HomeEquity Bank™

BASEL III PILLAR 3 DISCLOSURES

March 31, 2021

Table of Contents

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.

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 which may be used as additional liquidity if the Bank is unable to meet its obligations when they become due. 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. In July 2020, the Bank arranged another source of liquidity under the Bank of Canada's Standing Term Liquidity Facility, which the Bank of Canada recently made available to support the financial sector.

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 a bank that started offering reverse mortgages in January 2019. 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 have caused material disruption to businesses globally and the extent of economic recovery remains uncertain. The Canadian government and central bank introduced significant monetary and fiscal interventions to stabilize economic conditions; however, the success of these interventions is not currently determinable. The arrival of effective vaccinations is positive to the economy however the continued spread of the virus 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 units and average prices in the second half of 2020. That record sales activity continued in Q1 2021 with record number of transactions and record price appreciation. The economists, whose projections the Bank refers to, have positive predictions of the Canadian real estate market for 2021 and for future years. Although the unemployment rate has reduced to lowest levels since February 2020, it continues to be higher than pre-COVID period. The government continues to provide various programs to subsidize incomes however, it is unknown what the lasting effect of COVID-19 will be on the unemployment rate and what the impact of high unemployment will be on the real estate market. The Bank of Canada has stated that it will hold the policy interest rate at the effective lower bound until sometime in the second half of 2022 which may continue to have a positive impact on real estate purchasing power.

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 has not changed the scenario weightings in the Bank's ECL calculation for March 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 (GIC) 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 significantly eased its monetary policy, reducing its key benchmark interest rate to 25 bps, a rate last seen during the global financial crisis, and other market and administered rates have experienced similar declines. The Bank of Canada has stated that it will hold the policy interest rate at the effective lower bound until sometime in the second half of 2022.

These reductions impact 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 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 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.

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, accumulated other comprehensive income (loss) 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 March 31, 2021, the Bank had 135,501 common shares issued and outstanding.

(in thousands of Canadian dollars)	Mar 31 2020	Jun 30 2020	Sept 30 2020	Dec 31 2020	Mar 31 2021
Common shares	165,901	165,901	165,901	165,901	**165,916**
Contributed surplus	1,126	1,136	1,146	1,131	**1,129**
Retained earnings	107,923	120,588	138,186	150,892	**164,629**
Accumulated other comprehensive income	12	23	18	—	—
Regulatory adjustments	(808)	(437)	(1,232)	(1,706)	**(1,917)**
Common Equity Tier 1 capital and Tier 1 capital	273,154	287,211	304,019	316,218	**329,757**
Unsecured subordinated debt	16,000	16,000	16,000	16,000	**16,000**
Eligible Stage 1 and Stage 2 allowance	7,340	7,922	7,682	7,782	**7,902**
Tier 2 capital	23,340	23,922	23,682	23,782	**23,902**
Total regulatory capital	297,494	311,133	327,701	340,000	**353,659**

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

Capital Structure (continued)

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 $1,490 as of Q1 2021. The incremental $1,490 is subject to this transition. Assuming a 27.50% tax rate, and after applying the 50% factor, $540 is to be included in CET1 capital. The balance of $950 is to be added to Tier 2 capital. This results in the total allowances included in Total capital during the period ended March 31, 2021 of $8,442: $6,952 in Tier 2 as the baseline plus $540 added to CET1 and $950 added to Tier 2.

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% at March 31, 2021. All other assets are risk-weighted at 100%.

Risk-weighted assets *(in thousands of Canadian dollars)*	**Mar 31 2020**	**Jun 30 2020**	**Sept 30 2020**	**Dec 31 2020**	**Mar 31 2021**
Deposits with regulated financial institutions	37,139	29,404	23,576	52,636	**29,527**
Residential reverse mortgages	1,835,774	1,916,691	1,963,730	2,011,476	**2,079,825**
Other assets	76,100	76,156	75,588	78,477	**77,379**
	1,949,013	2,022,251	2,062,894	2,142,589	**2,186,731**
Off-balance sheet exposure	24,691	24,631	24,443	24,468	**24,635**
Credit risk	1,973,704	2,046,882	2,087,337	2,167,057	**2,211,366**
Operational risk (average three-year gross income)	164,938	174,888	187,975	202,000	**212,563**
Total risk-weighted assets	2,138,642	2,221,770	2,275,312	2,369,057	**2,423,929**

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

Capital ratios

Capital ratios	Mar 31 2020	Jun 30 2020	Sept 30 2020	Dec 31 2020	Mar 31 2021
Common Equity Tier 1 ratio (1)	12.8%	12.9%	13.4%	13.4%	**13.6%**
Tier 1 Capital Ratio (2)	12.8%	12.9%	13.4%	13.4%	**13.6%**
Total Capital Ratio (3)	13.9%	14.0%	14.4%	14.4%	**14.6%**
Leverage ratio (4)	6.07%	6.18%	6.46%	6.38%	**6.63%**

Capital ratios without transitional ECL arrangement applied	Mar 31 2020	Jun 30 2020	Sept 30 2020	Dec 31 2020	Mar 31 2021
Common Equity Tier 1 ratio (1)	12.8%	12.9%	13.3%	13.3%	**13.6%**
Tier 1 Capital Ratio (2)	12.8%	12.9%	13.3%	13.3%	**13.6%**
Total Capital Ratio (3)	13.9%	14.0%	14.4%	14.4%	**14.6%**
Leverage ratio (4)	6.06%	6.15%	6.45%	6.36%	**6.62%**

(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 period ended March 31, 2021, 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. 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 Schedule I Canadian chartered banks with high credit rating.

Cash resources and securities

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	**Mar 31 2021 $**
Cash and deposits with banks	185,695	147,018	118,587	264,710	**147,825**
Treasury bills issued or guaranteed by Canada	990	994	998	—	—
	186,685	148,012	119,585	264,710	**147,825**

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 0.27%. 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 $15,000 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 36.0% indicates significant equity in the collateral which would mitigate the risk from economic downturns.

Province *(in thousands of Canadian dollars)*	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Ontario	1,836,026	1,943,466	2,006,626	2,100,707	**2,202,633**
British Columbia	1,442,864	1,495,756	1,517,355	1,534,476	**1,559,941**
Alberta	411,109	419,227	420,184	415,305	**419,831**
Quebec	275,339	279,099	278,461	281,150	**283,969**
Other Canadian provinces	224,590	227,096	226,257	222,746	**223,902**
	4,189,928	4,364,644	4,448,883	4,554,384	**4,690,276**

Provincial LTV %	Mar 31 2020 %	Jun 30 2020 %	Sept 30 2020 %	Dec 31 2020 %	Mar 31 2021 %
Ontario	35.1	35.1	35.1	34.7	**35.0**
British Columbia	33.4	33.6	33.8	33.8	**34.2**
Alberta	42.4	42.6	43.0	43.6	**43.9**
Quebec	40.3	40.5	40.5	40.2	**40.5**
Other Canadian provinces	41.9	42.1	42.3	42.1	**42.2**
Overall LTV	35.7	35.8	35.9	35.7	**36.0**

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 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
30.0% or less	815,148	842,795	857,134	901,001	**903,581**
30.1% - 40.0%	1,045,167	1,093,131	1,093,534	1,126,570	**1,144,356**
40.1% - 50.0%	1,156,434	1,200,958	1,222,270	1,249,580	**1,280,340**
50.1% - 60.0%	788,554	808,667	843,954	847,777	**888,106**
60.1% - 70.0%	279,380	298,016	294,046	289,239	**328,408**
70.1% - 83.0%	70,552	82,381	93,804	93,902	**97,652**
Greater than 83.0%	34,693	38,696	44,141	46,315	**47,833**
	4,189,928	4,364,644	4,448,883	4,554,384	**4,690,276**
Overall LTV	35.7%	35.8%	35.9%	35.7%	**36.0%**

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 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Mortgage principal plus accrued interest	34,693	38,696	44,142	46,315	**47,833**
Individual allowances (Stage 3)	(5,908)	(6,976)	(7,453)	(7,166)	**(7,800)**
	28,785	31,720	36,689	39,149	**40,033**
Appraised value of underlying properties	34,631	38,216	44,203	47,167	**48,445**

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)

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Individual allowances (Stage 3)					
Balance, beginning of period	(5,790)	(5,908)	(6,976)	(7,453)	**(7,166)**
Provision for credit losses	(766)	(1,269)	(1,072)	(1,221)	**(1,101)**
Realized losses net of recoveries	648	201	595	1,508	**467**
Balance, end of period	(5,908)	(6,976)	(7,453)	(7,166)	**(7,800)**
Expected credit losses (Stage 1 and Stage 2)					
Balance, beginning of period	(6,952)	(7,751)	(8,948)	(8,455)	**(8,653)**
Provision for credit losses	(791)	(1,196)	492	(198)	**191**
Realized gains /(losses) net of recoveries	(8)	(1)	1	—	**20**
Balance, end of period	(7,751)	(8,948)	(8,455)	(8,653)	**(8,442)**
Total expected credit losses	(13,659)	(15,924)	(15,908)	(15,819)	**(16,242)**
As a % of total mortgages outstanding	0.33%	0.36%	0.36%	0.35%	**0.35%**

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 March 31, 2021, the Bank has no amount pledged.

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 Schedule I Canadian chartered banks with high credit rating as counterparties. The maximum derivative credit exposure to the Bank is the fair value of derivative contracts presented in the summary table below.

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Derivative financial instrument assets					
Notional principal	320,000	370,000	405,000	450,000	**305,000**
Replacement cost	7,463	8,118	7,497	6,940	**5,265**
Credit risk equivalent	2,019	9,418	8,972	8,541	**6,065**
Risk-weighted assets	404	1,884	1,794	1,708	**1,214**
Fair value	7,463	8,118	7,497	6,940	**5,265**

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

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Notional principal					
Derivative assets					
Maturing within 1 year	50,000	110,000	110,000	130,000	**145,000**
Maturing in 1 to 3 years	145,000	220,000	270,000	170,000	**135,000**
Maturing in 3 to 5 years	125,000	40,000	25,000	150,000	**25,000**
	320,000	370,000	405,000	450,000	**305,000**
Derivative liabilities					
Maturing within 1 year	135,000	35,000	—	—	—
Maturing in 1 to 3 years	—	—	—	—	225,000
	135,000	35,000	—	—	225,000

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

Maturity terms

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Fair value					
Derivative assets					
Maturing within 1 year	133	257	157	631	**729**
Maturing in 1 to 3 years	1,161	5,915	6,289	5,114	**4,021**
Maturing in 3 to 5 years	6,169	1,946	1,051	1,195	**515**
	7,463	8,118	7,497	6,940	**5,265**
Derivative liabilities					
Maturing within 1 year	54	—	—	—	—
Maturing in 1 to 3 years	—	13	—	—	**3,998**
	54	13	—	—	**3,998**

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.

TABLE 12. Operational risk (continued)

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. Interest rates on approximately 4.00% 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 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.

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
Interest sensitive					
Total assets	4,384,076	4,520,444	4,575,965	4,826,034	**4,843,366**
Total liabilities	4,040,340	4,154,002	4,178,614	4,430,512	**4,445,610**
Total interest rate sensitivity gap	343,736	366,442	397,351	395,522	**397,756**
Non-interest sensitive					
Total assets	46,163	36,943	44,666	47,845	**46,344**
Total liabilities and equity	389,899	403,385	442,017	443,367	**444,100**
Total non-interest rate sensitivity gap	(343,736)	(366,442)	(397,351)	(395,522)	**(397,756)**

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.

(in thousands of Canadian dollars)	Mar 31 2020 $	Jun 30 2020 $	Sept 30 2020 $	Dec 31 2020 $	Mar 31 2021 $
After-tax impact on net income of:					
100 bps increase in interest rates	904	1,236	1,736	1,699	**1,292**
100 bps decrease in interest rates	(904)	(1,236)	(1,736)	(1,699)	**(1,292)**

Modified Capital Disclosure Template

The following summarizes the Bank's interim Basel III Pillar 3 disclosures as at March 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	**167,045**
2	Retained earnings	**164,629**
3	Accumulated other comprehensive income (and other reserves)	
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**	**331,674**
	Common Equity Tier 1 capital: regulatory adjustments	
28	Total regulatory adjustments to Common Equity Tier 1	**(1,917)**
29	Common Equity Tier 1 capital (CET1)	**329,757**
29a	Common Equity Tier 1 capital (CET1) with transitional arrangements for ECL provisioning not applied	**329,217**
	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)**	**329,757**
45a	**Tier 1 capital with transitional arrangements for ECL provisioning not applied**	**329,217**
	Tier 2 capital: instruments and allowances	
46	Directly issued qualifying Tier 2 instruments plus related stock surplus	**16,000**
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	Eligible Stage 1 and Stage 2 allowance	**8,442**
51	**Tier 2 capital before regulatory adjustments**	**24,442**
	Tier 2 capital: regulatory adjustments	
57	**Total regulatory adjustments to Tier 2 capital**	**(540)**
58	**Tier 2 capital (T2)**	**23,902**

59	**Total capital (TC = T1 + T2)**	**353,659**
59a	**Total capital with transitional arrangements for ECL provisioning not applied**	**353,659**
60	**Total risk weighted assets**	**2,423,929**
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)	**13.6%**
61a	Common Equity Tier 1 Ratio with transitional arrangements for ECL provisioning not applied	**13.6%**
62	Tier 1 (as a percentage of risk weighted assets)	**13.6%**
62a	Tier 1 Capital Ratio with transitional arrangements for ECL provisioning not applied	**13.6%**
63	Total capital (as a percentage of risk weighted assets)	**14.6%**
63a	Total Capital Ratio with transitional arrangements for ECL provisioning not applied	**14.6%**
	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	*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 Basel III Pillar 3 Leverage Ratio as at March 31, 2021:

	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)	**4,907,020**
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)	**(7,722)**
5	**Total on-balance sheet exposures** (excluding derivatives and SFTs) (sum of lines 1 and 2)	**4,899,298**
6	Replacement cost associated with all derivative transactions	**5,265**
7	Add-on amounts for PFE associated with all derivative transactions	**3,226**
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)**	**8,491**
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	**135,646**
18	(Adjustments for conversion to credit equivalent amounts)	**(69,033)**
19	**Off-balance sheet items (sum of lines 17 and 18)**	**66,613**
20	**Tier 1 Capital**	**329,757**
20a	**Tier 1 Capital with transitional arrangements for ECL provisioning not applied**	**329,217**
21	**Total Exposures (sum of lines 5, 11, 16 and 19)**	**4,974,402**
22	**Basel III leverage ratio**	**6.63%**
22a	**Basel III leverage ratio with transitional arrangements for ECL provisioning not applied**	**6.62%**