do not always move in the same magnitude or velocity
2. Significant risk may be hidden in the repricing time frames of the GAP report
3. Option features of many deposit instruments and loans are not readily determinable
4. Exposures arising from new business generally are not captured.
5. Repriceable investments/funds may roll off at rates significantly different from current rates

For purposes of further assessing the bank's rate sensitivity position, a supplemental gap analysis may be performed utilizing the FDICIA Section 305 time bands for non-maturity deposits as follows:

DDA's and MMDA's: 60% within one year and 40% in one to three years.

Savings and NOW accounts: 60% within three years and 40% in three to five years

B. To address the limitations of GAP reports, the bank will concentrate on simulation modeling.

XIV. SIMULATION

A. The focus of simulation is to measure risk to net income by projecting the future composition of the bank and applying different interest rate scenarios. Simulation modeling will be incorporated to run "what if" analyses to determine the effect of different strategies on the bank's risk profile and profitability.

- B. In using simulation, the Bank will consider the varying interest rate spreads (Basis Risk) between deposits, CD rates, loans, investments, etc. The impact of prepayment rates on loans and mortgage securities, interest rate caps and floors, and other options will also be taken into account. Further, management will carefully assess and document the assumptions underlying the simulations including anticipated management reaction to a rise or decline in interest rates or changes in the yield curve.
- C. While simulation can adequately assess short term (1-2 years) interest rate risk, the Bank will not rely on this analysis to capture and isolate the risks associated with longer term repricing imbalances. Subjective analysis of the balance sheet and duration analysis of the investment portfolio will be utilized to evaluate long term fixed-rate positions.

XV. RISK LIMITS (One-Year Time Frame):

- 1. Rate Sensitive Assets/Rate Sensitive Liabilities _____to_____%
- 2. Gap (RSA - RSL)/Total Assets Less than _____%
- 3. Gap/Equity Less than _____%

- B. Adherence to the limits should only be maintained to the extent that exposure to interest rate risk is minimized. Attention should be focused on the change in net interest income. Limits will be based on definition of Rate Sensitive Liabilities and in accordance with FIDICIA Section 305 (Core Deposit Reporting).
- C. To control risk, limits should be established for the risk to earnings arising from mismatches between the repricing of assets and liabilities. Limits on "GAP" mismatches are best expressed in terms of net interest income at risk under various interest rate scenarios.

XVI. INTEREST RATE RISK LIMITS

<u>1 Year Change in Market Rates</u>	<u>Net Interest Change As a Percent of Net Interest Income</u>
+300 basis points	>-20%
+200 basis points	>- 20%
+150 basis points	>-15%
+100 basis points	>1-2.5%
-0-	>-10%
-100 basis points	>-12.5%
-150 basis points	>-15%
-200 basis points	>-20%
-300 basis points	>-20%

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XVII. ECONOMIC VALUE

If (1) aggregate rate sensitive assets or aggregate rate sensitive liabilities projected to reprice beyond two years exceed 20% of total assets, or (2) the Bank owns any off-balance derivatives or contracts (including swaps, futures and options) or (3) the total of a) CMO's failing the FFIEC high risk tests, b) agency or corporate structured notes which have projected price volatility greater than 17% for a +/-300 basis point rate change, c) callable securities having a remaining maturity longer than seven years, and d) fixed rate loans having a remaining final maturity longer than seven years, exceed 20% of total assets, then the bank shall maintain the following risk limits for interest rate shocks to fair value of equity:

Change in Interest Rates

Change in the Fair Value of Equity

+300 basis points	_____%
+200 basis points	_____%
+100 basis points	_____%
-0-	_____%
-100 basis points	_____%
-200 basis points	_____%
-300 basis points	_____%

XVIII. INVESTMENT PORTFOLIO DEPRECIATION LIMITS (As Measured by Duration)

Refer to Investment Policy for Portfolio Depreciation Limits.

XIX. CAPITAL ADEQUACY

- A. The Bank will maintain a primary capital to asset ratio of not less than 7% and an equity capital to asset ratio of not less than 6%. Further, the ALCO Committee will ensure that the Bank's capital levels based on Risk-Based Capital guidelines will be maintained at a minimum of 10% of risk-weighted assets. The Committee shall use its best efforts to ensure that the Bank's Total Risk Based Capital ratio, Tier 1 Risk Based Capital ratio and Tier 1 Leverage Ratio are maintained at levels which will afford the Bank "Well Capitalized" status for the purposes of FDIC deposit insurance premiums (presently 10.0%, 6.0% and 5.0% respectively). See Exhibit 1 to this policy for description of classes of capital for regulatory purposes.

XX. ASSET ALLOCATION / STRATEGIES

- A. Interest rate risk will be managed through (1) investments (2) loan pricing, and (3) deposit pricing. Asset/Liability policies and strategies will be formulated upon the examination of how interest rate risk affects overall business risk, i.e., capital risk, and liquidity risk, credit risk, interest rate risk. After review of the current situation, the ALCO will devise various strategies to minimize risk while maximizing earnings and net worth. The following methods for managing the asset/liability mix will be reviewed:
1. Buying and selling assets
 2. Changing liability structure and mix
 3. Balance sheet growth, structure, and maturity
 4. Hedging
- B. The proper strategy will depend on the current level of risk, the time frame, and the current interest rate environment. If the Bank determines that there is a good chance that interest rates will increase, an attempt will be made to extend fixed-rate liabilities to longer maturities while purchasing variable rate assets in order to widen the net interest margin. If it is perceived that interest rates will decline, an attempt will be made to shorten fixed rate liabilities while securing

longer term fixed-rate assets in order to increase the net interest margin. Asset maturities will be managed as a result of the liability structure to maintain compliance within the ranges detailed.

XXI. DIVIDENDS

- A. Actual dividend payout, as a percentage of net income, will be determined by the capital position relative to loans, deposits, total assets, and projected growth trends.

XXII. TAX POSITION

- A. The tax position of _____ Bank of _____ will be managed to provide maximum benefit to shareholders on a consistent basis. The ALCO Committee will review monthly the estimated tax situation to determine the usefulness of tax-exempt securities, leases, and other legitimate tax shelters.

XXIII. LOAN PARTICIPATIONS

- A. The ALCO Committee will ensure that adequate sources of liquidity are available through loan participations should the need arise. The Committee will review the levels of loan participations purchased and sold on a quarterly basis.
- B.

XXIV. OTHER SHORT-TERM BORROWINGS

- A. The Committee will select and utilize other short-term borrowing sources (such as the Federal Reserve Bank or the Federal Home Loan Bank) as appropriate. The decision for utilization will be based on the needs of the Bank, alternative sources, the profitability of usage as well as the requirements or conditions in accessing these funding sources.

XXV. MARK-TO-MARKET TAXATION --I.R.C. SEC. 475

Refer to Investment Policy

XXVI. PROVISIONS FOR EXCEPTIONS

- A. In those situations where it seems prudent to act contrary to this policy, and when it is impossible for the entire ALCO Committee to convene, two members of the ALCO, one of whom should be a member of the Board of Directors, may act for the entire Committee. This policy is intended to

be flexible to deal with rapidly changing conditions; any variations from policy shall be reported at the next Board of Directors' meeting with recommendations for approval and amendment.

Adopted:
The Board of Directors

_____ Bank

By: _____

Attest:

By: _____
Secretary

EXHIBIT 1

CLASSIFICATION OF CAPITAL

CORE CAPITAL (Tier 1)

Includes: Common stockholders' equity (common stock, undivided profits, retained earnings, surplus, etc.)

Non-cumulative perpetual preferred stock

Minority interest in consolidated subsidiaries

Excludes: Goodwill and other ineligible intangibles

Excess qualifying intangibles

SUPPLEMENTARY CAPITAL (Tier 2)

(limit: 100% of core capital)

Includes: Cumulative perpetual preferred stock

Auction rate preferred stock

Limited life preferred stock (subject to limitations)

Mandatory convertible debt

Term subordinated debt (subject to limitations)

Allowance for loan and lease losses (subject to limitations)

TOTAL CAPITAL

Total capital equals the sum of core (Tier 1) and supplementary (Tier 2) capitals.

CAPITAL LEVELS FOR EACH CAPITAL CATEGORY

	Total RBC Ratio	Tier 1 RBC Ratio	Tier 1 Leverage Ratio
Well Capitalized (1)	\$10.0	\$6.0	\$5.0
Adequately Capitalized	\$8.0	\$4.0	\$4.0 (2)
Under Capitalized	+8.0	+4.0	+4.0 (2)
Significantly Under	+6.0	+3.0	+3.0
Critically Under	-	-	#2.0

(1) Additionally, banks must not be under a capital order or directive

(2) 3.0 for 1 rated banks

Revised July 14, 1997