

Digital Federal Credit Union and Subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2010 and 2009

Digital Federal Credit Union and Subsidiaries

CONSOLIDATED FINANCIAL STATEMENTS Years Ended December 31, 2010 and 2009

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INDEPENDENT AUDITOR'S REPORT

Supervisory Committee
Digital Federal Credit Union and Subsidiaries
Marlborough, Massachusetts

We have audited the accompanying consolidated statements of financial condition of Digital Federal Credit Union (a federally chartered credit union) and Subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, comprehensive income, members' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Credit Union's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Digital Federal Credit Union and Subsidiaries as of December 31, 2010 and 2009, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

March 25, 2011
Boston, Massachusetts

Digital Federal Credit Union and Subsidiaries

Consolidated Statements of Financial Condition

December 31, 2010 and 2009

(In Thousands)

	<u>2010</u>	<u>2009</u>
ASSETS		
Cash and cash equivalents	\$ 266,121	\$ 351,689
Investments:		
Trading	21,107	40,063
Other	46,909	46,932
Loans held-for-sale	7,975	19,657
Loans, net	3,168,548	3,340,033
Accrued interest receivable	13,838	14,718
Property and equipment, net	54,602	58,659
National Credit Union Share Insurance Fund deposit	30,142	33,558
Other assets	41,682	32,556
	<u>3,650,924</u>	<u>3,937,865</u>
Total assets	\$ 3,650,924	\$ 3,937,865
LIABILITIES AND MEMBERS' EQUITY		
Liabilities:		
Members' shares	\$ 3,109,157	\$ 3,328,234
Borrowed funds	241,243	314,844
Accrued expenses and other liabilities	33,112	29,564
Total liabilities	<u>3,383,512</u>	<u>3,672,642</u>
Commitments and contingent liabilities		
Members' equity:		
Retained earnings, substantially restricted	270,537	268,059
Accumulated other comprehensive loss	(3,125)	(2,836)
Total members' equity	<u>267,412</u>	<u>265,223</u>
	<u>\$ 3,650,924</u>	<u>\$ 3,937,865</u>
Total liabilities and members' equity	\$ 3,650,924	\$ 3,937,865

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

Digital Federal Credit Union and Subsidiaries

Consolidated Statements of Income

Years Ended December 31, 2010 and 2009

(In Thousands)

	2010	2009
Interest income:		
Loans	\$ 187,557	\$ 217,769
Investments and cash equivalents	1,077	1,127
Total interest income	<u>188,634</u>	<u>218,896</u>
Interest expense:		
Members' shares	25,145	58,467
Borrowed funds	13,592	15,526
Total interest expense	<u>38,737</u>	<u>73,993</u>
Net interest income	149,897	144,903
Provision for loan losses	<u>92,600</u>	88,755
Net interest income after provision for loan losses	<u>57,297</u>	56,148
Noninterest income:		
Service charges and other fees	16,120	17,359
Interchange income	14,603	13,665
Net gain on sales of loans	913	8,970
Impairment loss on capital investment in a corporate credit union	-	(3,500)
Recapitalization gain on National Credit Union Share Insurance Fund deposit	-	20,924
Loss on early termination of borrowed funds	-	(7,265)
Other noninterest income	1,582	7,445
Total noninterest income	<u>33,218</u>	<u>57,598</u>
Net income before noninterest expenses	<u>90,515</u>	113,746
Noninterest expense:		
Salaries and benefits	39,693	40,687
Operations	25,689	29,199
Occupancy	14,582	13,620
Impairment loss on National Credit Union Share Insurance Fund deposit and members insurance premium	8,073	25,958
Total noninterest expense	<u>88,037</u>	<u>109,464</u>
Net income	<u>\$ 2,478</u>	<u>\$ 4,282</u>

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

Digital Federal Credit Union and Subsidiaries

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2010 and 2009

(In Thousands)

	<u>2010</u>	<u>2009</u>
Net income	\$ 2,478	\$ 4,282
Other comprehensive income:		
Defined benefit plan net costs and losses	<u>(289)</u>	<u>283</u>
Comprehensive income	<u>\$ 2,189</u>	<u>\$ 4,565</u>

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

Digital Federal Credit Union and Subsidiaries

Consolidated Statements of Members' Equity
 Years Ended December 31, 2010 and 2009
 (In Thousands)

	Retained Earnings			Accumulated Other Comprehensive Income (Loss)
	Regular Reserve	Unappropriated	Total	
Balance, December 31, 2008	\$ 88,277	\$ 175,500	\$ 263,777	\$ (3,119)
Net income	-	4,282	4,282	-
Defined benefit plan net costs and losses	-	-	-	283
Appropriations	8,050	(8,050)	-	-
Balance, December 31, 2009	96,327	171,732	268,059	(2,836)
Net income	-	2,478	2,478	-
Defined benefit plan net costs and losses	-	-	-	(289)
Appropriations	3,900	(3,900)	-	-
Balance, December 31, 2010	\$ 100,227	\$ 170,310	\$ 270,537	\$ (3,125)

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

Digital Federal Credit Union and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended December 31, 2010 and 2009

(In Thousands)

	2010	2009
Operating activities:		
Net income	\$ 2,478	\$ 4,282
Adjustments to reconcile net income to net cash provided by operating activities:		
Capitalization of servicing assets	(730)	(4,512)
Amortization of servicing assets	2,665	2,557
Provision for loan losses	92,600	88,755
Net gain on sales of loans	(913)	(8,970)
Proceeds from sales of loans	98,595	415,078
Loans originated for sale	(86,000)	(421,071)
Depreciation and amortization	5,875	5,978
Impairment loss on capital investment in a corporate credit union	-	3,500
Impairment loss on National Credit Union Share Insurance Fund deposit	-	20,924
Recapitalization gain on National Credit Union Share Insurance Fund deposit	-	(20,924)
Net change in:		
Accrued interest receivable	880	1,543
Other assets	(11,061)	(2,602)
Accrued expenses and other liabilities	3,259	(8,566)
Net cash provided by operating activities	<u>107,648</u>	<u>75,972</u>
Investing activities:		
Net change in trading investments	18,956	(40,063)
Net change in other investments	23	-
Net change in loans	78,885	568,237
Decrease (increase) in the National Credit Union Share Insurance Fund deposit	3,416	(5,461)
Purchases of property and equipment	(1,818)	(1,798)
Net cash provided by investing activities	<u>99,462</u>	<u>520,915</u>
Financing activities:		
Repayment of borrowed funds	(73,601)	(378,466)
Net change in members' shares	(219,077)	(166,076)
Net cash used in financing activities	<u>(292,678)</u>	<u>(544,542)</u>
Increase (decrease) in cash and cash equivalents	(85,568)	52,345
Cash and cash equivalents, beginning of year	<u>351,689</u>	<u>299,344</u>
Cash and cash equivalents, end of year	<u>\$ 266,121</u>	<u>\$ 351,689</u>
Supplemental cash flow information:		
Foreclosed assets acquired in settlement of loans	<u>\$ 18,734</u>	<u>\$ 4,237</u>
Dividends paid on members' shares and interest paid on borrowed funds	<u>\$ 40,690</u>	<u>\$ 77,360</u>

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

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Digital Federal Credit Union (the Credit Union) is a cooperative association holding a corporate charter under the provisions of the Federal Credit Union Act. Participation in the Credit Union is limited to those individuals who qualify for membership as defined in the Credit Union's Charter and Bylaws.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Credit Union and its subsidiaries, Financial Vision, LLC, organized for the purpose of software development, DCU Financial Insurance, LLC, which provides financial services to members and DCU Realty, LLC, which provides brokerage services to members in Massachusetts. All significant intercompany balances and transactions have been eliminated in consolidation.

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 to the consolidated financial statements are to *The FASB Accounting Standards Codification*TM commonly referred to as the Codification or ASC.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses and the fair value of financial instruments.

Subsequent Events

The Credit Union has evaluated subsequent events through March 25, 2011, the date on which the consolidated financial statements were available to be issued.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

Concentrations of Credit Risk

Most of the Credit Union's business activity is with its members who reside in or are employed in the Northeastern part of the United States of America. The Credit Union may be exposed to credit risk from a regional economic standpoint, since a significant concentration of its borrowers work or reside in the Northeastern part of the United States of America. However, the loan portfolio is well-diversified and the Credit Union does not have any significant concentrations of credit risk except unsecured loans, which by their nature increase the risk of loss compared to those loans that are collateralized. The Credit Union's policy for repossessing collateral is that when all other collection efforts have been exhausted, the Credit Union enforces its first lien holder status and repossesses the collateral. Repossessed collateral normally consists of vehicles and real estate.

In addition, the ongoing financial deterioration resulting from the general economic conditions of the Credit Union's market area have yielded significant loan losses for the Credit Union and those with whom it does business, including other financial institutions and corporate credit unions. Management continues to monitor the Credit Union's operations for potential impairment and other accounting consequences.

Fair Value

The Codification defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurement. Fair value is a market-based measurement, not an entity-specific measurement, and the hierarchy gives the highest priority to quoted prices in active markets. Fair value measurements are disclosed by level within the fair value hierarchy.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Valuation techniques are to be consistent with the market approach, the income approach and/or the cost approach. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

In that regard, the Codification establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- 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 reporting entity's own assumptions about the assumptions that market participants would be used in pricing an asset or liability

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

Fair Value...continued

A summary of the Credit Union's financial instruments, including methodologies and resulting values, is discussed in Note 14 to these consolidated financial statements.

Cash and Cash Equivalents

For the purpose of the consolidated statements of financial condition and the consolidated statements of cash flows, cash and cash equivalents includes 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.

Investments

Trading investments are carried at fair value, with realized and unrealized gains and losses recorded in other noninterest income. Other investments are classified separately and are stated at cost. If such investments are deemed to be impaired, the recorded cost is reduced by the amount of impairment.

In determining whether investments other-than-temporary impairment exists, management considers many factors, including (1) credit losses (which are reflected in earnings as realized losses) or (2) noncredit losses (which are recorded in other comprehensive income). In determining whether other-than-temporary impairment 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 investment 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.

Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Federal Home Loan Bank (FHLB) Stock

The Credit Union, as a member of the FHLB of Boston system, is required to maintain an investment in capital stock of the FHLB. No ready market exists for the FHLB stock and it has no quoted market value.

Derivatives Loan Commitments

The Credit Union enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans to be held for sale are considered to be derivatives. Accordingly, such commitments, on the consolidated statements of financial condition are recorded at fair value, with changes in fair value recorded in the net gain or loss on sale of mortgage loans. Fair value is based on the change in estimated fair value of the underlying mortgage loan. The fair value is subject to change primarily due to changes in interest rates.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

Derivatives Loan Commitments...continued

To hedge the exposure of changes in interest rates impacting the fair value of loans held for sale and related loan commitments, the Credit Union typically enters in to forward sales commitments with its secondary market investors at the time a loan commitment is granted to lock in the ultimate sale and price of the loan. These commitments require the Credit Union to pay a penalty for nonperformance in the event the committed loans are not delivered. As such, these sales commitments are derivative instruments, recorded on the consolidated statements of financial condition at fair value in other assets or liabilities. Changes in fair value are reported in income from mortgage banking operations.

Loans Held for Sale

Loans held for sale are those loans the Credit Union has the intent to sell in the foreseeable future. They are carried at the lower of aggregate cost or market value. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Gains and losses on sales of loans are recognized at settlement dates and are determined by the difference between the sales proceeds and the carrying value of the loans after allocating cost to servicing rights retained. All sales are made without recourse.

Loans, Net

The Credit Union grants mortgage, commercial and consumer loans. The ability of the members to honor their contracts is dependent upon the real estate and general economic conditions of the area.

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 loans is discontinued at the time the loan is 90 days past due, unless the credit is well-secured and in the process of collection. Other personal loans are typically charged off no later than 180 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 that are 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. 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 fee or cost is recognized as an adjustment to interest income using the interest method over the contractual life of the loans, adjusted for estimated prepayments based on the Credit Union's historical prepayment experience.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements

Years Ended December 31, 2010 and 2009

(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred though a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility 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.

The Credit Union's allowance for loan losses is that amount considered adequate to absorb probable losses in the portfolio based on management's evaluations of the size and current risk characteristics of the loan portfolio. Such evaluations consider prior loss experience, the risk rating and the levels of nonperforming loans. 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. General allowances are established for loans that can be grouped into pools based on similar characteristics as required by the Codification. In this process, general allowance factors are based on an analysis of historical charge-off experience and expected losses given default derived from the Credit Union's internal risk rating process. These factors are developed and applied to the portfolio by loan type. The qualitative factors associated with the allowances are subjective and require a high degree of management judgment. These factors include the credit quality statistics, recent economic uncertainty, losses incurred from recent events and lagging data.

Loan Servicing

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. For sales of loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable servicing contracts, when available, or alternatively, is based 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 assets 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.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

Loan Servicing...continued

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. 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. 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 servicing assets is netted against loan servicing fee income.

Property and Equipment

Land is carried at cost. Land improvements, building and improvements, furniture, and equipment and leasehold improvements are carried at cost, less accumulated depreciation and amortization. Building and improvements and 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 terms of the related leases. Construction in progress is carried at cost and will be depreciated using the straight-line method over the estimated useful life of the asset once placed in service.

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 (1) the assets have been isolated from the Credit Union, (2) 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 (3) the Credit Union does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Foreclosed Assets

Assets acquired through foreclosure or other proceedings are initially recorded at fair value at the date of foreclosure less estimated costs of disposal, which establishes a new cost. After foreclosure, valuations are periodically performed by management of the Credit Union and foreclosed assets held for sale and are carried at the lower of cost or fair value less estimated costs of disposal. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for loan losses. Property is evaluated regularly to ensure the recorded amount is supported by its current fair value and valuation allowances to reduce the carrying amount to fair value less estimated costs to dispose are recorded as necessary. Income and expense from the operations of foreclosed assets and changes in the valuation allowance are included net expenses from foreclosed assets.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

National Credit Union Share Insurance Fund (NCUSIF) Deposit and Insurance Premium

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 1 percent of its insured members' shares. The deposit would be refunded to the Credit Union if its insurance coverage is terminated, if it converts its insurance coverage to another source or if management of the fund is transferred from the NCUA Board. The Credit Union is also required to pay an annual insurance premium equal to one-twelfth of 1 percent of total insured members' shares, unless the payment is waived or reduced by the NCUA Board. During the year ended December 31, 2009, the Credit Union recognized an impairment loss and recapitalization gain of \$20,924 to the NCUSIF deposit. The Credit Union recognized member insurance premium assessments of \$8,073 and \$5,034 for the years ended December 31, 2010 and 2009, respectively.

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.

Income Taxes

The Credit Union is exempt, by statute, from federal and state income taxes. Since the Credit Union's subsidiaries are organized as Limited Liability Companies, they effectively pay no taxes.

The Credit Union adopted new Codification guidance on accounting for uncertainty in income taxes for the year ended December 31, 2009. Management evaluated the Credit Union's subsidiaries' tax positions and concluded that the subsidiaries have taken no uncertain tax positions that require adjustment to the consolidated financial statements to comply with the provisions of this guidance. With few exceptions, the Credit Union's subsidiaries are no longer subject to income tax examinations by the U.S. federal, state or local tax authorities for years before 2010.

Defined Benefit Plan

The Credit Union has a qualified, noncontributory defined benefit pension plan covering certain employees. The Credit Union's policy is to fund an amount in excess of the minimum amount required under ERISA.

Defined Contribution Plan

The Credit Union has established a contributory 401(k) plan for qualified employees. The Credit Union's policy is to fund contributions as accrued.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES...continued

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 the defined benefit plan net costs and losses, are reported as a separate component of members' equity on the consolidated statements of financial condition.

Reclassifications

Certain account reclassifications have been made to the 2009 consolidated financial statements in order to conform to classifications used in the current year.

Recent Accounting Pronouncements

In July 2010, the FASB issued additional guidance on improving disclosure about credit quality of financing receivables and allowance for credit losses. The guidance requires more robust and disaggregated disclosures about the credit quality and risk exposure of financing receivables and credit reserves. The expanded disclosures for nonpublic entities are effective for fiscal years ending on or after December 15, 2011. The Credit Union is currently evaluating the future impact of the Codification on improving disclosure about credit quality of financing receivables and allowance for credit losses on the Credit Union's consolidated financial position, results of operations or cash flows.

In January 2010, the FASB issued additional guidance on improving disclosures about fair value measurements. The guidance describes amendments that require new disclosures and clarify existing disclosure requirements about fair value measurement. These requirements will be effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Credit Union is currently evaluating the future impact of the Codification on improving disclosure about fair value measurements on the Credit Union's consolidated financial position, results of operations or cash flows.

2. INVESTMENTS

Investments classified as trading consist of Trust for Credit Unions Short Duration Government Portfolio funds amounting to \$21,107 and \$40,063 as of December 31, 2010 and 2009, respectively.

Other investments consist of the following:

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
FHLB of Boston stock	\$ 44,218	\$ 44,218
Paid-in capital account in a corporate credit union	1,477	1,500
Other	<u>1,214</u>	<u>1,214</u>
	<u>\$ 46,909</u>	<u>\$ 46,932</u>

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
Years Ended December 31, 2010 and 2009
(In Thousands)

2. INVESTMENTS...continued

FHLB of Boston stock, paid-in capital and other investment accounts have no contractual maturity.

The Credit Union views its investments in the FHLB of Boston stock and in the paid-in capital account in a corporate credit union as long-term investments. Accordingly, when evaluating for impairment, the value is determined based on the ultimate recoverability of the par value rather than recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability is influenced by factors such as (1) the significance of the decline in net assets of the institution as compared to the investment amount and length of time a decline has persisted, (2) impact of legislative and regulatory changes on the institution, and (3) the liquidity position of the institution.

The Credit Union does not believe that its investment in the FHLB of Boston stock is impaired as of this date. However, this estimate could change in the near term by the following: (1) significant other-than-temporary losses are incurred on the FHLB of Boston's mortgage-backed securities causing a significant decline in their regulatory capital status, (2) the economic losses resulting from credit deterioration on the FHLB of Boston's mortgage-backed securities increases significantly, and (3) capital preservation strategies being utilized by the FHLB of Boston become ineffective.

As of December 31, 2010, the Credit Union does not believe that its investment in paid in capital account in a corporate credit union is impaired. However, during the year ended December 31, 2009, the Credit Union recorded an impairment loss on this investment in the amount of \$3,500.

3. LOANS, NET

Loans consist of the following:

	December 31,	
	2010	2009
Mortgage loans:		
Fixed rate	\$ 649,450	\$ 474,510
Home equity, fixed and variable rate	228,797	294,108
Variable rate	4,527	4,935
Hybrid	514,871	596,435
Home equity line of credit, variable rate	437,111	497,479
Construction commercial	12,814	14,935
Commercial real estate	<u>338,889</u>	<u>326,574</u>
	2,186,459	2,208,976
Vehicle loans	670,467	800,604
Commercial loans	23,862	35,233
Credit card loans, unsecured	313,161	330,256
Other consumer loans	<u>67,200</u>	<u>40,431</u>
	3,261,149	3,415,500
Deferred net loan origination costs	12,348	14,686
Allowance for loan losses	<u>(104,949)</u>	<u>(90,153)</u>
	<u>\$ 3,168,548</u>	<u>\$ 3,340,033</u>

Digital Federal Credit Union and Subsidiaries

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3. LOANS, NET...continued

The Credit Union offers nontraditional mortgage loans to its members. These loans include hybrid loans that consist of loans that are fixed for an initial period of three, five, seven or 10 years. After this period, the mortgages are converted to variable rate using the fully indexed rate, which can result in significant payment shock to the borrower.

Nontraditional mortgage loans may have significantly different credit risk characteristics than traditional fixed and variable rate mortgages. However, the Credit Union believes it has established prudent underwriting standards as well as adequate risk management functions to monitor these additional risks.

A loan is considered impaired, in accordance with the impairment accounting guidance in the Codification, when based on current information and events, it is probable that the Credit Union will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include loans delinquent more than 90 days, loans modified and loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan and payment extensions.

Information about impaired loans as of and for the years ended December 31, are as follows:

	<u>2010</u>	<u>2009</u>
Impaired loans without an allowance	\$ 26,371	\$ 40,698
Impaired loans with an allowance	<u>117,221</u>	<u>118,587</u>
Total impaired loans	<u>\$ 143,592</u>	<u>\$ 159,285</u>
Allowance for impaired loans	<u>\$ 35,526</u>	<u>\$ 41,984</u>
Average recorded investment in impaired loans	<u>\$ 154,141</u>	<u>\$ 109,366</u>
Average individual loan balances held	<u>\$ 97</u>	<u>\$ 120</u>

Impaired loans with an allowance include approximately \$71,534 and \$45,134 of restructured loans at December 31, 2010 and 2009, respectively.

Loans on which accrual of interest has been discontinued or reduced amounted to \$67,746 and \$93,960 at December 31, 2010 and 2009, respectively. For the years ended December 31, 2010 and 2009, interest collected on impaired loans for the period of impairment was not significant. There were no loans past due more than 90 days for which interest accrual continued.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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3. LOANS, NET...continued

The following is an analysis of the allowance for loan losses:

	December 31,	
	2010	2009
Balance, beginning of year	\$ 90,153	\$ 48,230
Provision for loan losses	92,600	88,755
Recoveries	1,544	1,079
Loans charged off	<u>(79,348)</u>	<u>(47,911)</u>
Balance, end of year	<u>\$ 104,949</u>	<u>\$ 90,153</u>

The allowance for loan losses is considered by the Credit Union as adequate to cover probable losses inherent in the loan portfolio at December 31, 2010. However, no assurance can be given that the Credit Union, 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.

4. LOAN SERVICING

Loans serviced for others are not included in the accompanying consolidated statements of financial condition. The unpaid principal balances of these loans at 2010 and 2009, are summarized as follows:

	December 31,	
	2010	2009
Mortgage loans serviced for Federal Home Loan Mortgage Corporation	\$ 883,967	\$ 1,034,199
Mortgage loans serviced for Federal National Mortgage Association	24,069	31,835
Mortgage loans serviced for FHLB	668	876
Vehicle loans serviced for others	<u>5,957</u>	<u>10,956</u>
	<u>\$ 914,661</u>	<u>\$ 1,077,866</u>

Custodial escrow balances maintained in connection with the foregoing loan servicing, and included in members' shares, were approximately \$4,285 and \$4,248 at December 31, 2010 and 2009, respectively.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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4. LOAN SERVICING...continued

A summary of the changes in the balance of servicing assets, classified as other assets, are as follows:

	December 31,	
	2010	2009
Balance, beginning of year	\$ 9,375	\$ 7,420
Capitalization of servicing assets	730	4,512
Amortization of servicing assets	<u>(2,665)</u>	<u>(2,557)</u>
Balance, end of year	<u>\$ 7,440</u>	<u>\$ 9,375</u>
Fair value	<u>\$ 7,800</u>	<u>\$ 9,600</u>

Significant assumptions used in the calculation of fair value of servicing assets include a discount rate of 7.56 percent and 8.01 percent at December 31, 2010 and 2009, respectively, and a weighted average prepayment speed assumption of 296 and 291 at December 31, 2010 and 2009, respectively.

5. PROPERTY AND EQUIPMENT, NET

Property and equipment are summarized as follows:

	December 31,	
	2010	2009
Land and improvements	\$ 10,061	\$ 10,061
Building and improvements	51,022	49,996
Furniture and equipment and leasehold improvements	28,208	27,588
Construction in progress	<u>46</u>	<u>71</u>
	89,337	87,716
Accumulated depreciation and amortization	<u>(34,735)</u>	<u>(29,057)</u>
	<u>\$ 54,602</u>	<u>\$ 58,659</u>

The Credit Union leases various branches. The operating leases contain renewal options and provisions requiring the Credit Union to pay property taxes and operating expenses over base period amounts. 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, 2010, are as follows:

Years Ending December 31,	
2011	\$ 2,262
2012	1,965
2013	1,678
2014	1,281
2015	1,068
Subsequent years	<u>4,094</u>
	<u>\$ 12,348</u>

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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5. PROPERTY AND EQUIPMENT, NET...continued

Rental expense for the years ended December 31, 2010 and 2009, for all facilities leased under operating leases totaled \$3,046 and \$2,881, respectively.

6. FORECLOSED ASSETS

Assets acquired through foreclosure or other proceedings amounted to \$17,400 and \$3,045 at December 31, 2010 and 2009, respectively. At December 31, 2010 and 2009, there were no valuation allowances on foreclosed assets. During the years ended December 31, 2010 and 2009, the Credit Union incurred expenses related to foreclosed assets in the amount of \$1,117 and \$1,342, respectively.

7. MEMBERS' SHARES

Members' shares are summarized as follows:

	December 31,	
	2010	2009
Regular shares	\$ 543,281	\$ 465,704
Share draft accounts	707,551	651,630
Money market accounts	890,493	857,697
Individual retirement accounts	32,121	28,032
Certificates	<u>935,711</u>	<u>1,325,171</u>
	<u>\$ 3,109,157</u>	<u>\$ 3,328,234</u>

Shares by maturity as of December 31, 2010, are summarized as follows:

No contractual maturity	\$ 2,173,446
0-1 year maturity	667,662
1-2 years maturity	137,874
2-3 years maturity	47,440
3-4 years maturity	23,158
4-5 years maturity	<u>59,577</u>
	<u>\$ 3,109,157</u>

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

The NCUSIF insures members' shares and certain individual retirement and Keogh accounts. In July 2010, new legislation permanently provides for an increase in the minimum NCUSIF coverage from \$100 to \$250 on all member share accounts.

The aggregate amount of certificates in denominations of \$100 or more at December 31, 2010 and 2009, is approximately \$260,139 and \$338,421, respectively.

Digital Federal Credit Union and Subsidiaries

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8. BORROWED FUNDS

The Credit Union utilizes a demand loan agreement with the FHLB of Boston. The terms of the agreement call for pledging a portion of the Credit Union's mortgage portfolio, which as of December 31, 2010 and 2009, amounted to approximately \$821,834 and \$806,434, respectively. The agreement provides for a maximum borrowing amount determined on a continual basis by the Credit Union and the FHLB. At December 31, 2010 and 2009, there were advances of \$241,243 and \$314,844, respectively, outstanding with interest rates ranging from 3.77 percent and 4.15 percent and with maturities all during the year ending December 31, 2013.

The Credit Union utilizes a demand loan agreement with a corporate credit union. The terms of this agreement call for the pledging of certain assets as security for any and all obligations taken by the Credit Union under this agreement. The agreement provides for a credit limit of \$50,000 with interest charged at a rate determined by the lender on a periodic basis. At December 31, 2010 and 2009, there were no borrowings under this agreement. The agreement is reviewed for continuation by the lender and the Credit Union annually.

The Credit Union also has access to an Ideal Way line of credit with the FHLB. The agreement provides for a credit limit of \$1,000 with interest charged at a rate determined by the lender on a periodic basis. At December 31, 2010 and 2009, there were no borrowings under this agreement.

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 that includes 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 consolidated 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 consolidated financial statements.

Outstanding loan commitments at December 31, 2010 and 2009, total approximately \$44,604 and \$22,388, respectively.

Unfunded loan commitments under lines of credit are summarized as follows:

	December 31,	
	2010	2009
Home equity	\$ 494,012	\$ 692,882
Credit card	1,109,572	1,188,705
Commercial	9,497	53,512
Other consumer	22,096	24,953
	<u>\$ 1,635,177</u>	<u>\$ 1,960,052</u>

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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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 commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and 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.

10. COMMITMENTS AND CONTINGENT LIABILITIES

Loan Funding Commitments

As of December 31, 2010 and 2009, the Credit Union had commitments to fund mortgage loans with agreed-upon rates amounting to \$4,906 and \$11,930, respectively.

Forward Sales Commitments

Commitments to sell loans generally have fixed expiration dates or other termination clauses and may require the payment of a fee. The Credit Union may settle the forward sales commitments on a net basis; therefore, the commitments outstanding do not necessarily represent future cash obligations. The Credit Union has \$5,775 and \$14,325 of forward sales commitments outstanding as of December 31, 2010 and 2009, respectively, that will be settled within 90 days of the individual commitment date.

Contingencies

The Credit Union is a 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.

11. EMPLOYEE BENEFITS

Defined Benefit Plan

The Credit Union sponsors a defined benefit pension plan (the Plan) for the benefit of its employees based on years of service. The Plan calls for benefits to be paid to eligible employees at retirement equal to (a) 1.5 percent of their average five-year compensation up to the integration level (as defined), plus (b) a 0.5 percent of their average five-year compensation in excess of the integration level, (c) multiplied by years of service. The maximum number of years of service credited is 20 years. Effective January 31, 2002, the Plan was frozen. Accordingly, the participants ceased to earn additional benefits under the Plan and no additional employees shall become eligible to participate in the Plan.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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11. EMPLOYEE BENEFITS...continued

Defined Benefit Plan...continued

The accrued pension benefit and net pension cost for the years ended December 31, 2010 and 2009, are as follows:

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Benefit obligation	\$ (6,545)	\$ (6,100)
Fair value of plan assets	<u>4,494</u>	<u>4,486</u>
Funded status	<u>\$ (2,051)</u>	<u>\$ (1,614)</u>
Accumulated benefit obligation	<u>\$ 6,545</u>	<u>\$ 6,100</u>

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Assumptions used to determine benefit obligation:		
Discount rate	5.50%	6.00%
Rate of compensation increase	NA	NA

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Net pension cost	\$ 128	\$ 169
Employer contribution	96	14
Plan participants' contributions	-	-
Benefit payments	452	82

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Assumptions used to determine net pension cost:		
Discount rate	6.00%	6.00%
Expected long-term return on Plan assets	8.00%	8.00%
Rate of compensation increase	NA	NA

The 8 percent expected long-term return on plan assets assumption was derived from historical rates of return of stocks, government bonds and 30-day T-bills, assuming a portfolio composed of 55 percent equity securities, 45 percent bonds, and 5 percent cash and cash equivalents.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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11. EMPLOYEE BENEFITS...continued

Defined Benefit Plan...continued

Amounts recognized in the consolidated statements of financial condition consist of:

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Noncurrent assets	\$ -	\$ -
Current liabilities	-	-
Noncurrent liabilities	<u>(2,051)</u>	<u>(1,614)</u>
Net amount recognized	<u>\$ (2,051)</u>	<u>\$ (1,614)</u>

Amounts recognized in accumulated other comprehensive loss consist of:

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Loss	\$ (3,125)	\$ (2,836)
Prior service cost	-	-
Transition obligation	<u>-</u>	<u>-</u>
	<u>\$ (3,125)</u>	<u>\$ (2,836)</u>

The Credit Union's pension plan weighted-average asset allocations by asset category are as follows:

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Common Stocks	24%	20%
Bonds	22%	20%
Mutual Funds	<u>54%</u>	<u>60%</u>
	<u>100%</u>	<u>100%</u>

The Plan's investment policies and strategies are diversified to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. The Plan may employ one or more investment managers of varying styles and philosophies to attain the account's objectives.

Digital Federal Credit Union and Subsidiaries

Notes to Consolidated Financial Statements
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11. EMPLOYEE BENEFITS...continued

Defined Benefit Plan...continued

The Credit Union does not expect to make any contributions into the Plan in 2011.

The following pension benefit payments, which reflect expected future service, as appropriate, are anticipated to be paid as follows for the years ending December 31:

2011	\$	187
2012		194
2013		210
2014		235
2015		270
2016 – 2020		<u>1,797</u>
	<u>\$</u>	<u>2,893</u>

The fair values of the Credit Union's pension plan assets at December 31, 2010, by asset category are as follows:

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash	\$ 16	\$ 16	\$ -	\$ -
Common stock	1,063	1,063	-	-
Mutual funds	2,212	2,212	-	-
Corporate bond	<u>1,203</u>	<u>1,203</u>	-	-
	<u>\$ 4,494</u>	<u>\$ 4,494</u>	<u>\$ -</u>	<u>\$ -</u>

The fair values of the Credit Union's pension plan assets at December 31, 2009, by asset category are as follows:

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash	\$ 9	\$ 9	\$ -	\$ -
Common stock	915	915	-	-
Mutual funds	2,665	2,665	-	-
Corporate bond	<u>897</u>	<u>897</u>	-	-
	<u>\$ 4,486</u>	<u>\$ 4,486</u>	<u>\$ -</u>	<u>\$ -</u>

Defined Contribution Plan

The Credit Union has a defined contribution 401(k) plan that allows employees to defer a portion of their salary into the plan. The Credit Union has the option of making a matching and/or a profit sharing contribution. The total 401(k) plan expense for the years ended December 31, 2010 and 2009, was \$424 and \$389, respectively. The 401(k) plan costs are accrued and funded on a current basis.

Digital Federal Credit Union and Subsidiaries

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11. EMPLOYEE BENEFITS...continued

Incentive Bonuses and Deferred Compensation Plan

The Credit Union has incentive bonuses and deferred compensation agreements with members of the executive management team that provides benefits payable to these employees if they remain employed by the Credit Union for a specified period of time. If these employees become fully disabled as defined in certain agreements, accrued benefits are immediately payable. The benefits are subject to forfeiture if employment is terminated for cause as defined in the agreements. The estimated liability under the agreements is being accrued as defined in the plans over the remaining years.

12. MEMBERS' EQUITY

The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's consolidated financial statements. Under capital adequacy 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 in assets are also required to calculate a Risk-Based Net Worth (RBNW) requirement that 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, 2010 and 2009, were 4.40 percent and 4.38 percent, respectively. The minimum requirement to be considered "complex" under the regulatory framework is 6 percent. Management believes, as of December 31, 2010 and 2009, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2010, 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 are no conditions or events since that notification that management believes have changed the institution's category.

Digital Federal Credit Union and Subsidiaries

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12. MEMBERS' EQUITY...continued

As of December 31, 2009, the NCUA categorized the Credit Union as adequately capitalized under the regulatory framework for prompt corrective action and, therefore, net worth and the regular reserve account must increase quarterly by 0.1 percent of assets.

The Credit Union's actual capital amounts and ratios are presented in the following table:

	December 31, 2010		December 31, 2009	
	Amount	Ratio/ Requirement	Amount	Ratio/ Requirement
Amount needed to be classified as "adequately capitalized"	\$ 219,055	6.00%	\$ 236,272	6.00%
Amount needed to be classified as "well-capitalized"	255,565	7.00%	275,650	7.00%
Actual net worth	270,537	7.41%	268,059	6.81%

Because the RBNW requirement is less than the net worth ratio, the Credit Union retains its original category. Further, in performing its calculation of total assets, the Credit Union used the quarter-end balance option in 2010 and 2009, as permitted by regulation.

13. RELATED-PARTY TRANSACTIONS

In the normal course of business, the Credit Union extends credit to directors, Supervisory Committee members and executive officers. The aggregate loans to related parties at December 31, 2010 and 2009, are approximately \$2,472 and \$3,085, respectively. Deposits from related parties at December 31, 2010 and 2009, amounted to approximately \$1,657 and \$1,568, respectively.

14. FAIR VALUE OF FINANCIAL INSTRUMENTS

As described in Note 1 to the consolidated financial statements, the following methods and assumptions were used by the Credit Union in estimating fair values of financial instruments as disclosed herein:

Cash and Cash Equivalents

The carrying amounts of cash and cash equivalents approximate their fair value.

Investments

Fair values for investments classified as trading are based on quoted market prices. The carrying value of other investments approximate fair value based on the redemption provisions of the underlying investments.

Digital Federal Credit Union and Subsidiaries

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14. FAIR VALUE OF FINANCIAL INSTRUMENTS...continued

Loans, Including Loans Held-for-Sale

For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (for example, one-to-four family residential), credit card loans and other consumer loans are estimated using a discounted cash flow calculation that applies interest rates currently being offered similar loans to a schedule of aggregated expected monthly maturities of these loans. Fair values for business real estate and business loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

For impaired loans, an allowance for loan losses has been calculated based upon the probability the Credit Union is unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Level 3 assets primarily relate to residential and commercial real estate loans. The losses on the Level 3 impaired loans were calculated primarily by models incorporating internally derived discounted cash flow valuations of the collateral.

Loan Servicing

Servicing assets do not trade in an active, open market with readily observable prices. While sales of servicing assets do occur, the precise terms and conditions typically are not readily available. Accordingly, the Credit Union estimates the fair value of servicing assets and certain other retained interests in securitizations using discounted cash flow models incorporating numerous assumptions from the perspective of market participants including servicing income, servicing costs, market discount rates, prepayment speeds and default rates. Due to the nature of the valuation inputs, servicing assets are classified within Level 3 of the valuation hierarchy.

Foreclosed Assets

Foreclosed assets represent property acquired as the result of borrower defaults on loans. Foreclosed assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure. Write-downs occurring at foreclosure are charged against the allowance for loan losses. On an ongoing basis, foreclosed assets are appraised as required by market indications and applicable regulations. Write-downs are provided for subsequent declines in value and are included in other non-interest expense along with other expenses related to maintaining the foreclosed assets.

Accrued Interest Receivable

Accrued interest receivable represents interest on loans and investments. The carrying amount of accrued interest receivable approximates fair value.

Digital Federal Credit Union and Subsidiaries

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14. FAIR VALUE OF FINANCIAL INSTRUMENTS...continued

Members' Shares

The fair values disclosed for regular share, share draft and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of regular share, share draft and money market accounts approximate their fair values at the reporting date. Fair values for share certificates are estimated using a discounted cash flow calculation that applies interest rates currently being offered on share certificates to a schedule of aggregated expected monthly maturities on the Credit Union's current share certificates.

Borrowed Funds

The fair values of the Credit Union's borrowed funds are estimated using discounted cash flow analyses based on the Credit Union's incremental borrowing rates for similar types of borrowing arrangements.

Off-Balance Sheet Credit-Related Instruments

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value for such financial instruments is nominal.

Fair Value on a Recurring Basis

The table below presents the balances of assets measured at fair value on a recurring basis.

	December 31, 2010			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments, trading	\$ 21,107	\$ 21,107	\$ -	\$ -

	December 31, 2009			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments, trading	\$ 40,063	\$ 40,063	\$ -	\$ -

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14. FAIR VALUE OF FINANCIAL INSTRUMENTS...continued

Fair Value on a Nonrecurring Basis

Certain assets are measured at fair value on a nonrecurring basis; that is, 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). The following table presents the assets carried on the consolidated statements of financial condition by caption and by level within the valuation hierarchy for which a nonrecurring change in fair value has been recorded.

	Carrying Value at December 31, 2010				Year Ended December 31, 2010
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Net (Income) Expense</u>
Loans, impaired	\$ 108,066	\$ -	\$ -	\$ 108,066	\$ (6,458)
Foreclosed assets	17,400	-	17,400	-	1,117

	Carrying Value at December 31, 2009				Year Ended December 31, 2009
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Net (Income) Expense</u>
Loans, impaired	\$ 117,301	\$ -	\$ -	\$ 117,301	\$ 27,354
Foreclosed assets	3,045	-	3,045	-	1,342

Financial Instruments

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

	December 31, 2010		December 31, 2009	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Financial assets:				
Cash and cash equivalents	\$ 266,121	\$ 266,121	\$ 351,689	\$ 351,689
Investments, trading	21,107	21,107	40,063	40,063
Investments, other	46,909	46,909	46,932	46,932
Loans held-for-sale	7,975	7,975	19,657	19,657
Loans, net	3,168,548	3,172,132	3,340,033	3,312,521
Accrued interest receivable	13,838	13,838	14,718	14,718
Financial liabilities:				
Members' shares	3,109,157	3,057,771	3,328,234	3,228,985
Borrowed funds	241,243	257,464	314,844	328,065