



BASEL III PILLAR 3 DISCLOSURES

December 31, 2021

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HomeEquity Bank
Basel III Pillar 3 Disclosures
December 31, 2021

Table 1. Scope of application

HomeEquity Bank (the Bank) is a federally regulated Schedule I bank, incorporated and domiciled in Canada. The Bank's main business is to originate and administer reverse mortgages. The Bank also issues guaranteed investment certificates and through its principal subsidiary, medium-term debt to fund its mortgage portfolio. The Bank is a wholly owned subsidiary of HOMEQ Corporation (HOMEQ), a private company. HOMEQ is wholly owned by Birch Hill Equity Partners Management Inc., which is the ultimate parent of the Bank. The Bank's principal subsidiary is CHIP Mortgage Trust. All of the Bank's subsidiaries are directly or indirectly wholly owned.

Basis of preparation

This document represents the Basel III Pillar 3 disclosures for the Bank. These disclosures are made pursuant to the Office of the Superintendent of Financial Institutions (OSFI) requirements, which are based on global standards established by the Bank of International Settlements, Basel Committee on Banking Supervision (BCBS).

The amounts disclosed in this document are based on the Bank's annual and interim consolidated financial statements, which reflect the financial position and results of operations of the Bank consolidated with the financial position and results of operations of its subsidiaries. The interim consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), including the accounting requirements specified by OSFI, and reflect, where necessary, management's best estimates and judgments. This report is unaudited.

Risk Management

The Board of Directors (Board) has developed and approved a Capital Management Policy (CMP) in accordance with the Board-approved Risk Appetite Framework (RAF). The Policy addresses minimum regulatory capital requirements as prescribed by regulators and internal capital targets as per the Board-approved RAF, which allows for the appropriate allocation of capital to meet the Bank's strategic goals. The CMP dictates that capital be adequately maintained by the Bank.

Adherence to the CMP ensures that the Bank has sufficient capital to maintain its operations based on current activities, expected future business developments and the possibility of various disruptive or adverse scenarios based on the Bank's stress testing program. Such stress testing scenarios include periods of economic downturn and/or asset re-pricing. In addition, in accordance with the Bank's annual strategic planning, a 3-year forecast is prepared and provides guidance as to the type and extent of capital that will be required over this period of time.

The Bank's Asset Liability Committee (ALCO) ensures adherence to the policy on at least a monthly basis and the Conduct Review and Risk Management Committee (CRRMC) of the Board ensures capital management in accordance with the Policy. The CRRMC meets at least three times a year.

Table 1. Scope of application (continued)

Risk Management (continued)

The Bank uses the annual Internal Capital Adequacy Assessment Process (ICAAP) to determine the quantity and quality of capital to conduct its business activities. In preparing the ICAAP, the high-risk areas established in the Enterprise Risk Management Framework (ERMF) are subject to stress testing which incorporates assumptions established in the annual strategic planning process. The results of the stress tests help to determine the quantum of capital required to enable management and the Board to set capital levels consistent with the Board-approved RAF.

The Bank's CRRMC is responsible for overseeing the types of risk to which the Bank may be exposed, and the techniques and systems used to identify, measure, monitor, report on and mitigate those risks. It is also responsible for reviewing capital management plans recommended by Management. The Bank's stress testing program is reviewed with the CRRMC by Management at least three times a year. The ICAAP is reviewed by the CRRMC and approved by the Board based on the timeframe set by OSFI.

Corporate Governance

The Bank maintains a rigorous corporate governance structure as follows:

- Board of Directors
- Conduct Review and Risk Management Committee
- Audit Committee
- Corporate Governance and Compensation Committee

The Bank also has independent oversight functions which include a Chief Risk Officer, a Chief Compliance Officer and a Chief Anti-Money Laundering Officer that report directly to the CEO and the CRRMC. The Board seeks to achieve long-term sustainable risk adjusted growth in order to ensure the health of the Bank and the stability of earnings while protecting the Bank's well-respected brand name and reputation and the interests of its depositors, customers and investors.

Table 1. Scope of application (continued)

Auditor Assessment

At least annually, the Audit Committee evaluates the performance, qualifications, skills, resources, and independence of the external auditor, including the lead partner, in order to support the Board of Directors in reaching its recommendation to appoint the external auditor. This evaluation includes an assessment of audit quality and service considerations such as: auditor independence, objectivity and professional skepticism; quality of the engagement team; and quality of the communication and service provided by the external auditor. In the evaluation, the Audit Committee considers the nature and extent of communications received from the external auditor during the year and the responses from management and the Audit Committee to a questionnaire regarding the performance of, and interactions with, the external auditor. In 2021, the Audit Committee performed a comprehensive assessment of the external audit service. Based on the results of this assessment, KPMG LLP has been re-appointed as the independent external auditor for the year ended December 31, 2021, in accordance with the recommendation by the Audit Committee.

Business risks

As a result of the Bank's business model and the terms and conditions of a reverse mortgage, the most material risks faced by the Bank are described below:

Funding and Liquidity Risk

Funding and liquidity risk can occur as a result of the uncertain timing of reverse mortgage cash flows and the Bank's reliance on raising funds by the issuance of guaranteed investment certificates and medium-term notes. The Bank has a diversified range of funding sources and has created policies and procedures to ensure that cash flows are accurately predicted and monitored. It also maintains a sufficient amount of liquid assets to fund its anticipated loan commitments, operations, deposit maturities and interest payments should a shortfall arise. In addition, the Bank has a line of credit facility in place with a syndicate of Canadian Banks and has access to the Bank of Canada's Standing Term Liquidity Facility, both of which may be used as additional liquidity if the Bank is unable to meet its obligations when they become due. Lastly, selling portions of its reverse mortgages to a third-party investor is a cash flow source for the Bank for managing funding and liquidity risk.

Interest Rate Risk

The Bank's operating margin is primarily derived from the spread between interest earned on the mortgage portfolio, and the interest paid on the debt and deposits used to fund the portfolio. Risk arises from the Bank's assets and liabilities having mismatched re-pricing dates or being referenced to different underlying instruments. The Bank has adopted hedging practices to maintain a relatively stable spread between interest earned on the mortgages and interest paid on the highly rated debt used to fund them.

Table 1. Scope of application (continued)

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It is the chance of unexpected income losses or increased costs that may emerge as a consequence of human, process or system failure and due to external developments. Risks included in this category include but are not limited to legal risk, fraud, security risk, process risk, business disruption and system failures, cybersecurity risk and loss of key personnel.

Regulatory Compliance Risk

Regulatory compliance risk arises from a financial institution's non-compliance with applicable laws, rules, regulations, and prescribed standards in any jurisdiction in which the institution operates. The Bank addresses regulatory requirements in a timely manner to ensure it is compliant with new applicable regulations. The Compliance Department keeps the Management team and the Board of Directors, or its committees informed of new regulations, guidelines, and changes to existing regulatory requirements.

Reputational Risk

Management is aware of the potential negative effects of reputational risk exposure. The Bank has implemented complaint and incident resolution processes to mitigate these potential risks.

Strategic Risk

The Bank is Canada's only national underwriter of reverse mortgages; however, there are companies in Canada that offer other alternative products that may compete with the Bank, including several companies that are now offering reverse mortgages. It is also possible that at some time in the future, banks, other financial services companies or foreign held reverse mortgage providers may decide to enter the market in direct competition to the Bank. The Bank believes that it has established a defensible competitive advantage as a result of its low-cost funding, proprietary data, internally developed systems and its established brand recognition and marketing network.

Underwriting Risk

Provided the homeowner is not in default, the right of the Bank to receive principal and interest when due under the reverse mortgage is limited to the realized value of the property. Underwriting risk is the potential for financial loss if the assets as currently reflected on the Bank's balance sheet become impaired and not fully recoverable. In particular, this can result from a significant and persistent drop in real estate values and/or customers choosing not to repay their mortgages for an extended period of time. The Bank has developed reverse mortgage underwriting criteria, which provide reasonable loan to value ratios for the homeowner while seeking to provide assurance that the value of the related property upon maturity will be sufficient to repay the reverse mortgage.

Table 1. Scope of application (continued)

COVID-19

In March 2020, the World Health Organization declared the outbreak of a novel coronavirus (COVID-19) as a pandemic. Governments worldwide, including Canadian federal and provincial governments, enacted emergency measures to combat the spread of this virus. These measures caused material disruption to businesses globally. The Canadian government and central bank introduced significant monetary and fiscal interventions to stabilize economic conditions which continued through 2021; however, the long-term success of these interventions is not currently determinable. Through 2021, the increase in the number of Canadians vaccinated and the loosening of COVID restrictions has been positive to the economy, however the continued spread of variants creates considerable uncertainty. This challenging economic environment may have a direct impact on the Bank's operating results and financial position in the future. This situation is dynamic and the magnitude of the potential impact on the economy and the operating results and financial position of the Bank is not fully known

Below is an analysis of the financial risks arising from the COVID-19 outbreak on the Bank's financial statements:

Credit risk and Impairment under IFRS 9

The Bank has considered macro-economic information and potential impacts of COVID-19 in its assessment of a) forecasts of key macro-economic variables, b) weighting of the three macro-economic scenarios, c) whether there has been a significant increase in credit risk in the mortgage portfolio when measuring ECL, and d) measurement of the aggregate amount of ECL. The factors considered include the real estate market, unemployment rate and interest rates. The pandemic affected the Canadian real estate market, resulting in lower number of sales and listings in the 2020 spring months. This softening reversed with record setting months for number of units and average prices for sales in the second half of 2020. The real estate market was resilient in 2021 setting records for the number of transactions and record price appreciation for the year. Certain economists, whose projections the Bank refers to, have differing predictions of the Canadian real estate market for 2022 and for future years. The unemployment rate has recently reduced from the initial months of the pandemic, reaching similar pre-COVID-19 levels. However, it is unknown what the lasting effect of COVID-19 and variants will be on the unemployment rate and what the impact of high unemployment will be on the real estate market. The Bank of Canada stated that it has decided to end its extraordinary commitment to hold its policy rate at the effective lower bound. Looking ahead, the Bank of Canada expects interest rates will need to increase, with the timing and pace of those increases guided by the Bank of Canada's commitment to achieving the 2% inflation target.

Table 1. Scope of application (continued)

COVID-19 (continued)

The Bank's reverse mortgage portfolio is comprised of long-term loans and management has taken into account the known and expected effects of the pandemic in arriving at the forecasts for economic variables under different ECL scenarios and the weighting for these scenarios for purpose of determining ECL. Based on information known as of the reporting date, management believes that the risk of loss over the term of the portfolio due to the pandemic has decreased. As such, the assumptions used in the ECL calculation have returned to the pre-pandemic levels, weighted to be more to the optimistic scenario for December 31, 2021, from December 31, 2020. If the actual economic activity and projections are significantly stronger or weaker than the Bank's current projections, the ECL estimate may be materially impacted.

Liquidity risk

The Bank has not experienced any disruption in its cash inflow from operations and its ability to raise financing from the Guaranteed Investment Certificate broker deposit market. In July 2020, as a prudent liquidity and risk management measure, the Bank arranged for liquidity under the Bank of Canada's Standing Term Liquidity Facility. Management believes that it has adequate liquidity and contingency plans to continue normal business operations and to mitigate risks associated with COVID-19 for the foreseeable future.

Interest rate risk

In an effort to mitigate the economic impact of COVID-19, the Bank of Canada held the key benchmark interest rate to 25 bps through 2021. The Bank of Canada has stated that it has decided to end its extraordinary commitment to hold its policy rate at the effective lower bound. Looking ahead, the Bank of Canada expects interest rates will need to increase, with the timing and pace of those increases guided by the Bank of Canada's commitment to achieving the 2% inflation target. There is uncertainty on timing of rate changes due to recent high inflation rates in Canada.

These low interest rates impacted the interest earned on the Bank's assets as well as the interest costs of funding raised to support those assets. Since the Bank has more assets than liabilities repricing in the short-term, fully parallel rate reductions would have reduced net interest income since the interest expense on liabilities would not decrease as much as the reduction in interest income on assets. The Bank mitigated this impact through pricing actions taken to preserve its net interest margin. The Bank is continuing to manage interest rate risk and believes that it has sufficient tools to manage spread in the current interest rate environment.

Table 2/3. Capital Structure and Capital Adequacy

Objectives, policies, and processes

The overall objective of capital management is to ensure that the Bank has sufficient capital to maintain its operations based on current activities and expected business developments in the future and to provide a return to its shareholder commensurate with the risk of the business. The Bank's capital resources have consisted of equity and unsecured subordinated debt.

The Bank's regulatory capital requirements are specified by OSFI guidelines. These requirements are consistent with the framework of risk-based capital standards developed by the BCBS and are referred to as Basel III.

The Bank has implemented policies and procedures to monitor compliance with regulatory capital requirements. The Bank has implemented an ICAAP which is based on the Bank's assessment of the business risks of the Bank. The Bank's capital structure, risk-weighted assets, capital, and leverage ratios are detailed in the tables below.

Table 2/3. Capital structure and Capital Adequacy (continued)

Capital structure

The Bank's internal capital consists of Common Equity Tier 1 and Tier 2 capital. Common Equity Tier 1 capital consists of common shares, contributed surplus and retained earnings reduced by regulatory adjustments. Tier 2 capital consists of subordinated debt and eligible stage 1 and stage 2 allowances. The Bank has authorized an unlimited number of common shares. As at December 31, 2021, the Bank had 135,501 common shares issued and outstanding.

<i>(in thousands of Canadian dollars)</i>	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
Common shares	165,901	165,916	165,916	165,916	165,916
Contributed surplus	1,131	1,129	1,148	1,166	1,182
Retained earnings	150,892	164,629	182,282	200,356	208,754
Regulatory adjustments	(1,706)	(1,917)	(1,647)	(1,638)	(1,548)
Common Equity Tier 1 capital and Tier 1 capital	316,218	329,757	347,699	365,800	373,304
Unsecured subordinated debt	16,000	16,000	16,000	—	—
Eligible Stage 1 and Stage 2 allowance	7,782	7,902	8,227	8,090	8,241
Tier 2 capital	23,782	23,902	24,227	8,090	8,241
Total regulatory capital	340,000	353,659	371,926	373,890	382,545

OSFI introduced transitional arrangements for expected credit loss provisioning which results in a portion of allowances that would otherwise be included in Tier 2 capital to instead be included in Common Equity Tier 1 (CET1) capital. The Bank, at the end of the baseline period (Q4 2019), had \$6,952 of stage 1 and 2 allowances allocated to its standardized portfolios and included as part of its Tier 2 capital. The Stage 1 and 2 allowances allocated to its standardized portfolio increased by \$2,034 as of Q4 2021. The incremental \$2,034 is subject to this transition. Assuming a 26.75% tax rate, and after applying the 50% factor, \$745 is to be included in CET1 capital. The balance of \$1,289 is to be added to Tier 2 capital. This results in the total allowances included in Total Capital during the year ended December 31, 2021, of \$8,986: \$6,952 in Tier 2 as the baseline plus \$745 added to CET1 and \$1,289 added to Tier 2.

Table 2/3. Capital structure and Capital Adequacy (continued)

Risk-weighted assets

The Bank's risk-weighted assets include all on-balance sheet assets weighted for the risk inherent in each type of asset, an operational risk component based on a percentage of average risk-weighted revenues and a market risk component for off-balance sheet derivative financial instruments. The Bank uses the standardized approach for credit risk for all on-balance sheet assets, basic indicator approach for operational risk and the standardized approach for market risk.

The Bank's investment securities may consist of bank debt securities, government and provincial debt securities and corporate debt securities with ratings ranging from R1-low to R1-high and their equivalents. The Bank uses DBRS Limited for determining credit ratings. Cash and investment securities, based on their credit rating, have risk-weightings ranging from 0% to 50%. Loans receivable, consisting of residential reverse mortgages have a risk-weighting of 35% to 100% with an average risk-weighting of 44.5% as at December 31, 2021. All other assets are risk-weighted at 100%.

Risk-weighted assets (in thousands of Canadian dollars)	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
Deposits with regulated financial institutions	52,636	29,527	28,570	18,506	29,119
Residential reverse mortgages	2,011,476	2,079,825	2,141,680	2,218,707	2,280,765
Other assets	78,477	77,379	77,598	76,890	77,608
	2,142,589	2,186,731	2,247,848	2,314,103	2,387,492
Off-balance sheet exposure	24,468	24,635	25,794	28,344	30,889
Credit risk	2,167,057	2,211,366	2,273,642	2,342,447	2,418,381
Operational risk (average three-year gross income)	202,000	212,563	225,625	237,088	252,988
Total risk-weighted assets	2,369,057	2,423,929	2,499,267	2,579,535	2,671,369

Table 2/3. Capital structure and Capital Adequacy (continued)

Capital ratios

Capital ratios	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
Common Equity Tier 1 ratio (1)	13.4%	13.6%	13.9%	14.2%	14.0%
Tier 1 Capital Ratio (2)	13.4%	13.6%	13.9%	14.2%	14.0%
Total Capital Ratio (3)	14.4%	14.6%	14.9%	14.5%	14.3%
Leverage ratio (4)	6.38%	6.63%	6.80%	7.00%	6.89%

Capital ratios without transitional ECL arrangement applied	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
Common Equity Tier 1 ratio (1)	13.3%	13.6%	13.9%	14.2%	14.0%
Tier 1 Capital Ratio (2)	13.3%	13.6%	13.9%	14.2%	14.0%
Total Capital Ratio (3)	14.4%	14.6%	14.9%	14.5%	14.3%
Leverage ratio (4)	6.36%	6.62%	6.79%	6.98%	6.88%

(1) The Common Equity Tier 1 Ratio is defined as Common Equity Tier 1 capital divided by total risk-weighted assets.

(2) The Tier 1 Capital Ratio is defined as Tier 1 capital divided by total risk-weighted assets.

(3) The Total Capital Ratio is defined as total regulatory capital divided by total risk-weighted assets.

(4) The Leverage Ratio is calculated by dividing Tier 1 capital by total exposures, which includes on-balance assets and certain derivatives exposure.

During the year ended December 31, 2021, the Common Equity Tier 1, Tier 1 and Total Capital ratios remain above OSFI's stated minimum capital ratios of 7.0%, 8.5% and 10.5%, respectively, for a well-capitalized financial institution. The Bank's Leverage Ratio was also above the minimum assigned to the Bank by OSFI.

Table 4/5. Credit risk – general disclosures for all banks

The Bank performs regular monitoring of its risks, assessments, and related action plans. Senior management and the Board of Directors obtain information that allows them to keep informed regarding the effectiveness of their risk management process and activities. The Bank has a CRRMC to assist the Board in fulfilling its responsibilities.

Credit risk is the potential for financial loss if a borrower or counterparty in a transaction fails to meet its obligations in accordance with agreed terms. Credit risk on the Bank’s cash and deposits with banks is mitigated by maintaining cash balances at highly rated Schedule I Canadian chartered banks.

Cash resources and securities

<i>(in thousands of Canadian dollars)</i>	Dec 31 2020 \$	Mar 31 2021 \$	Jun 30 2021 \$	Sept 30 2021 \$	Dec 31 2021 \$
Cash and deposits with banks	264,710	147,825	143,220	93,156	145,600
Treasury bills issued or guaranteed by Canada	—	—	—	—	1,724
	264,710	147,825	143,220	93,156	147,324

Residential reverse mortgages

Underwriting risk on the mortgage loans is mitigated by following Board-approved underwriting policies. In particular, during the underwriting process, every property is appraised. The initial appraised value is subsequently discounted, typically by between 5% and 30%. A rate of future property appreciation assumed for the life of the mortgage is low in comparison with the Canadian average for the past 20 years. The average rate of assumed appreciation used in the initial underwriting of the existing mortgage portfolio is approximately 0.33%. The reverse mortgage must be registered as a first charge on title or may be registered as a second charge provided the first charge is less than \$15 for liens only and title insurance coverage is in place for any losses associated with the first charge. Underwriting risk is mitigated further by the geographic diversity and the collateralization of the portfolio.

Table 4/5. Credit risk – general disclosures for all banks (continued)

Residential reverse mortgages (continued)

Geographic region and loan-to-value

Residential reverse mortgages are lifetime, interest accruing mortgages that are secured by residential real property. Interest income is recognized on an accrual basis on all mortgages and is due together with repayment of the principal at the time the property is vacated by the homeowner(s). There are no contractual maturity dates for repayment of the mortgages and all mortgages are uninsured.

The following tables show the composition of the residential reverse mortgage portfolio by geographic region and loan-to-value (LTV) ratio range, which measures the outstanding mortgage balance as a percentage of the most recent appraised value of the property. The overall LTV of the portfolio at 35.1% indicates significant equity in the collateral which would mitigate the risk from economic downturns.

Province (in thousands of Canadian dollars)	Dec 31 2020 \$	Mar 31 2021 \$	Jun 30 2021 \$	Sept 30 2021 \$	Dec 31 2021 \$
Ontario	2,100,707	2,202,633	2,312,237	2,436,937	2,570,174
British Columbia	1,534,476	1,559,941	1,588,799	1,622,632	1,638,471
Alberta	415,305	419,831	418,490	414,868	409,155
Quebec	281,150	283,969	287,655	292,658	294,839
Other Canadian provinces	222,746	223,902	224,349	225,375	222,298
	4,554,384	4,690,276	4,831,530	4,992,470	5,134,937

Provincial LTV %	Dec 31 2020 %	Mar 31 2021 %	Jun 30 2021 %	Sept 30 2021 %	Dec 31 2021 %
Ontario	34.7	35.0	33.6	33.8	34.1
British Columbia	33.8	34.2	33.5	33.7	33.7
Alberta	43.6	43.9	43.7	43.9	44.2
Quebec	40.2	40.5	38.2	38.5	38.6
Other Canadian provinces	42.1	42.2	40.8	40.9	40.7
Overall LTV	35.7	36.0	34.8	35.0	35.1

Table 4/5. Credit risk – general disclosures for all banks (continued)

Residential reverse mortgages (continued)

	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
Loan-to-value (in thousands of Canadian dollars)	\$	\$	\$	\$	\$
30.0% or less	901,001	903,581	1,038,357	1,056,607	1,062,121
30.1% - 40.0%	1,126,570	1,144,356	1,265,375	1,285,332	1,286,272
40.1% - 50.0%	1,249,580	1,280,340	1,304,770	1,354,937	1,423,696
50.1% - 60.0%	847,777	888,106	788,300	841,407	934,710
60.1% - 70.0%	289,239	328,408	287,357	299,948	293,916
70.1% - 83.0%	93,902	97,652	97,350	99,328	93,308
Greater than 83.0%	46,315	47,833	50,021	54,911	40,914
	4,554,384	4,690,276	4,831,530	4,992,470	5,134,937
Overall LTV	35.7%	36.0%	34.8%	35.0%	35.1%

Impaired loans

The following table shows residential reverse mortgages with a loan-to-value ratio of greater than 83%, which management considers impaired, and the appraised value of those underlying properties:

	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
(in thousands of Canadian dollars)	\$	\$	\$	\$	\$
Mortgage principal plus accrued interest	46,315	47,833	50,021	54,911	40,914
Individual allowances (Stage 3)	(7,166)	(7,800)	(7,891)	(8,581)	(6,922)
	39,149	40,033	42,130	46,330	33,992
Appraised value of underlying properties	47,167	48,445	51,133	56,251	41,279

Table 4/5. Credit risk – general disclosures for all banks (continued)

Residential reverse mortgages (continued)

Expected credit losses

The Bank's Loan Provisioning Policy follows requirements under IFRS 9, Financial Instruments. The Loan Provisioning Policy utilizes an expected credit loss (ECL) impairment model for all financial assets not measured at fair value through profit and loss (FVTPL). The ECL model contains a three-stage approach which is based on the change in credit quality of financial assets since initial recognition. Through its staging process, the model calculates the expected credit loss within the portfolio, which is the present value of projected future cash flow shortfalls. The Bank evaluates and monitors the underwriting performance indicators of mortgages as well as changes in the characteristics of the portfolio. These indicators include a review of general real estate conditions and trends and their potential impact on the portfolio, the expected occupancy term and interest rates experienced over the life of a mortgage compared to initial underwriting assumptions.

As reverse mortgages do not have similar credit risk as conventional mortgages, the risk of loss is based on the underlying collateral and the performance of the loan relative to the date of initial advance which is measured by the mortgage loan-to-value (LTV). The Bank has determined that a significant increase in credit risk is based on the relative change in LTV. As LTV increases, the possibility of incurring a loss increase. The Bank uses the movement of LTV as a factor in determining the movement of loans between Stage 1 and Stage 2. The ECL allowance on the mortgage portfolio is calculated on a mortgage-by-mortgage basis. The risk assessment staging determines the level of ECL that is to be recognized. If the mortgage balance exceeds the property value at any point in the future, the excess is considered the lifetime loss. For Stage 3 loans, the Bank provides a reserve on any mortgage where the LTV exceeds 83%.

Table 4/5. Credit risk – general disclosures for all banks (continued)

Residential reverse mortgages (continued)

Expected credit losses (continued)

	Dec 31 2020 \$	Mar 31 2021 \$	Jun 30 2021 \$	Sept 30 2021 \$	Dec 31 2021 \$
<i>(in thousands of Canadian dollars)</i>					
Individual allowances (Stage 3)					
Balance, beginning of period	(7,453)	(7,166)	(7,800)	(7,891)	(8,581)
Provision for credit losses	(1,221)	(1,101)	(632)	(1,033)	905
Realized losses, net of recoveries	1,508	467	541	343	754
Balance, end of period	(7,166)	(7,800)	(7,891)	(8,581)	(6,922)
Expected credit losses (Stage 1 and Stage 2)					
Balance, beginning of period	(8,455)	(8,653)	(8,442)	(8,953)	(8,737)
(Provision) / recovery for credit losses	(198)	191	(511)	152	(220)
(Recoveries)/ realized losses	—	20	—	64	(29)
Balance, end of period	(8,653)	(8,442)	(8,953)	(8,737)	(8,986)
Total expected credit losses	(15,819)	(16,242)	(16,844)	(17,318)	(15,908)
As a % of total mortgages outstanding	0.35%	0.35%	0.35%	0.35%	0.31%

TABLE 8. General disclosure for exposures related to counterparty credit risk

Derivative instruments

In the normal course of business, the Bank enters into interest rate derivative contracts to manage interest rate risk, following internal interest rate risk management policies. Derivative financial instruments are financial contracts that derive their value from underlying changes in interest rates or other financial measures.

Interest rate swaps are contracts in which two counterparties agree to exchange cash flows over a period of time based on rates applied to a specified notional principal amount. A typical interest rate swap would require one counterparty to pay interest based on a fixed rate and receive interest based on a variable market interest rate determined from time to time with both calculated on a specified notional principal amount. No exchange of principal amount takes place at inception.

A bond forward is a contractual obligation for the contract holder to purchase or sell a bond on a specified date at a predetermined price. The Bank uses bond forwards to hedge changes in future cash flows attributable to interest rate fluctuations arising on highly probable forecasted issuances of fixed-rate medium-term debt. No exchange of principal amount takes place at inception.

The Bank's International Swaps and Derivatives Association agreements require a credit support obligation in the form of government issued securities under certain circumstances. As at December 31, 2021, the Bank has pledged \$860 (December 31, 2020 - \$nil).

Market risk

Derivative financial instruments have either no or an insignificant market value at inception. Their value changes in response to relevant interest rates, or credit price changes, such that the previously contracted terms of the derivative transactions have become more or less favourable than what can be negotiated under current market conditions for contracts with the same terms and the same remaining period to expiry. The potential for derivatives to increase or decrease in value as a result of the foregoing factors is generally referred to as market risk. This market risk exposure to earnings is mitigated as the Bank does not hold or use any derivative contracts for speculative trading purposes.

TABLE 8. General disclosure for exposures related to counterparty credit risk (continued)

Credit risk

Credit risk on derivative financial instruments is the risk of a financial loss occurring as a result of a default of a counterparty on its obligation to the Bank. Credit risk is limited by dealing only with highly rated Schedule I Canadian chartered banks as counterparties. The maximum derivative credit exposure to the Bank is the fair value of derivative contracts presented in the summary table below.

	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
Derivative financial instrument assets					
Notional principal	450,000	305,000	295,000	295,000	135,000
Replacement cost	6,940	5,265	4,188	3,358	1,784
Credit risk equivalent	8,541	6,065	4,813	3,983	2,284
Risk-weighted assets	1,708	1,214	963	797	457
Fair value	6,940	5,265	4,188	3,358	1,784

The following tables summarize the notional principal and fair value by term to maturity of derivative financial instruments outstanding as at December 31, 2021. Maturity dates range from within 1 year to within 5 years of December 31, 2021.

	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
	\$	\$	\$	\$	\$
Notional principal					
Derivative assets					
Maturing within 1 year	130,000	145,000	170,000	170,000	35,000
Maturing in 1 to 3 years	170,000	135,000	100,000	100,000	100,000
Maturing in 3 to 5 years	150,000	25,000	25,000	25,000	—
	450,000	305,000	295,000	295,000	135,000

TABLE 8. General disclosure for exposures related to counterparty credit risk (continued)

Credit risk (continued)

	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
Notional principal					
Derivative liabilities					
Maturing within 1 year	—	—	—	—	35,000
Maturing in 1 to 3 years	—	225,000	50,000	175,000	175,000
Maturing in 3 to 5 years	—	—	250,000	250,000	275,000
	—	225,000	300,000	425,000	485,000

Maturity terms

	Dec 31 2020	Mar 31 2021	Jun 30 2021	Sept 30 2021	Dec 31 2021
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
Fair value					
Derivative assets					
Maturing within 1 year	631	729	490	237	66
Maturing in 1 to 3 years	5,114	4,021	3,273	2,778	1,718
Maturing in 3 to 5 years	1,195	515	426	343	—
	6,940	5,265	4,188	3,358	1,784
Derivative liabilities					
Maturing within 1 year	—	—	—	—	28
Maturing in 1 to 3 years	—	3,998	139	453	2,420
Maturing in 3 to 5 years	—	—	4,082	4,616	7,525
	—	3,998	4,221	5,069	9,973

TABLE 12. Operational risk

The Bank's Operational Risk Management Framework (ORMF) is an integral part of the Bank's Enterprise Risk Management Framework and is aligned with the Board-approved RAF. The ORMF governance structure has three lines of defense to safeguard the Bank against operational risk. The first line of defense from operational risk is at the transaction level where the Bank's business units are responsible for ensuring that appropriate internal controls are in place and operating effectively. The Bank also has a Risk and Compliance Department (second line of defense) which serves as independent challenge to the business units and whose function is to identify key operational risks that the Bank is exposed to and independently validate the effectiveness of the Bank's operational internal controls. The Bank also has an Internal Audit function (third line of defense) which audits the Bank using a risk-based approach.

The Bank mitigates its operational risk by implementing policies and procedures directed at identified risks, employing knowledgeable and experienced senior managers, segregating duties among employees, training all employees with respect to effective risk management, and continually reviewing and upgrading the policies, procedures and controls that form the Bank's ORMF. Effective risk management plays an essential role in the Bank's ability to meet its financial targets and remain financially sound.

Senior management is responsible for identifying risks and developing risk management policies. The Board, both directly or through its committees, reviews and approves Bank policies, and implements specific reporting procedures to enable it to monitor the Bank's risk profile and ensure compliance with the Board-approved RAF. The Bank uses the basic indicator approach to measure operational risk in its calculation of risk-weighted assets. Operational risk is calculated as shown in Table 3 Capital Adequacy.

TABLE 14. Interest rate risk in the banking book

Objectives, policies and processes

The Bank's operating margin is primarily derived from the spread between interest earned on the mortgage portfolio and the interest paid on the debt and deposits used to fund the portfolio. Mortgages have various interest rate reset terms, ranging from variable to five-year. Interest on the Bank's term debt is variable or fixed until maturity. The Bank uses derivative contracts to alter the fixed rate on the debt to match the rate reset terms of the mortgage portfolio and to mitigate any fluctuations that changes to the underlying benchmark rates may have on its operating margin at the time of the mortgage resets.

The Bank's management is responsible for monitoring, managing, and reporting interest rate risk in accordance with the Board-approved RAF. To support the RAF, the Bank has developed an Enterprise Risk Management Framework which includes the Board-approved Risk Policies. Compliance with various internal limits articulated in the RAF for net interest income and market value sensitivities are periodically reported to the Bank's CRRMC which has the oversight responsibility for risk governance and practices.

TABLE 14. Interest rate risk (continued)

Exposure to interest rate risk

The Bank is exposed to interest rate risk as a result of the mismatch, or gap, between the maturity or repricing date of interest sensitive assets and liabilities. The following table identifies the Bank's assets and liabilities which are sensitive to interest rate movements and those which are non-interest rate sensitive.

<i>(in thousands of Canadian dollars)</i>	Dec 31 2020 \$	Mar 31 2021 \$	Jun 30 2021 \$	Sept 30 2021 \$	Dec 31 2021 \$
Interest sensitive					
Total assets	4,826,034	4,843,366	4,978,938	5,088,984	5,284,045
Total liabilities	4,430,512	4,445,610	4,565,272	4,643,804	4,826,138
Total interest rate sensitivity gap	395,522	397,756	413,666	445,180	457,907
Non-interest sensitive					
Total assets	47,845	46,344	45,539	43,914	46,423
Total liabilities and equity	443,367	444,100	459,205	489,094	504,330
Total non-interest rate sensitivity gap	(395,522)	(397,756)	(413,666)	(445,180)	(457,907)

Interest rate sensitivity

The following table provides the potential after-tax impact of an immediate and sustained 100 bps increase or decrease in interest rates on net interest income. These sensitivities are hypothetical and should be used with caution.

<i>(in thousands of Canadian dollars)</i>	Dec 31 2020 \$	Mar 31 2021 \$	Jun 30 2021 \$	Sept 30 2021 \$	Dec 31 2021 \$
After-tax impact on net income of:					
100 bps increase in interest rates	1,699	1,292	1,936	2,001	1,572
100 bps decrease in interest rates	(1,699)	(1,292)	(1,936)	(2,001)	(1,572)

REMUNERATION

The Bank's remuneration policies are consistent with financial services industry practice. Rewards are based on both business and individual specific performance objectives. Oversight of the Bank's compensation structure is the responsibility of the Corporate Governance and Compensation Committee, which is comprised of three Directors, two of whom are independent. The Corporate Governance and Compensation Committee met twice in 2021. External compensation advisors are retained by the Corporate Governance and Compensation Committee as needed. In 2021 no external compensation advisors were retained.

The Bank's compensation structure includes base salary, short-term cash incentives and for executives a long-term incentive plan. Base salary for all employees is reviewed annually and as required by market conditions. In addition to their salaries, Bank employees participate in a benefits plan that provides certain health care, dental care, life insurance and other benefits. Bank employees also participate in a combination Group Registered Savings Plan/Deferred Profit-Sharing Plan.

Executive Management

The Bank's executive compensation program is guided by the tenet that a meaningful portion of key management personnel's pay should be based on business results. Pay for performance encourages senior management to make decisions and take actions that are aligned with the Bank's business objectives and shareholder's interests. The Bank's executive compensation program for vice-presidents, senior vice-presidents, executive vice-presidents, and the president and chief executive officer is built on the core principles of balanced compensation and risk, market competitiveness and shareholder value creation. Other than executive management, there are no other material risk takers at the Bank.

A measured approach to compensation is required. Incentives must drive the right behaviours within the Bank's risk appetite. Incentive compensation plans must factor in risk, rewarding results that are achieved only within a defined risk tolerance. In order for the Bank to achieve its strategic goals it needs to attract, motivate and retain experienced talent and leadership. Compensation opportunities are to be competitive with similarly sized Canadian financial institutions. There must be a strong link between incentive compensation and long-term shareholder value creation. Management's compensation opportunity must be tied to the achievement of objectives that create sustainable growth and long-term shareholder value. The salaries are set in reference to the executive's level of responsibility, competitive market data, internal pay relationships and the individual's proven capabilities. Some key measures that remuneration is linked to include originations, cash cost of originations, adjusted net income and return on equity targets. All remuneration agreements linked to these measures are adjusted as a percentage based against stated targets. Every year the CEO makes a recommendation to the Corporate Governance and Compensation Committee for each executive's base salary.

REMUNERATION (continued)

Key management personnel and Director's compensation for 2021 and 2020 was comprised of:

<i>(in thousands of Canadian dollars)</i>	Number of recipients	2021 \$	Number of recipients	2020 \$
Fixed remuneration				
Cash-based	20	5,434	21	4,885
Severance payments	3	889	2	718
Directors' fees and expenses	5	362	5	301
		6,685		5,904
Variable remuneration				
Cash-based	19	6,611	18	4,271
Executive Signing Bonuses	—	—	1	15
Total Compensation		13,296		10,175

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Modified Capital Disclosure Template

The following summarizes the Bank's interim Basel III Pillar 3 disclosures as at December 31, 2021:

Modified Capital Disclosure Template (in thousands of Canadian dollars)		Amounts
Common Equity Tier 1 capital: instruments and reserves		
1	Directly issued qualifying common share capital (and equivalent for non-joint stock companies) plus related stock surplus	167,098
2	Retained earnings	208,754
3	Accumulated other comprehensive income (and other reserves)	
4	<i>Directly issued capital subject to phase out from CET1 (only applicable to non-joint stock companies)</i>	
5	Common share capital issued by subsidiaries and held by third parties (amount allowed in group CET1)	
6	Common Equity Tier 1 capital before regulatory adjustments	375,852
Common Equity Tier 1 capital: regulatory adjustments		
28	Total regulatory adjustments to Common Equity Tier 1	(1,548)
29	Common Equity Tier 1 capital (CET1)	374,304
29a	Common Equity Tier 1 capital (CET1) with transitional arrangements for ECL provisioning not applied	373,559
Additional Tier 1 capital: instruments		
30	Directly issued qualifying Additional Tier 1 instruments plus related stock surplus	
31	of which: classified as equity under applicable accounting standards	
32	of which: classified as liabilities under applicable accounting standards	
33	Directly issued capital instruments subject to phase out from Additional Tier 1	
34	Additional Tier 1 instruments (and CET1 instruments not included in row 5) issued by subsidiaries and held by third parties (amount allowed in group AT1)	
35	<i>of which: instruments issued by subsidiaries subject to phase out</i>	
36	Additional Tier 1 capital before regulatory adjustments	—
Additional Tier 1 capital: regulatory adjustments		
43	Total regulatory adjustments to Additional Tier 1 capital	
44	Additional Tier 1 capital (AT1)	—
45	Tier 1 capital (T1 = CET1 + AT1)	374,304
45a	Tier 1 capital with transitional arrangements for ECL provisioning not applied	373,559
Tier 2 capital: instruments and allowances		
46	Directly issued qualifying Tier 2 instruments plus related stock surplus	
47	Directly issued capital instruments subject to phase out from Tier 2	
48	Tier 2 instruments (and CET1 and AT1 instruments not included in rows 5 or 34) issued by subsidiaries and held by third parties (amount allowed in group Tier 2)	
49	<i>of which: instruments issued by subsidiaries subject to phase out</i>	
50	Eligible Stage 1 and Stage 2 allowance	8,986
51	Tier 2 capital before regulatory adjustments	8,986
Tier 2 capital: regulatory adjustments		
57	Total regulatory adjustments to Tier 2 capital	(745)
58	Tier 2 capital (T2)	8,241

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59	Total capital (TC = T1 + T2)	382,545
59a	Total capital with transitional arrangements for ECL provisioning not applied	382,545
60	Total risk weighted assets	2,671,369
60a	Common Equity Tier 1 (CET1) Capital RWA	
60b	Tier 1 Capital RWA	
60c	Total Capital RWA	
Capital ratios		
61	Common Equity Tier 1 (as a percentage of risk weighted assets)	14.0%
61a	Common Equity Tier 1 Ratio with transitional arrangements for ECL provisioning not applied	14.0%
62	Tier 1 (as a percentage of risk weighted assets)	14.0%
62a	Tier 1 Capital Ratio with transitional arrangements for ECL provisioning not applied	14.0%
63	Total capital (as a percentage of risk weighted assets)	14.3%
63a	Total Capital Ratio with transitional arrangements for ECL provisioning not applied	14.3%
OSFI target		
69	Common Equity Tier 1 capital target ratio	7.0%
70	Tier 1 capital target ratio	8.5%
71	Total capital target ratio	10.5%
Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2013 and 1 Jan 2022)		
80	<i>Current cap on CET1 instruments subject to phase out arrangements</i>	
81	<i>Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)</i>	
82	<i>Current cap on AT1 instruments subject to phase out arrangements</i>	
83	<i>Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)</i>	
84	<i>Current cap on T2 instruments subject to phase out arrangements</i>	
85	<i>Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)</i>	

Leverage Ratio Template

The following summarizes the Bank's Basel III Pillar 3 Leverage Ratio as at December 31, 2021:

<i>Item (in thousands of Canadian dollars)</i>		<i>Leverage Ratio Framework</i>
On-balance sheet exposures		
1	On-balance sheet items (excluding derivatives, SFTs and grandfathered securitization exposures but including collateral)	5,347,736
2	Gross-up for derivatives collateral provided where deducted from balance sheet assets pursuant to the operative accounting framework (IFRS)	
3	(Deductions of receivable assets for cash variation margin provided in derivatives transactions)	
4	(Asset amounts deducted in determining Tier 1 capital)	(4,077)
5	Total on-balance sheet exposures (excluding derivatives and SFTs) (sum of lines 1 and 2)	5,343,659
6	Replacement cost associated with all derivative transactions	1,784
7	Add-on amounts for PFE associated with all derivative transactions	1,414
8	(Exempted CCP-leg of client cleared trade exposures)	
9	Adjusted effective notional amount of written credit derivatives	
10	(Adjusted effective notional offsets and add-on deductions for written credit derivatives)	
11	Total derivative exposures (sum of lines 6 to 10)	3,198
12	Gross SFT assets (with no recognition of netting), after adjusting for sale accounting	
13	(Netted amounts of cash payables and cash receivables of gross SFT assets)	
14	Counterparty credit risk (CCR) exposure for SFT assets	
15	Agent transaction exposures	
16	Total securities financing transaction exposures (sum of lines 12 to 15)	—
17	Off-balance sheet exposure at gross notional amount	177,114
18	(Adjustments for conversion to credit equivalent amounts)	(90,778)
19	Off-balance sheet items (sum of lines 17 and 18)	86,336
20	Tier 1 Capital	374,304
20a	Tier 1 Capital with transitional arrangements for ECL provisioning not applied	373,559
21	Total Exposures (sum of lines 5, 11, 16 and 19)	5,433,193
22	Basel III leverage ratio	6.89%
22a	Basel III leverage ratio with transitional arrangements for ECL provisioning not applied	6.88%