HomEquity Bank®

# BASEL III PILLAR 3 DISCLOSURES

**March 31, 2015**

## Table of Contents

## Table 1. Scope of application

HomEquity 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 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 and the interests of its depositors, customers and investors.

### 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:

## 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. 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 is the potential for loss resulting from some external event, human error or the inadequacy or failure of processes or controls. Operational risk can affect the Bank's financial position, reputation, competitive position, and regulatory position. The financial measure of operational risk is the losses incurred by the Bank; there were no material operational risk losses incurred over the period. The Bank has an Operational Risk Management Framework which includes internal controls and processes designed to safeguard the Bank's customers, assets, information and reputation.

### 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. 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 of adoption was the deduction from Common Equity Tier 1 capital on an all-in basis at March 31, 2015 of $544 (December 31, 2014 - $480) 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, capital and leverage ratios, on the all-in and transitional basis 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 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 March 31, 2015, the Bank had 113,683 common shares issued and outstanding.

| *ALL-IN BASIS (in thousands of Canadian dollars)* | Mar 31 2014 | Jun 30 2014 | Sep 30 2014 | Dec 31 2014 | Mar 31 2015 |
|---|---|---|---|---|---|
| Common shares | 134,261 | 134,261 | 134,261 | 134,261 | **134,261** |
| Contributed surplus | — | — | — | — | **61** |
| Deficit | (23,168) | (20,399) | (17,104) | (14,002) | **(11,397)** |
| Accumulated other comprehensive income | — | — | — | (347) | **(1,431)** |
| Regulatory adjustments (1) | (1,161) | (1,165) | (1,202) | (1,098) | **(1,294)** |
| Common Equity Tier 1 capital | 109,932 | 112,697 | 115,955 | 118,814 | **120,200** |
| | | | | | |
| Book value of unsecured subordinated debt | 30,975 | 26,475 | 26,475 | 26,475 | **20,975** |
| Less: accumulated amortization for capital adequacy | (7,795) | (4,400) | (4,400) | (4,400) | **(692)** |
| | 23,180 | 22,075 | 22,075 | 22,075 | **20,283** |
| Eligible collective allowance | 4,034 | 3,633 | 3,875 | 3,659 | **4,022** |
| Tier 2 capital | 27,214 | 25,708 | 25,950 | 25,734 | **24,305** |
| | | | | | |
| Tier 1 capital and Total regulatory capital | 137,146 | 138,405 | 141,905 | 144,548 | **144,505** |

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

| *TRANSITIONAL BASIS (in thousands of Canadian dollars)* | Mar 31 2014 | Jun 30 2014 | Sep 30 2014 | Dec 31 2014 | Mar 31 2015 |
|---|---|---|---|---|---|
| All-in Common Equity Tier 1 capital | 109,932 | 112,697 | 115,955 | 118,814 | **120,200** |
| Transitional adjustments | 402 | 407 | 400 | 662 | **1,184** |
| Common Equity Tier 1 capital | 110,334 | 113,104 | 116,355 | 119,476 | **121,384** |
| Tier 2 capital | 27,214 | 25,708 | 25,950 | 25,734 | **24,305** |
| Tier 1 capital and Total regulatory capital | 137,548 | 138,812 | 142,305 | 145,210 | **145,689** |

## 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 44.7% at March 31, 2015. All other assets are risk-weighted at 100%.

| ***ALL-IN BASIS*** **Risk-weighted assets** ***(in thousands of Canadian dollars)*** | **Mar 31 2014** | **Jun 30 2014** | **Sep 30 2014** | **Dec 31 2014** | **Mar 31 2015** |
|---|---|---|---|---|---|
| Corporate debt securities | — | 1,593 | 1,437 | 795 | **100** |
| Deposits with regulated financial institutions | 12,100 | 12,618 | 11,157 | 12,002 | **13,444** |
| Residential reverse mortgages | 695,145 | 719,762 | 742,830 | 765,520 | **786,638** |
| Other assets | 58,662 | 57,181 | 57,229 | 57,952 | **58,245** |
| | 765,907 | 791,154 | 812,653 | 836,269 | **858,427** |
| Off-balance sheet exposure | 2,306 | 2,245 | 1,655 | 1,928 | **3,681** |
| Credit risk | 768,213 | 793,399 | 814,308 | 838,197 | **862,108** |
| Operational risk (average three-year gross income) | 53,619 | 54,050 | 55,946 | 57,258 | **58,642** |
| **Total risk-weighted assets** | 821,832 | 847,449 | 870,254 | 895,455 | **920,750** |

| ***TRANSITIONAL BASIS*** **Risk-weighted assets** ***(in thousands of Canadian dollars)*** | **Mar 31 2014** | **Jun 30 2014** | **Sep 30 2014** | **Dec 31 2014** | **Mar 31 2015** |
|---|---|---|---|---|---|
| Total risk-weighted assets on all-in basis | 821,832 | 847,449 | 870,254 | 895,455 | **920,750** |
| Transitional adjustments | 402 | 407 | 400 | 384 | **326** |
| **Total risk-weighted assets on transitional basis** | 822,234 | 847,856 | 870,654 | 895,839 | **921,076** |

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

### Capital ratios

| *ALL-IN BASIS* | Mar 31 2014 | Jun 30 2014 | Sep 30 2014 | Dec 31 2014 | Mar 31 2015 |
|---|---|---|---|---|---|
| Common Equity Tier 1 ratio (1) | 13.4% | 13.3% | 13.3% | 13.3% | **13.1%** |
| Tier 1 Capital Ratio (2) | 13.4% | 13.3% | 13.3% | 13.3% | **13.1%** |
| Total Capital Ratio (3) | 16.7% | 16.3% | 16.3% | 16.1% | **15.7%** |
| Leverage ratio (5) | — | — | — | — | **6.30%** |

(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 include on-balance assets and certain derivatives exposure.

| *TRANSITIONAL BASIS* | Mar 31 2014 | Jun 30 2014 | Sep 30 2014 | Dec 31 2014 | Mar 31 2015 |
|---|---|---|---|---|---|
| Common Equity Tier 1 ratio | 13.4% | 13.3% | 13.4% | 13.3% | **13.2%** |
| Tier 1 Capital Ratio | 13.4% | 13.3% | 13.4% | 13.3% | **13.2%** |
| Total Capital Ratio | 16.7% | 16.4% | 16.3% | 16.2% | **15.8%** |

For purposes of meeting minimum regulatory capital ratios prescribed by OSFI, the all-in basis is required. During the period ended March 31 2015, the Common Equity Tier 1, Tier 1 and Total Capital ratios remain above OSFI's stated minimum capital ratios of 7%, 8.5% and 10.5%, respectively, for a well-capitalized financial institution. Commencing on January 1, 2015, the Basel III Leverage ratio (LR) replaced the previous Asset to Capital Multiple measure. The LR is a non-risk based ratio intended to act as a supplementary measure to the risk-based capital requirements. The Leverage Ratio is calculated by dividing Tier 1 capital by total exposures, which include on-balance sheet assets and certain derivatives exposure. The Bank's LR 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 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 0.66%. 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

| *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| Cash and non-interest bearing deposits with banks | 51,524 | 19,673 | 11,398 | 16,807 | **67,218** |
| Bank debt securities | 8,972 | 43,416 | 44,386 | 43,205 | — |
| Treasury bills issued or guaranteed by Canada | 8,994 | — | 6,215 | 5,997 | — |
| Treasury bills issued or guaranteed by provinces | 2,990 | 2,998 | 1,398 | 4,492 | **8,693** |
| Other debt securities | — | 7,966 | 7,187 | 3,976 | **500** |
| | 72,480 | 74,053 | 70,584 | 74,477 | **76,411** |

## 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 37.4% indicates significant equity in the collateral which would mitigate the risk from economic downturns.

| Province *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| Ontario | 559,734 | 577,248 | 595,016 | 618,880 | **634,136** |
| British Columbia | 526,179 | 541,005 | 549,924 | 561,948 | **574,186** |
| Alberta | 199,527 | 210,870 | 219,326 | 225,684 | **233,899** |
| Quebec | 167,506 | 172,988 | 180,241 | 186,662 | **192,301** |
| Other | 104,449 | 110,978 | 116,595 | 123,273 | **128,257** |
| | 1,557,395 | 1,613,089 | 1,661,102 | 1,716,447 | **1,762,779** |

| Provincial LTV % | Mar 31 2014 % | Jun 30 2014 % | Sep 30 2014 % | Dec 31 2014 % | Mar 31 2015 % |
|---|---|---|---|---|---|
| Ontario | 38.5 | 38.3 | 38.0 | 37.7 | **37.6** |
| British Columbia | 36.6 | 36.7 | 36.9 | 36.8 | **37.0** |
| Alberta | 38.9 | 38.8 | 38.9 | 39.3 | **39.5** |
| Quebec | 36.1 | 36.2 | 36.2 | 36.4 | **36.5** |
| Other | 35.8 | 36.2 | 36.6 | 36.2 | **36.3** |
| | 37.4 | 37.4 | 37.5 | 37.4 | **37.4** |

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

### Residential reverse mortgages (continued)

| Loan-to-value *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| Less than 30.0% | 247,436 | 256,157 | 263,647 | 272,553 | **275,059** |
| 30.1% - 40.0% | 378,331 | 384,812 | 389,210 | 403,427 | **411,299** |
| 40.1% - 50.0% | 479,479 | 493,175 | 507,512 | 527,135 | **540,492** |
| 50.1% - 60.0% | 306,564 | 326,212 | 340,802 | 349,034 | **361,377** |
| 60.1% - 70.0% | 98,889 | 106,531 | 110,207 | 115,424 | **119,027** |
| Greater than 70.1% | 46,696 | 46,202 | 49,724 | 48,874 | **55,525** |
| | 1,557,395 | 1,613,089 | 1,661,102 | 1,716,447 | **1,762,779** |
| Overall LTV | 37.4% | 37.4% | 37.5% | 37.4% | **37.4%** |

### 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:

| *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| Mortgage principal plus accrued interest | 13,205 | 10,239 | 12,067 | 11,607 | **11,629** |
| Individual allowances | (1,463) | (1,332) | (1,643) | (1,715) | **(1,654)** |
| | 11,742 | 8,907 | 10,424 | 9,892 | **9,975** |
| Appraised value of underlying properties | 14,161 | 10,743 | 12,560 | 11,920 | **11,969** |

## 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.

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

### Residential reverse mortgages (continued)

### Allowance for mortgage losses (continued)

| *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| Individual allowances | | | | | |
| Balance, beginning of year | (1,304) | (1,304) | (1,304) | (1,304) | **(1,715)** |
| Provision for credit losses | (484) | (564) | (918) | (1,433) | **(450)** |
| Write-offs | 232 | 345 | 376 | 751 | **480** |
| Recoveries | 93 | 191 | 203 | 271 | **31** |
| Balance, end of year | (1,463) | (1,332) | (1,643) | (1,715) | **(1,654)** |
| Collective allowances | | | | | |
| Balance, beginning of year | (3,648) | (3,648) | (3,648) | (3,648) | **(3,659)** |
| Recovery (provision) for credit losses | (386) | 15 | (227) | (11) | **(670)** |
| Balance, end of year | (4,034) | (3,633) | (3,875) | (3,659) | **(4,329)** |
| Total allowances | (5,497) | (4,965) | (5,518) | (5,374) | **(5,983)** |
| As a % of total mortgages outstanding | 0.35% | 0.31% | 0.33% | 0.31% | **0.34%** |

## 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 March 31, 2015, there was no requirement for the Bank to post 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)

| *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| **Derivative financial instrument assets** | | | | | |
| Notional principal | 643,500 | 873,500 | 782,000 | 1,025,000 | **925,000** |
| Replacement cost | 9,015 | 7,578 | 5,498 | 6,063 | **15,514** |
| Credit risk equivalent | 11,532 | 11,223 | 8,275 | 9,639 | **18,403** |
| Risk-weighted assets | 2,306 | 2,245 | 1,655 | 1,927 | **3,681** |
| Fair value | 9,015 | 7,578 | 5,498 | 6,063 | **15,514** |

### Maturity terms

The following tables summarize the notional principal and fair value by term to maturity of derivative financial instruments outstanding as at March 31, 2015. Maturity dates range from within 1 year to within five years of March 31, 2015.

| *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| **Notional principal** | | | | | |
| Derivative assets | | | | | |
| Maturing within 1 year | 140,000 | 144,500 | 226,500 | 310,000 | **347,000** |
| Maturing in 1 to 3 years | 443,500 | 521,000 | 382,500 | 492,000 | **342,000** |
| Maturing in 3 to 5 years | 60,000 | 208,000 | 173,000 | 223,000 | **236,000** |
| | 643,500 | 873,500 | 782,000 | 1,025,000 | **925,000** |
| Derivative liabilities | | | | | |
| Maturing within 1 year | 180,000 | 295,000 | 285,000 | 195,000 | **430,000** |
| Maturing in 1 to 3 years | 76,000 | 36,000 | 71,000 | 20,000 | **25,000** |
| Maturing in 3 to 5 years | 256,000 | 133,000 | 124,000 | — | — |
| | 512,000 | 464,000 | 480,000 | 215,000 | **455,000** |

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

### Maturity terms (continued)

| *(in thousands of Canadian dollars)* | Mar 31 2014 $ | Jun 30 2014 $ | Sep 30 2014 $ | Dec 31 2014 $ | Mar 31 2015 $ |
|---|---|---|---|---|---|
| **Fair value** | | | | | |
| Derivative assets | | | | | |
| Maturing within 1 year | 393 | 529 | 1,844 | 1,215 | **3,033** |
| Maturing in 1 to 3 years | 8,541 | 6,378 | 3,264 | 2,978 | **5,300** |
| Maturing in 3 to 5 years | 81 | 671 | 390 | 1,870 | **7,181** |
| | 9,015 | 7,578 | 5,498 | 6,063 | **15,514** |
| Derivative liabilities | | | | | |
| Maturing within 1 year | 38 | 66 | 110 | 560 | **2,604** |
| Maturing in 1 to 3 years | 145 | 88 | 76 | — | **398** |
| Maturing in 3 to 5 years | 986 | 329 | 365 | — | **—** |
| | 1,169 | 483 | 551 | 560 | **3,002** |

## TABLE 12. Operational risk

The Bank's Operational Risk Management Framework governance structure has three lines of defence to safeguard the Bank against operational risk. The first line of defence 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 group (second line of defence) 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 validates the effectiveness of the Bank's operational internal controls. The Bank also has an Internal Audit function (third line of defence) 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 Operational Risk Framework. 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 defining the framework for identifying risks and developing the appropriate risk management policies that form part of the Bank's Operational Risk Management Framework. The Board of Directors, 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 Risk Appetite Framework. 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 23% 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.

## 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.

| *(in thousands of Canadian dollars)* | **Mar 31 2014 $** | **Jun 30 2014 $** | **Sep 30 2014 $** | **Dec 31 2014 $** | **Mar 31 2015 $** |
|---|---|---|---|---|---|
| **Interest sensitive** | | | | | |
| Total assets | 1,638,889 | 1,694,720 | 1,737,182 | 1,796,987 | **1,854,704** |
| Total liabilities and equity | 1,533,293 | 1,583,177 | 1,620,689 | 1,674,022 | **1,733,580** |
| Total interest rate sensitivity gap | 105,596 | 111,543 | 116,493 | 122,965 | **121,124** |
| **Non-interest sensitive** | | | | | |
| Total assets | 45,186 | 44,424 | 43,557 | 44,225 | **44,497** |
| Total liabilities and equity | 150,782 | 155,967 | 160,050 | 167,190 | **165,621** |
| Total interest rate sensitivity gap | (105,596) | (111,543) | (116,493) | (122,965) | **(121,124)** |

### 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.

| *(in thousands of Canadian dollars)* | **Mar 31 2014 $** | **Jun 30 2014 $** | **Sep 30 2014 $** | **Dec 31 2014 $** | **Mar 31 2015 $** |
|---|---|---|---|---|---|
| Before-tax impact on net income of: | | | | | |
| 100 bps increase in interest rates | 39 | 54 | 304 | 42 | **328** |
| 100 bps decrease in interest rates | (39) | (54) | (304) | (42) | **(328)** |

## Modified Capital Disclosure Template

The following summarizes the Bank's interim transitional and all-in capital Basel III Pillar 3 disclosures as at March 31, 2015:

| | ***Modified Capital Disclosure Template(in thousands of Canadian dollars)*** | ***ALL-IN BASIS*** | ***TRANISTIONAL BASIS*** |
|---|---|---|---|
| | **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 | **134,261** | |
| 2 | Retained earnings | **(11,336)** | |
| 3 | Accumulated other comprehensive income (and other reserves) | **(1,431)** | |
| 4 | *Directly issued capital subject to phase out from CET1 (only applicable to non-joint stock companies)* | | |
| 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** | **121,494** | |
| | **Common Equity Tier 1 capital: regulatory adjustments** | | |
| 28 | Total regulatory adjustments to Common Equity Tier 1 | **1,294** | |
| 29 | Common Equity Tier 1 capital (CET1) | **120,200** | **121,384** |
| | **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 | *of which: instruments issued by subsidiaries subject to phase out* | | |
| 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)** | **120,200** | **121,384** |
| | **Tier 2 capital: instruments and allowances** | | |
| 46 | Directly issued qualifying Tier 2 instruments plus related stock surplus | **20,283** | |
| 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 | *of which: instruments issued by subsidiaries subject to phase out* | | |
| 50 | Collective allowances | **4,022** | |
| 51 | **Tier 2 capital before regulatory adjustments** | **24,305** | |
| | **Tier 2 capital: regulatory adjustments** | | |
| 57 | **Total regulatory adjustments to Tier 2 capital** | — | |
| 58 | **Tier 2 capital (T2)** | **24,305** | |
| 59 | **Total capital (TC = T1 + T2)** | **144,505** | **145,689** |

| | | | |
|---|---|---|---|
| 60 | **Total risk weighted assets** | **920,750** | **921,076** |
| | **Capital ratios** | | |
| 61 | Common Equity Tier 1 (as a percentage of risk weighted assets) | **13.1%** | **13.2%** |
| 62 | Tier 1 (as a percentage of risk weighted assets) | **13.1%** | **13.2%** |
| 63 | Total capital (as a percentage of risk weighted assets) | **15.7%** | **15.8%** |
| | **OSFI all-in target** | | |
| 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 | | |
| | ***Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2013 and 1 Jan 2022)*** | | |
| 80 | *Current cap on CET1 instruments subject to phase out arrangements* | | |
| 81 | *Amount excluded from CET1 due to cap (excess over cap after redemptions and maturities)* | | |
| 82 | *Current cap on AT1 instruments subject to phase out arrangements* | | |
| 83 | *Amount excluded from AT1 due to cap (excess over cap after redemptions and maturities)* | | |
| 84 | *Current cap on T2 instruments subject to phase out arrangements* | | |
| 85 | *Amount excluded from T2 due to cap (excess over cap after redemptions and maturities)* | | |

## Leverage Ratio Template

The following summarizes the Bank's all-in Basel III Pillar 3 Leverage Ratio as at March 31, 2015:

| | ***Item (in thousands of Canadian dollars)*** | ***Leverage Ratio Framework*** |
|---|---|---|
| | **On-balance sheet exposures** | |
| 1 | On-balance sheet items (excluding derivatives, SFTs and grandfathered securitization exposures but including collateral) | **1,892,332** |
| 2 | (Asset amounts deducted in determining Basel III transitional Tier 1 capital) | **1,294** |
| 3 | **Total on-balance sheet exposures** (excluding derivatives and SFTs) (sum of lines 1 and 2) | **1,891,038** |
| | **Derivative exposures** | |
| 4 | Replacement cost associated with all derivative transactions (ie net of eligible cash variation margin) | **15,514** |
| 5 | Add-on amounts for PFE associated with all derivative transactions | **2,890** |
| 6 | Gross up for derivatives collateral provided where deducted from the balance sheet assets pursuant to the operative accounting framework | |
| 7 | (Deductions of receivables assets for cash variation margin provided in derivative | |
| 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 4 to 10)** | **18,404** |
| | **Securities financing transaction exposures** | |
| 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)** | **—** |
| | **Other off-balance sheet exposures** | |
| 17 | Off-balance sheet exposure at gross notional amount | |
| 18 | (Adjustments for conversion to credit equivalent amounts) | |
| 19 | **Off-balance sheet items (sum of lines 17 and 18)** | **—** |
| | **Capital and Total Exposures** | |
| 20 | **Tier 1 capital** | **120,200** |
| 21 | **Total Exposures (sum of lines 3, 11, 16 and 19)** | **1,909,442** |
| | **Leverage Ratios** | |
| 22 | **Basel III leverage ratio** | **6.30%** |