



**BASEL III PILLAR 3 DISCLOSURES**

**December 31, 2013**

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**HomeEquity Bank**  
**Basel III Pillar 3 Disclosures**  
**December 31, 2013**

**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 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 disclosure 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 annual 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 the 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 on at least a quarterly basis.



**Table 1. Scope of application (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 appropriate with the Bank's RAF.

The Bank's CRRMC is responsible for overseeing the types of risk to which the Bank may be exposed and of 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 on a quarterly basis and the ICAAP is reviewed annually prior to recommendation by the CRRMC to the Board for approval.

**Corporate Governance**

The Bank maintains a rigorous corporate governance structure as follows:

- Board of Director's Oversight
- 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, the interests of its depositors and customers and investors. The Board is in support of the Bank increasing new mortgage originations and long-term sustainable portfolio growth with increased profitability and improved Return on Equity while managing and maintaining all the associated potential risks with prescribed regulatory limits.

**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 as listed below:

**Table 1. Scope of application (continued)**

**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.

**Competition 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. 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.

**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

**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, being referenced to different underlying instruments or when the long term expectation of the quality of assets diminishes. 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.

**Media and Reputation Risk**

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

**Table 1. Scope of application (continued)**

**Operational Risk**

Operational risk can arise through breakdowns in internal controls and corporate governance, resulting in financial loss. The Bank has implemented policies, procedures and internal controls to detect, prevent and manage business activity and to control operational risk.

**Regulatory Risk**

Regulatory 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 and Risk Management functions keep the Management team and the Board of Directors (the Board) informed of new regulations, guidelines and changes to existing regulatory requirements.

**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 and comparable to other, similar companies. The Bank's capital resources consist 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 adopted certain Basel III capital requirements, as required by OSFI, beginning January 1, 2013. The transitional basis allows for the transition of certain capital deductions over a period ending January 1, 2018, whereas the all-in basis includes all applicable deductions immediately. Amounts not yet deducted from capital under OSFI's transitional rules are risk weighted, creating a difference between risk-weighted assets on a transitional and on an all-in basis.

The primary impact at adoption was the deduction from Common Equity Tier 1 capital on an all-in basis of \$481 related to intangible assets which included bank license costs and software, net of deferred taxes. The remaining regulatory adjustment relates to excess mortgage allowances which are applicable to both the all-in and transitional basis.

The Bank has implemented policies and procedures to monitor compliance with regulatory capital requirements. The Bank has implemented an Internal Capital Adequacy Assessment Process which is based on the Bank's assessment of the business risks of the Bank.

The Bank's capital structure, risk-weighted assets and capital ratios, on the all-in and transitional basis are detailed in the tables below:

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**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 and deficit reduced by regulatory adjustments. Tier 2 capital consists of subordinated debt in compliance with OSFI Guideline A requirements for Tier 2B limited life instruments. The Bank has authorized an unlimited number of common shares. As at December 31, 2013, the Bank had 108,683 common shares issued and outstanding.

<i>ALL-IN BASIS</i> <i>(in thousands of Canadian dollars)</i>	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
Common shares	129,261	129,261	129,261	129,261	<b>129,261</b>
Deficit	(32,749)	(31,665)	(30,139)	(27,261)	<b>(24,821)</b>
Regulatory adjustments (1)	(371)	(979)	(1,050)	(1,096)	<b>(1,050)</b>
<b>Common Equity Tier 1 capital</b>	<b>96,141</b>	<b>96,617</b>	<b>98,072</b>	<b>100,904</b>	<b>103,390</b>
Book value of unsecured subordinated debt	40,975	30,975	30,975	30,975	<b>30,975</b>
Less: accumulated amortization for capital adequacy	(12,000)	(4,897)	(6,000)	(6,000)	<b>(6,000)</b>
	28,975	26,078	24,975	24,975	<b>24,975</b>
Regulatory adjustments	3,563	3,681	4,136	3,579	<b>3,648</b>
<b>Tier 2 capital</b>	<b>32,538</b>	<b>29,759</b>	<b>29,111</b>	<b>28,554</b>	<b>28,623</b>
<b>Tier 1 capital and Total regulatory capital</b>	<b>128,679</b>	<b>126,376</b>	<b>127,183</b>	<b>129,458</b>	<b>132,013</b>

(1) Regulatory deductions on the all-in basis include intangible assets related to bank license costs and software, net of deferred taxes, and excess mortgage allowances.

<i>TRANSITIONAL BASIS</i> <i>(in thousands of Canadian dollars)</i>	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
All-in Common Equity Tier 1 capital	96,617	98,072	100,904	<b>103,390</b>
Transitional adjustments	558	539	512	<b>481</b>
<b>Common Equity Tier 1 capital</b>	<b>97,175</b>	<b>98,611</b>	<b>101,416</b>	<b>103,871</b>
<b>Tier 2 capital</b>	<b>29,759</b>	<b>29,111</b>	<b>28,554</b>	<b>28,623</b>
<b>Tier 1 capital and Total regulatory capital</b>	<b>126,934</b>	<b>127,722</b>	<b>129,970</b>	<b>132,494</b>

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. Investment securities have risk-weightings ranging from 0% to 50% based on their credit rating. Loans receivable, consisting of residential reverse mortgages have a risk-weighting of 35% to 100% with an average risk-weighting of 44.4% at December 31, 2013. All other assets are risk-weighted at 100%.

<i>ALL-IN BASIS Risk-weighted assets (in thousands of Canadian dollars)</i>	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
Corporate debt securities	9,098	4,718	3,786	4,595	<b>3,596</b>
Provincial treasury bills	594	—	—	—	—
Deposits with regulated financial institutions	13,918	9,106	7,732	12,408	<b>10,444</b>
Residential reverse mortgages	583,444	605,027	622,626	647,247	<b>671,333</b>
Other assets	57,983	57,016	56,828	57,520	<b>57,564</b>
	665,037	675,867	690,972	721,770	<b>742,937</b>
Off-balance sheet exposure	3,703	3,645	2,498	2,482	<b>2,423</b>
Credit risk	668,740	679,512	693,471	724,252	<b>745,360</b>
Operational risk (average three-year gross income)	47,031	47,391	48,723	49,894	<b>51,375</b>
<b>Total risk-weighted assets</b>	<b>715,771</b>	<b>726,903</b>	<b>742,193</b>	<b>774,146</b>	<b>796,735</b>

<i>TRANSITIONAL BASIS Risk-weighted assets (in thousands of Canadian dollars)</i>		Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
Total risk-weighted assets on All-in basis		726,903	742,193	774,146	<b>796,735</b>
Transitional adjustments		558	539	512	<b>481</b>
<b>Total risk-weighted assets on Transitional basis</b>		<b>727,461</b>	<b>742,732</b>	<b>774,658</b>	<b>797,216</b>



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

Capital ratios

<i>ALL-IN BASIS</i>	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
Common Equity Tier 1 ratio (1)	n/a	13.3%	13.2%	13.0%	<b>13.0%</b>
Tier 1 Capital Ratio (2)	13.4%	13.3%	13.2%	13.0%	<b>13.0%</b>
Total Capital Ratio (3)	18.0%	17.4%	17.1%	16.7%	<b>16.6%</b>
Assets-to-Capital Multiple (4)	11.9x	12.0x	12.0x	12.8x	<b>12.5x</b>

- (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 Assets-to-Capital Multiple is calculated by dividing total assets, including specified off-balance sheet items net of other specified deductions, by total capital.

<i>TRANSITIONAL BASIS</i>	March 31 2013	June 30 2013	Sept 30 2013	Dec 31 2013
Common Equity Tier 1 ratio (1)	13.4%	13.3%	13.1%	<b>13.0%</b>
Tier 1 Capital Ratio (2)	13.4%	13.3%	13.1%	<b>13.0%</b>
Total Capital Ratio (3)	17.5%	17.2%	16.8%	<b>16.6%</b>
Assets-to-Capital Multiple (4)	12.0x	12.0x	12.8x	<b>12.5x</b>

- (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 Assets-to-Capital Multiple is calculated by dividing total assets, including specified off-balance sheet items net of other specified deductions, by total capital.

For purposes of meeting minimum regulatory capital ratios prescribed by OSFI, the all-in basis is required. The Assets-to-Capital Multiple (ACM) is calculated and evaluated on a transitional basis. During the year ended December 31, 2013 and 2012, the Bank complied with the OSFI guideline related to capital ratios and the assets-to-capital multiple. Both the Tier 1 and Total Capital Ratios remain above OSFI's stated minimum capital ratios of 7% and 10%, respectively, for a well-capitalized financial institution. The Bank's ACM remains below the maximum permitted 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 Conduct Review and Risk Management Committee 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 cash equivalents is mitigated by maintaining cash balances at Schedule I Canadian chartered banks.

Underwriting risk on the mortgage loans is mitigated by following Board-approved underwriting policies. In particular, during the underwriting process, every property is appraised by a certified appraiser with particular attention paid to property type, location and days on market of each comparative property. 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 0.77%. Each mortgage originated is limited in maximum dollar amount and loan-to-value ratio in accordance with internal guidelines. The Bank also obtains a first charge on the underlying property securing the mortgage. Underwriting risk is mitigated further by the geographic diversity and the collateralization of the portfolio.

**Cash resources and securities**

	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
Cash and non-interest bearing deposits with banks	40,225	23,891	29,847	49,056	<b>38,732</b>
Bank securities	29,363	14,892	8,812	12,983	<b>8,986</b>
Treasury bills issued or guaranteed by Canada	4,981	4,993	3,993	19,991	<b>3,985</b>
Treasury bills issued or guaranteed by provinces	2,969	2,979	2,988	43,394	<b>2,982</b>
Other debt securities	45,491	23,592	18,930	16,977	<b>17,982</b>
	<b>123,029</b>	<b>70,347</b>	<b>64,570</b>	<b>142,401</b>	<b>72,667</b>

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

Residential reverse mortgages

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 weighted average LTV of the portfolio at 37.3% indicates significant equity in the collateral which would mitigate the risk from economic downturns.

Province (in thousands of Canadian dollars)	Dec 31 2012 \$	Mar 31 2013 \$	Jun 30 2013 \$	Sep 30 2013 \$	Dec 31 2013 \$
Ontario	485,445	498,226	507,441	524,589	<b>542,439</b>
British Columbia	470,071	481,548	490,210	503,700	<b>517,091</b>
Alberta	169,437	175,336	180,315	186,450	<b>194,542</b>
Quebec	133,573	139,514	144,257	152,697	<b>161,184</b>
Other	76,547	81,237	85,174	89,973	<b>97,999</b>
	<b>1,335,073</b>	<b>1,375,861</b>	<b>1,407,397</b>	<b>1,457,409</b>	<b>1,513,255</b>

  

Provincial LTV %	Dec 31 2012 %	Mar 31 2013 %	Jun 30 2013 %	Sep 30 2013 %	Dec 31 2013 %
Ontario	38.3	38.5	38.5	38.5	<b>38.4</b>
British Columbia	35.7	35.9	36.1	36.4	<b>36.3</b>
Alberta	37.8	38.4	39.1	39.1	<b>39.3</b>
Quebec	35.9	36.3	36.3	36.1	<b>35.9</b>
Other	35.6	35.8	35.7	35.8	<b>35.8</b>
	<b>36.9</b>	<b>37.2</b>	<b>37.3</b>	<b>37.4</b>	<b>37.3</b>

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

Residential reverse mortgages (continued)

	Dec 31 2012 \$	Mar 31 2013 \$	Jun 30 2013 \$	Sep 30 2013 \$	Dec 31 2013 \$
<i>Loan-to-value (in thousands of Canadian dollars)</i>					
Less than 30.0%	219,325	221,683	228,107	239,248	<b>242,008</b>
30.1% - 40.0%	358,113	355,653	351,837	355,009	<b>369,803</b>
40.1% - 50.0%	406,602	425,707	436,114	450,602	<b>475,111</b>
50.1% - 60.0%	248,370	255,614	265,605	275,768	<b>292,301</b>
60.1% - 70.0%	73,007	83,652	85,291	89,994	<b>89,519</b>
Greater than 70.1%	29,656	33,552	40,443	46,788	<b>44,513</b>
	<b>1,335,073</b>	<b>1,375,861</b>	<b>1,407,397</b>	<b>1,457,409</b>	<b>1,513,255</b>
Overall LTV	36.9%	37.2%	37.3%	37.4%	<b>37.3%</b>

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 2012 \$	Mar 31 2013 \$	Jun 30 2013 \$	Sep 30 2013 \$	Dec 31 2013 \$
<i>(in thousands of Canadian dollars)</i>					
Mortgage principal plus accrued interest	7,350	7,048	7,671	9,141	<b>10,925</b>
Individual allowances	(660)	(758)	(895)	(1,228)	<b>(1,304)</b>
	<b>6,690</b>	<b>6,290</b>	<b>6,776</b>	<b>7,913</b>	<b>9,621</b>
Appraised value of underlying properties	8,060	7,577	8,164	9,534	<b>11,583</b>

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

**Residential reverse mortgages (continued)**

**Allowance for mortgage losses**

The allowance for mortgage losses is maintained at a level that is considered adequate to absorb incurred losses to the mortgage loan portfolio. A mortgage allowance is recorded when, in the opinion of management, there is no longer reasonable assurance of the collection of the full amount of principal and interest. Mortgage allowances, in an amount that approximates the present value of projected future cashflow shortfalls are determined based on mortgage loans outstanding and the most recently adjusted appraised value of the underlying properties. The Bank has both individual and collective allowances as described below.

**Individual allowances**

Individual allowances are recorded when, due to identified conditions specific to a particular mortgage, management believes there is no longer reasonable assurance of the collection of the full amount of principal and interest.

**Collective allowances**

Collective allowances are provided for losses incurred within the mortgage portfolio but not yet specifically identified and therefore not yet captured in the determination of individual allowances. 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.

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

Residential reverse mortgages (continued)

Allowance for mortgage losses (continued)

	Dec 31 2012 \$	Mar 31 2013 \$	Jun 30 2013 \$	Sep 30 2013 \$	Dec 31 2013 \$
<i>(in thousands of Canadian dollars)</i>					
<b>Individual allowances</b>					
Balance, beginning of year	(485)	(660)	(660)	(660)	<b>(660)</b>
Provision for credit losses	(699)	(167)	(319)	(687)	<b>(990)</b>
Write-offs	388	—	36	36	<b>208</b>
Recoveries	136	69	48	83	<b>138</b>
Balance, end of year	(660)	(758)	(895)	(1,228)	<b>(1,304)</b>
<b>Collective allowances</b>					
Balance, beginning of year	(2,969)	(3,563)	(3,563)	(3,563)	<b>(3,563)</b>
Provision for credit losses	(594)	(118)	(573)	(16)	<b>(85)</b>
Balance, end of year	(3,563)	(3,681)	(4,136)	(3,579)	<b>(3,648)</b>
<b>Total allowances</b>	<b>(4,223)</b>	<b>(4,439)</b>	<b>(5,031)</b>	<b>(4,807)</b>	<b>(4,952)</b>
As a % of total mortgages outstanding	0.32%	0.32%	0.36%	0.33%	<b>0.33%</b>

**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.

Forward rate agreements (FRAs) are contracts that effectively fix a future interest rate for a period of time. A typical FRA provides that, at a pre-determined future date, a cash settlement will be made between counterparties based on the difference between a contracted rate and a market rate to be determined in the future, calculated on a specified notional principal amount. 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. At December 31, 2013 \$1,500, has been pledged as collateral under these agreements.

#### Market risk

Derivative financial instruments have either no or an insignificant market value at inception. Their value changes in response to relevant interest rate, foreign exchange rate 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.

#### 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 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.

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

	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
<b>Derivative financial instrument assets</b>					
Notional principal	905,000	870,000	743,500	646,500	<b>548,000</b>
Replacement cost	15,602	15,299	10,275	10,189	<b>9,980</b>
Credit risk equivalent	18,517	18,227	12,490	12,409	<b>12,117</b>
Risk-weighted assets	3,703	3,645	2,498	2,482	<b>2,423</b>
Fair value	15,602	15,299	10,275	10,189	<b>9,980</b>

**Maturity terms**

The following tables summarize the notional principal and fair value by term to maturity of derivative financial instruments outstanding as at December 31, 2013. Maturity dates range from January 2014 to September 2018.

	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
<b>Notional principal</b>					
<b>Derivative assets</b>					
Maturing within 1 year	322,000	284,500	300,500	202,500	<b>120,500</b>
Maturing in 1 to 3 years	318,000	438,500	433,000	409,000	<b>392,500</b>
Maturing in 3 to 5 years	265,000	147,000	10,000	35,000	<b>35,000</b>
	<u>905,000</u>	<u>870,000</u>	<u>743,500</u>	<u>646,500</u>	<u><b>548,000</b></u>
<b>Derivative liabilities</b>					
Maturing within 1 year	69,500	69,500	35,000	195,000	<b>180,000</b>
Maturing in 1 to 3 years	—	—	—	55,000	<b>86,000</b>
Maturing in 3 to 5 years	104,000	89,000	241,000	216,000	<b>230,000</b>
	<u>173,500</u>	<u>158,500</u>	<u>276,000</u>	<u>466,000</u>	<u><b>496,000</b></u>



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

Maturity terms (continued)

	Dec 31 2012	Mar 31 2013	Jun 30 2013	Sep 30 2013	Dec 31 2013
<i>(in thousands of Canadian dollars)</i>	\$	\$	\$	\$	\$
<b>Fair value</b>					
<b>Derivative assets</b>					
Maturing within 1 year	439	626	538	345	<b>227</b>
Maturing in 1 to 3 years	7,829	13,212	9,728	9,762	<b>9,541</b>
Maturing in 3 to 5 years	7,334	1,461	9	82	<b>212</b>
	<u>15,602</u>	<u>15,299</u>	<u>10,275</u>	<u>10,189</u>	<u><b>9,980</b></u>
<b>Derivative liabilities</b>					
Maturing within 1 year	142	42	1	41	<b>60</b>
Maturing in 1 to 3 years	—	—	—	63	<b>276</b>
Maturing in 3 to 5 years	434	145	4,156	3,283	<b>2,763</b>
	<u>576</u>	<u>187</u>	<u>4,157</u>	<u>3,387</u>	<u><b>3,099</b></u>

**TABLE 12. Operational risk**

Operational risk can arise through breakdowns in internal controls and corporate governance, resulting in financial loss. The Bank has implemented policies, procedures and internal controls to detect, prevent and manage business activity and to control operational risk. The Bank's Operational Risk committee is responsible for the oversight of operational risk, with assistance from various internal business groups.

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**

**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 all of the Bank's debt is 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. Interest rates on approximately 31% of the mortgage portfolio are based on the Government of Canada Treasury-bill and bond rates whereas interest rates on the debt and derivative instruments are based on the Bankers' Acceptance rates. Historically, changes in interest rates do not impact each benchmark rate equally, which may result in a variation in spread.

The Bank's Management is responsible for monitoring, managing and reporting interest rate risk in accordance with 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 Conduct Review and Risk Management Committee which has the oversight responsibility for risk governance and practices.

**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 2012 \$	Mar 31 2013 \$	Jun 30 2013 \$	Sep 30 2013 \$	Dec 31 2013 \$
<b>Interest sensitive</b>					
Total assets	1,473,703	1,463,506	1,482,242	1,610,000	<b>1,595,901</b>
Total liabilities and equity	1,384,053	1,371,751	1,389,914	1,512,676	<b>1,491,518</b>
Total interest rate sensitivity gap	89,650	91,755	92,328	97,324	<b>104,383</b>
<b>Non-interest sensitive</b>					
Total assets	46,105	43,350	44,597	45,301	<b>45,431</b>
Total liabilities and equity	135,755	135,105	136,925	142,625	<b>149,814</b>
Total interest rate sensitivity gap	(89,650)	(91,755)	(92,328)	(97,324)	<b>(104,383)</b>

**TABLE 14. Interest rate risk (continued)**

**Interest rate sensitivity**

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

<i>(in thousands of Canadian dollars)</i>	Dec 31 2012 \$	Mar 31 2013 \$	Jun 30 2013 \$	Sep 30 2013 \$	Dec 31 2013 \$
Before-tax impact on net income of:					
100 bps increase in interest rates	175	196	51	51	84
100 bps decrease in interest rates	(175)	(196)	(51)	(51)	(84)

## REMUNERATION

The Bank's remuneration policies are consistent with financial services industry practice. Rewards are based on both on business and individual specific performance objectives. Oversight of the Bank's compensation structure is the responsibility of the Compensation Committee, which is comprised of three Directors, two of whom are independent. The Compensation Committee meets at least twice annually, and met four times in 2013. External compensation advisors are retained by the Compensation Committee as needed.

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 are 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 shareholders' interests. The Bank's executive compensation program for vice-presidents, senior 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. Every year the CEO makes a recommendation to the Compensation Committee for each executive's base salary.

Prior to November 30, 2012, while the Bank's parent, HOMEQ was still publicly traded, Directors and executive management participated in HOMEQ's long-term incentive plans (LTIPs) and received shares under various plans. These plans ceased on November 30, 2012, when HOMEQ was acquired by Birch Hill Equity Partners Management Inc. and became a privately-held company.

REMUNERATION (continued)

Key management personnel and Directors compensation for 2013 and 2012 was comprised of:

<i>(in thousands of Canadian dollars)</i>	Number of recipients	2013 \$	Number of recipients	2012 \$
Fixed remuneration				
Cash-based	12	2,206	10	2,060
Share-based (1)	12	43	10	973
Severance payments	2	730	—	—
Directors' fees, expenses and share-based (1)	5	254	8	1,805
		<u>3,233</u>		<u>4,838</u>
Variable remuneration				
Cash-based	12	789	10	928
		<u>4,022</u>		<u>5,766</u>

(1) 2012 includes the settlement of LTIPs during the acquisition of HOMEQ by Birch Hill Equity Partners Management Inc., described above.

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**Modified Capital Disclosure Template**

The following summarizes the Bank's interim transitional and all-in capital Basel III Pillar 3 disclosures as at December 31, 2013:

<i>Modified Capital Disclosure Template (in thousands of Canadian dollars)</i>		<b>ALL-IN BASIS</b>	<b>TRANSITIONAL BASIS</b>
<b>Common Equity Tier 1 capital: instruments and reserves</b>			
1	Directly issued qualifying common share capital (and equivalent for non-joint stock companies) plus related stock surplus	<b>129,261</b>	
2	Retained earnings	<b>(24,821)</b>	
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	<b>Common Equity Tier 1 capital before regulatory adjustments</b>	<b>104,440</b>	
<b>Common Equity Tier 1 capital: regulatory adjustments</b>			
28	Total regulatory adjustments to Common Equity Tier 1	<b>1,050</b>	
29	<b>Common Equity Tier 1 capital (CET1)</b>	<b>103,390</b>	<b>103,871</b>
<b>Additional Tier 1 capital: instruments</b>			
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	<b>Additional Tier 1 capital before regulatory adjustments</b>	<b>—</b>	
<b>Additional Tier 1 capital: regulatory adjustments</b>			
43	<b>Total regulatory adjustments to Additional Tier 1 capital</b>		
44	<b>Additional Tier 1 capital (AT1)</b>	<b>—</b>	
45	<b>Tier 1 capital (T1 = CET1 + AT1)</b>	<b>103,390</b>	<b>103,871</b>
<b>Tier 2 capital: instruments and allowances</b>			
46	Directly issued qualifying Tier 2 instruments plus related stock surplus	<b>24,975</b>	
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	Collective allowances	<b>3,648</b>	
51	<b>Tier 2 capital before regulatory adjustments</b>	<b>28,623</b>	
<b>Tier 2 capital: regulatory adjustments</b>			
57	<b>Total regulatory adjustments to Tier 2 capital</b>	<b>—</b>	
58	<b>Tier 2 capital (T2)</b>	<b>28,623</b>	
59	<b>Total capital (TC = T1 + T2)</b>	<b>132,013</b>	<b>132,494</b>
60	<b>Total risk weighted assets</b>	<b>796,735</b>	<b>797,216</b>

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<b>Capital ratios</b>			
61	Common Equity Tier 1 (as a percentage of risk weighted assets)	<b>13.0%</b>	<b>13.0%</b>
62	Tier 1 (as a percentage of risk weighted assets)	<b>13.0%</b>	<b>13.0%</b>
636	Total capital (as a percentage of risk weighted assets)	<b>16.6%</b>	<b>16.6%</b>
<b>OSFI all-in target</b>			
69	Common Equity Tier 1 capital all-in target ratio		
70	Tier 1 capital all-in target ratio		
71	Total capital all-in target ratio		
<b>Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2013 and 1 Jan 2022)</b>			
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>		