

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF OPERATIONS AND FINANCIAL CONDITION

This management's discussion and analysis ("MD&A") of operations and financial condition for the third quarter of fiscal 2017, dated August 28, 2017, should be read in conjunction with the unaudited interim consolidated financial statements for the period ended July 31, 2017, included herein and which have been prepared in accordance with International Financial Reporting Standards ("IFRS"). This MD&A should also be read in conjunction with Versabank's (the "Bank") MD&A and the Audited Consolidated Financial Statements for the year ended October 31, 2016, which are available on the Bank's website at [www.versabank.com](http://www.versabank.com) and SEDAR at [www.sedar.com](http://www.sedar.com). Except as discussed below, all other factors discussed and referred to in the MD&A for the year ended October 31, 2016, remain substantially unchanged.

### HIGHLIGHTS

(unaudited)	for the three months ended		for the nine months ended	
	July 31	July 31	July 31	July 31
(\$CDN thousands except per share amounts)	2017	2016	2017	2016
<b>Results of operations</b>				
Net interest income	\$ 10,751	\$ 9,836	\$ 32,475	\$ 28,338
Non-interest income (loss)	12	343	(154)	953
Total revenue	10,763	10,179	32,321	29,291
Provision (recovery) for credit losses	38	24	(241)	449
Non-interest expenses	7,012	6,654	19,690	19,177
Income before restructuring charges and income taxes*	3,713	3,501	12,872	9,665
Restructuring charges	-	98	2,045	543
<b>Net income</b>	<b>2,682</b>	<b>2,456</b>	<b>16,650</b>	<b>6,574</b>
Income per common share:				
Basic	\$ 0.10	\$ 0.09	\$ 0.72	\$ 0.25
Diluted	\$ 0.10	\$ 0.09	\$ 0.72	\$ 0.25
Yield*	4.14%	4.13%	4.23%	4.20%
Cost of funds*	1.61%	1.82%	1.67%	1.92%
Net interest margin*	2.53%	2.31%	2.56%	2.28%
Return on average common equity*	4.81%	4.90%	12.03%	4.37%
Book value per common share*	\$ 8.38	\$ 7.72	\$ 8.38	\$ 7.72
Gross impaired loans to total loans	0.04%	0.00%	0.04%	0.00%
Provision (recovery) for credit losses as a % of average loans	0.00%	0.00%	(0.02%)	0.03%
	<b>as at</b>			
<b>Balance Sheet Summary</b>				
Cash and securities	\$ 103,579	\$ 152,028	\$ 103,579	\$ 152,028
Total loans	1,534,893	1,499,006	1,534,893	1,499,006
Average loans*	1,539,080	1,510,643	1,549,253	1,473,333
Total assets	1,684,523	1,685,294	1,684,523	1,685,294
Average assets*	1,686,688	1,691,800	1,694,462	1,655,550
Deposits	1,343,612	1,357,963	1,343,612	1,357,963
Subordinated notes payable	9,772	14,039	9,772	14,039
Shareholders' equity	206,267	184,537	206,267	184,537
<b>Capital ratios*</b>				
Risk-weighted assets	\$ 1,360,050	\$ 1,384,117	\$ 1,360,050	\$ 1,384,117
Total capital	184,941	187,235	184,941	187,235
Common Equity Tier 1 (CET1) ratio	11.00%	10.70%	11.00%	10.70%
Tier 1 capital ratio	13.16%	12.82%	13.16%	12.82%
Total capital ratio	13.60%	13.53%	13.60%	13.53%
Leverage ratio	10.27%	9.77%	10.27%	9.77%

\* This is a non-GAAP measure. See definition under 'Basis of Presentation' in the attached Management's Discussion and Analysis.

## **Overview**

VersaBank is a technologically proficient Canadian Schedule I chartered bank which operates using an electronic branchless model. The Bank sources its funding through a well-established and widely diversified nationwide network of deposit brokers, holdback balances retained from vendor partners, and from insolvency industry professionals through a customized banking software solution. The Bank purchases loan and lease receivables from non-bank financial companies and also originates and services real estate development and commercial loans that are sourced through direct contact with its clients as well as through mortgage brokers and syndication partners. The Bank's Common Shares, Series 1 Preferred Shares, and Series 3 Preferred Shares trade on the Toronto Stock Exchange.

On September 12, 2016 and November 15, 2016, PWC Capital Inc. ("PWC") and VersaBank jointly announced that they had entered into an agreement to merge by amalgamation under the Bank Act (Canada) (the "Amalgamation"). This transaction was completed on January 31, 2017, pursuant to section 228 of the Bank Act (Canada), with the amalgamated entity continuing under the name VersaBank. Pursuant to the Amalgamation: (i) each issued and outstanding common share of PWC (other than PWC common shares with respect to which dissent rights were exercised) was converted into common shares of the Bank on the basis of 54.508758 PWC common shares for 1 Bank common share, resulting in a total of 13,643,713 Bank common shares being issued, (ii) 12,615,219 outstanding common shares of VersaBank held by PWC prior to the Amalgamation were cancelled, and (iii) each issued and outstanding security of VersaBank held prior to the Amalgamation continued on under the same arrangement subsequent to the Amalgamation. As a result of the above, at January 31, 2017 the issued and outstanding common shares of the Bank increased by 1,028,494 shares to 21,123,559 common shares.

In addition, each outstanding option to acquire PWC Common Shares was converted into an option to purchase Bank common shares resulting in 7,059 additional options being issued.

Net income for the quarter was \$2.7 million or \$0.10 per common share (basic and diluted), compared to \$2.1 million or \$0.07 per common share (basic and diluted) last quarter and \$2.5 million or \$0.09 per common share (basic and diluted) for the same period a year ago. The quarter over quarter improvement was primarily due to higher fees earned on real estate assets combined with a reduction in the Bank's cost of funds and a decrease in restructuring charges partially offset by higher non-interest expenses related to a feasibility study conducted by the Bank pertaining to the Advanced Internal Rating-Based (AIRB) approach to risk capitalization. The year over year improvement was primarily due to a reduction in the Bank's cost of funds partially offset by an increase in non-interest expenses as noted above.

Income before restructuring charges and income taxes for the quarter was \$3.7 million compared to \$4.5 million last quarter and \$3.5 million for the same period a year ago. The quarter over quarter decline was primarily a function of higher non-interest expenses incurred in the current quarter as noted above and the impact of a recovery of credit losses in the amount of \$582,000 realized last quarter related to the sale of the Bank's credit card portfolio. The year over year improvement was due primarily to a reduction in the Bank's cost of funds over the same period partially offset by an increase in non-interest expenses as noted above.

Net income for the nine months ended July 31, 2017 was \$16.7 million or \$0.72 per common share (basic and diluted) compared to \$6.6 million or \$0.25 per common share (basic and diluted) for the same period

a year ago. The year over year improvement was primarily a function of the Bank recognizing \$8.8 million in deferred income tax assets derived from the tax loss carry-forwards assumed pursuant to the Amalgamation and a reduction in the Bank's cost of funds over the same period.

Total assets at July 31, 2017 were \$1.68 billion compared to \$1.69 billion last quarter and \$1.69 billion a year ago. Lending assets totalled \$1.53 billion compared to \$1.54 billion last quarter and \$1.50 billion a year ago. The modest quarter over quarter decline in lending assets was due to repayments in the real estate portfolio partially offset by growth in the purchased receivable portfolio.

Credit quality remains strong with gross impaired loans at July 31, 2017 totaling \$627,000 (\$nil at April 30, 2017 and a year ago), which represents approximately 0.04% of total loans.

### ***Total Revenue***

Total revenue consists of net interest income and non-interest income. Non-interest income consists primarily of income derived from credit card operations.

Total revenue for the quarter was \$10.8 million compared to \$10.1 million last quarter and \$10.2 million for the same period a year ago. The quarter over quarter improvement was due to higher interest income and fees earned on the real estate and purchased receivables portfolios combined with a reduction in the Bank's cost of funds over the same period partially offset by a reduction in credit card income resulting from the sale of the Bank's credit card portfolio in the previous quarter. The year over year improvement was primarily due to net interest income growth driven by increased income earned on the purchased receivables portfolio combined with a reduction in the Bank's cost of funds over the same period partially offset by a reduction in credit card income as a result of the sale of the Bank's credit card portfolio.

Total revenue for the nine months ended July 31, 2017 was \$32.3 million compared to \$29.3 million a year ago. The year over year improvement was primarily due to net interest income growth driven by a reduction in the Bank's cost of funds over the same period combined with increased income earned on lending assets partially offset by a reduction in credit card income resulting from the sale of the Bank's credit card portfolio.

### ***Net Interest Income***

Net interest income for the quarter was \$10.8 million compared to \$10.6 million last quarter and \$9.8 million a year ago. The quarter over quarter improvement was primarily due to higher interest income and fees earned on the real estate and purchased receivables portfolios combined with a reduction in the Bank's cost of funds over the same period partially offset by a reduction in credit card income resulting from the sale of the Bank's credit card portfolio in the previous quarter. The year over year improvement was primarily a function of a reduction in the Bank's cost of funds.

Net interest income for the nine months ended July 31, 2017 was \$32.5 million compared to \$28.3 million a year ago. The improvement was a function of the factors outlined above.

### ***Net Interest Margin***

Net interest margin or spread for the quarter was 2.53% compared to 2.51% last quarter and 2.31% a year ago. The modest quarter over quarter increase was primarily due to increased fees earned on real

estate assets combined with a reduction in the Bank's cost of funds. The year over year improvement was primarily due to a reduction in the Bank's cost of funds.

Net interest margin or spread for the nine months ended July 31, 2017 was 2.56% compared to 2.28% for the same period a year ago. The year over year improvement was primarily due to a reduction in the Bank's cost of funds.

### ***Provision for Credit Losses***

The Bank maintains strong underwriting standards and high credit quality and as a result typically requires lower provisions for credit losses. During the quarter the Bank recorded a net provision in the amount of \$38,000 compared to a recovery for credit losses in the amounts of \$582,000 last quarter and a provision for credit losses of \$24,000 a year ago. The recovery last quarter was due to a decrease in the Bank's collective allowance that resulted from the sale of the Bank's credit card portfolio during the same period.

For the nine months ended July 31, 2017 the Bank recorded a net recovery on credit losses of \$241,000 or 2 bps of average loans compared to a provision for credit losses of \$449,000 or 3 bps of average loans for the same period a year with the variance largely attributable to the recovery in the second quarter as noted above.

### ***Non-Interest Expenses***

Non-interest expenses of the Bank, excluding restructuring charges, totalled \$7.0 million for the quarter compared to \$6.2 million last quarter and \$6.7 million a year ago. The increase over the comparative periods was primarily due to costs related to a feasibility study conducted by the Bank pertaining to the AIRB approach to risk capitalization.

For the nine months ended July 31, 2017 non-interest expense, excluding restructuring charges, totalled \$19.7 million compared to \$19.2 million during the same period a year ago with the increase largely attributable to the feasibility study noted above.

### ***Restructuring Charges***

Restructuring charges for the quarter totalled \$nil compared to \$1.6 million last quarter and \$98,000 a year ago. The restructuring charges in the last quarter related to termination benefits incurred as a function of the sale of the credit card portfolio, costs associated with the Bank's corporate reorganization as well as costs associated with the Bank's corporate rebranding and strategic review that resulted in the Amalgamation.

For the nine months ended July 31, 2017 restructuring charges totalled \$2.0 million compared to \$0.5 million during the same period a year ago with the increase attributable to the items noted above.

### ***Income Taxes***

The statutory federal and provincial income tax rate of the Bank is approximately 27%, similar to that of the previous periods. The statutory rate is impacted by certain items not being taxable or deductible for income tax purposes.

For the three months ended July 31, 2017, the provision for income taxes was \$1.0 million compared to \$809,000 for the previous quarter and \$947,000 for the same period a year ago.

For the nine months ended July 31, 2017, the recovery of income taxes was \$5.8 million compared to a provision for income taxes of \$2.5 million for the same period a year ago. As noted in the "Overview" section above, the current year-to-date recovery reflects the impact of the Bank recognizing \$8.8 million in deferred income tax assets derived from the aggregate tax loss carry-forwards of PWC assumed by the Bank pursuant to the Amalgamation. See Note 11 to the unaudited interim consolidated financial statements for the additional information on the Amalgamation and its impact on the deferred income tax asset.

### ***Comprehensive Income***

Comprehensive income is comprised of net income for the period and other comprehensive income that consists of unrealized gains and losses on available-for-sale securities. Comprehensive income of the Bank for the quarter was \$2.7 million compared to \$2.1 million last quarter and \$2.5 million for the same period a year ago. Due to the current composition of the Bank's treasury portfolio, which consists primarily of liquid securities, unrealized gains or losses in the portfolio are not significant and as a result comprehensive income does not typically differ significantly from net income.

Comprehensive income for the nine months ended July 31, 2017 was \$16.6 million compared to \$6.6 million for the same period a year ago. The year over year increase is primarily a function of the Bank recognizing \$8.8 million in deferred income tax assets derived from the aggregate tax loss carry-forwards pursuant to the Amalgamation in the first quarter of this year and a reduction in the Bank's cost of funds over the same period.

### ***Consolidated Balance Sheet***

Total assets at July 31, 2017 were \$1.68 billion compared to \$1.69 billion at the end of the last quarter and \$1.69 billion a year ago. The modest quarter over quarter decrease was primarily a function of repayments in the real estate portfolio offset by modest growth in the purchased receivables portfolio.

### ***Cash and Securities***

Cash and securities, which are held primarily for liquidity purposes totalled \$104 million at July 31, 2017 or 6.2% of total assets compared to \$100 million or 5.9% of total assets last quarter and \$152 million or 9.0% of total assets a year ago. The decline in cash and securities from a year ago was a result of the Bank's efforts to normalize its liquidity levels to more closely align with policy.

### ***Loans***

At July 31, 2017, loans totalled \$1.53 billion compared to \$1.54 billion at the end of the last quarter and \$1.50 billion a year ago. The modest quarter over quarter decrease in loan balances was primarily a function of repayments in the real estate portfolio partially offset by modest growth in the purchased receivables portfolio. The year over year increase in loan balances was largely attributable to the increase in purchase receivable volumes.

Total new lending for the current quarter was \$212 million compared to \$279 million last quarter and \$234 million a year ago. The quarter over quarter decline was primarily a function of a decrease in real estate

loan fundings partially offset by an increase in purchased receivable volumes late in the quarter. The year over year decline was a function of decreased purchased receivable volumes and real estate loan fundings over the same period. Loan repayments for the quarter totalled \$230 million compared to \$337 million last quarter and \$259 million a year ago.

At July 31, 2017, loan commitments representing loans in the Bank's pipeline totalled \$185 million compared to \$185 million last quarter and \$301 million a year ago.

### *Residential mortgage exposures*

In accordance with the Office of the Superintendent of Financial Institutions (OSFI) *Guideline B-20 – Residential Mortgage Underwriting Practices and Procedures*, additional information is provided regarding the Bank's residential mortgage exposure. For the purposes of the Guideline, a residential mortgage is defined as a loan to an individual that is secured by residential property (one to four unit dwellings) and includes home equity lines of credit (HELOC's). This differs from the classification of residential mortgages used by the Bank which also includes multi-family mortgages.

Under OSFI's definition, the Bank's exposure to residential mortgages at July 31, 2017 totalled \$606,000 compared to \$617,000 at the end of the last quarter and \$647,000 a year ago. The Bank did not have any HELOC's outstanding at July 31, 2017, at the end of the previous quarter or a year ago.

### *Credit Quality*

Gross impaired loans at July 31, 2017, were \$627,000, compared to \$nil in the last quarter and a year ago. At July 31, 2017, the Bank's collective allowance totalled \$2.1 million compared to \$2.3 million last quarter and \$2.9 million a year ago. The quarter over quarter decline was primarily due to a reduction in real estate lending assets that typically attract a higher collective allowance combined with the impact of the removal of a small corporate loan from the collective allowance calculation that was determined to have become impaired over the course of the quarter. The Bank has recorded a specific provision for credit losses in the amount of \$200,000 related to the impaired loan.

Based on the Bank's review and analysis of its lending and treasury assets, combined with the secured nature of the existing loan portfolio, the Bank is of the view that any credit losses that exist, but cannot be identified specifically at this time, are adequately provided for. Additionally, the Bank's exposure to Western Canada and to the oil and gas industry remains limited and the Bank is not concentrated in the Toronto or Western Canada housing markets.

### *Other Assets*

Included in other assets are prepaid expenses as well as funds held for securitization liabilities, capital assets, and the Bank's deferred income tax asset. At July 31, 2017 other assets totalled \$46.1 million, compared to \$45.3 million last quarter and \$34.3 million a year ago. The quarter over quarter increase was primarily due to a modest increase in working capital items offset by draw downs on the Bank's deferred income tax asset related to taxable income generated by the Bank over the same period. The year over year increase was a function of the Bank recognizing \$8.8 million in deferred income tax assets derived from the aggregate tax loss carry-forwards pursuant to the Amalgamation partially offset by a decrease in funds held for securitization liabilities and draw downs on the Bank's deferred income tax asset related to taxable income earned by the Bank over the same period.

The deferred income tax asset of the Bank was \$25.3 million at July 31, 2017, compared to \$26.1 million last quarter and \$6.9 million a year ago. The quarter over quarter decrease was due to draw downs on the Bank's deferred income tax asset related to taxable income generated by the Bank over the same period. The year over year increase was a function of the factors outlined above. The Bank's income tax loss carry-forwards are scheduled to begin to expire in 2025 if unutilized.

### *Deposits and Other Liabilities*

Deposits are used as a primary source of financing growth in assets and are raised primarily through a well-established and widely diversified nationwide broker network that the Bank continues to grow and expand across Canada. Deposits at July 31, 2017, totalled \$1.34 billion compared to \$1.35 billion last quarter and \$1.36 billion a year ago, consisting primarily of guaranteed investment certificates. The quarter over quarter decrease in deposits was primarily due to the Bank having a reduced demand for new funds as a result of real estate repayments received over the course of the quarter combined with the Bank's continued efforts to normalize its liquidity levels to more closely align with policy. At July 31, 2017 demand savings accounts totalled \$18.6 million or approximately 1.39% of total deposits compared to \$19.3 million or 1.43% of total deposits last quarter and \$17.3 million or approximately 1.28% of total deposits a year ago.

Over the course of the quarter ended July 31, 2017 the Bank was able to continue to raise new, as well as renew existing term deposits at rates which were consistent with historical trends and in amounts adequate to fund its lending obligations and maintain liquidity levels which were comfortably within the Bank's liquidity policy thresholds.

An additional source of funds for the Bank, which not only contributes to diversifying the Bank's funding mix, but also to reducing its cost of new deposits, is a specialized chequing account for trustees in the Canadian insolvency industry. The Bank has developed banking software to enable this market to efficiently administer its chequing accounts and has provided specialized software to trustees operating across Canada. At July 31, 2017 trustee chequing account balances totalled \$252.4 million compared to \$213.4 million last quarter and \$160.3 million a year ago. The increase in trustee deposit balances from the comparative periods is the result of continued growth in the number of trustees that have established chequing accounts with the Bank.

Other liabilities typically consist of accounts payable and accruals and holdbacks payable related to the receivable purchase program. Other liabilities at July 31, 2017 totalled \$91.5 million compared to \$89.0 million at the end of the last quarter and \$85.1 million a year ago. The year over year increase was primarily due to the increase in holdbacks payable balances over the same period. Holdbacks payable totalled \$82.9 million at July 31, 2017 compared to \$81.1 million at the end of the last quarter and \$77.7 million a year ago. The year over year increase was a function of the growth of the Bank's purchased receivable portfolio over the same period.

### *Securitization Liabilities*

Securitization liabilities relate to amounts payable to counterparties for cash received upon the initiation of securitization transactions. Securitization liabilities at July 31, 2017 totalled \$33.4 million compared to \$33.2 million at the end of last quarter and \$43.7 million a year ago. The year over year reduction in securitization liabilities was due to the maturity of \$10.3 million in Canada Mortgage Bonds in December 2016. The amounts payable to counterparties bear interest at rates ranging from 3.55% - 3.95% and

mature in 2020. Residential mortgages and other assets are pledged as collateral for securitized liabilities.

### ***Subordinated Notes Payable***

Subordinated notes payable, net of issue costs, totalled \$9.8 million at July 31, 2017 compared to \$14.1 million at the end of the last quarter and \$14.0 million a year ago. The decrease from the comparative periods is a result of the Bank redeeming an 11%, ten-year, unsecured, callable subordinated note in the principal amount of \$4.5 million on May 31, 2017. Subsequent to the redemption of the \$4.5 million subordinated note the Bank has one remaining subordinated note outstanding in the principal amount of \$10 million bearing interest at 8% per annum and maturing in 2021. The \$10 million subordinated note is unsecured, callable and is payable to an unrelated party.

### ***Shareholders' Equity***

At July 31, 2017, shareholders' equity was \$206.3 million compared to \$204.1 million at the end of the last quarter and \$184.5 million a year ago. The quarter over quarter increase was primarily due to retained earnings growth over the same period. The year over year increase in shareholders' equity was a function of the recognition of net assets in the amount of \$6.7 million and retained earnings growth driven by the recognition of an additional \$8.8 million in deferred income tax assets pursuant to the Amalgamation, partially offset by \$1.4 million in transaction costs associated with the Amalgamation.

Common shares outstanding at July 31, 2017 totalled 21,123,559 compared to 21,123,559 last quarter and 20,095,065 a year ago. The increase was due to the issue of 13,643,713 common shares, offset by the cancellation of 12,615,219 common shares both pursuant to the Amalgamation.

The Bank's book value per common share (non-GAAP measure) at July 31, 2017 was \$8.38 compared to \$8.28 last quarter and \$7.72 a year ago with the increase from the comparative periods primarily a function of the factors outlined in the above.

See Note 10 and Note 19 to the unaudited interim consolidated financial statements for additional information relating to share capital.

### ***Updated Share Information***

As at August 30, 2017, there were no changes since July 31, 2017 in the number of outstanding common shares, Series 1 and Series 3 preferred shares and common share options.

### ***Off-Balance Sheet Arrangements***

As at July 31, 2017, the Bank does not have any significant off-balance sheet arrangements other than loan commitments and letters of credit resulting from normal course business activities. See Note 13 to the unaudited interim consolidated financial statements for more information.

### ***Related Party Transactions***

During the three months and nine months ended July 31, 2017, the Bank incurred management and other fees totalling \$nil (July 31, 2016 - \$225,000) and \$225,000 (July 31, 2016 - \$525,000) to PWC and a subsidiary of PWC.

The Bank's Board of Directors and senior executive officers represent key management personnel. See Note 15 to the unaudited interim consolidated financial statements for additional information on related party transactions and balances.

### ***Risk Management***

The risk management policies and procedures of the Bank are provided in its annual MD&A for the year ended October 31, 2016.

### ***Capital Management and Capital Resources***

The Basel Committee on Banking Supervision has rules supporting stringent global standards on capital adequacy and liquidity (Basel III). Significant rules under Basel III that are most relevant to the Bank include:

- Increased focus on tangible common equity.
- All forms of non-common equity such as the Bank's conventional subordinated notes must be non-viability contingent capital (NVCC) compliant. NVCC compliant means the subordinated notes must include a clause that would require conversion to common equity in the event that OSFI deems the institution to be insolvent or a government is ready to inject a "bail out" payment.
- Changes in the risk-weighting of certain assets.
- Additional capital buffers.
- Requirements for levels of liquidity and new liquidity measurements.

The Bank reports its regulatory capital ratios using the Standardized approach for calculating risk-weighted assets, as defined under Basel III, which may require the Bank to carry more capital for certain credit exposures compared to requirements under the Advanced Internal Ratings Based (AIRB) methodology. As a result, regulatory capital ratios of banks that utilize the Standardized approach are not directly comparable with the large Canadian banks which use the AIRB methodology.

OSFI requires that all Canadian banks must comply with the Basel III standards on an "all-in" basis for purposes of determining its risk-based capital ratios. Required minimum regulatory capital ratios are a 7.0% Common Equity Tier 1 (CET1) capital ratio, an 8.5% Tier 1 capital ratio and a 10.5% total capital ratio, all of which include a 2.5% capital conservation buffer. The Basel III rules provide for "transitional" adjustments whereby certain aspects of the new rules are to be phased in between 2013 and 2019. The only available transition allowed by OSFI for capital ratios is related to the 10 year phase out of non-qualifying capital instruments.

Under the Basel III standards, total regulatory capital of the Bank was \$184.9 million at July 31, 2017 compared to \$182.8 million last quarter and \$187.2 million a year ago. The quarter over quarter increase in total regulatory capital was a function of retained earnings growth over the same period partially offset by the impact of the reduction in the amount of the Bank's subordinate debt that is eligible for inclusion in the Bank's Tier II regulatory capital calculation due to the regulatory requirement to amortize such capital instruments on a straight line basis over the last five years of the instrument's term. The year over year reduction in total regulatory capital is a function of the reduction in eligible Tier II capital outlined above as

well as the impact of the transactions costs and adjustments to certain assets acquired pursuant to the Amalgamation

At July 31, 2017 the Bank exceeded the current minimum Basel III regulatory capital requirements referred to above with a CET1 ratio of 11.00% compared to 10.68% last quarter and 10.70% a year ago. At July 31, 2017, the Bank's Tier 1 capital ratio was 13.16% compared to 12.81% last quarter and 12.82% a year ago. In addition, the Bank's total capital ratio was 13.60% at July 31, 2017, compared to 13.31% last quarter and 13.53% a year ago. The trends from the comparative periods exhibited by the Bank's CET1 and Tier 1 capital ratios are primarily a function of retained earnings growth over the same period. The quarter over quarter increase in the Bank's total capital ratio was primarily a function of retained earnings growth over the same period. The year over year increase in the Bank's total capital ratio was a function of the factors outlined above.

At July 31, 2017, the Bank's leverage ratio was 10.27% compared to 10.07% at the end of the last quarter and 9.77% a year ago.

See Note 16 to the interim consolidated financial statements for more information regarding capital management.

### *Interest Rate Risk Management*

The Bank is subject to interest rate risk which is the risk that a movement in interest rates could negatively impact net interest margin, net interest income and the economic value of assets, liabilities and shareholders' equity. The following table provides the duration difference between the Bank's assets and liabilities and the potential after-tax impact of a 100 basis point shift in interest rates on the Bank's earnings during a 12 month period and the potential after-tax impact of a 100 basis point shift in interest rates on the Bank's shareholders' equity over a 60 month period if no remedial actions are taken.

(thousands of Canadian dollars)	July 31, 2017		October 31, 2016	
	Increase 100 bps	Decrease 100 bps	Increase 100 bps	Decrease 100 bps
Impact on projected net interest income during a 12 month period	\$ 2,481	\$ (2,480)	\$ 2,387	\$ (2,243)
Impact on reported equity during a 60 month period	\$ (1,695)	\$ 1,818	\$ (1,631)	\$ 1,667
Duration difference between assets and liabilities (months)	0.1		0.6	

The Bank's sensitivity to changes in interest rates and its duration difference between assets and liabilities at July 31, 2017 has not changed significantly since the end of the previous quarter. The Bank of Canada's 25 bps interest rate increase in July 2017 had a nominal impact on the Bank's earnings in the quarter. As indicated by the above, the impact on net interest income during a 12 month period of a 100 basis point increase would be approximately \$2.5 million and the impact on net interest income of a 100 basis point decrease would be approximately (\$2.5 million). Conversely at July 31, 2017, the impact on equity during a 60 month period of a 100 basis point increase would be approximately (\$1.7 million) and the impact on equity of a 100 basis point decrease would be approximately \$1.8 million. At July 31, 2017

the duration difference between assets and liabilities remains negligible compared to approximately 1 month at October 31, 2016 and indicates that the Bank's assets and liabilities would reprice at approximately the same time in the event of a change in interest rates.

### *Liquidity*

The unaudited Consolidated Statement of Cash Flows for the nine months ended July 31, 2017 shows cash provided by operations of \$19.8 million compared to \$598,000 for the same period last year. The operating cash flow is primarily affected by the change in the balance of the Bank's deposits (an increase in deposits has a positive impact on cash flow and a decrease in deposits has a negative impact on cash flow) as compared to the change in the balance of its loans (an increase in loans has a negative impact on cash flow and a decrease in loans has a positive impact on cash flow). Based on factors such as liquidity requirements and opportunities for investment in loans and securities, the Bank may manage the amount of deposits it receives and loans it funds in ways that result in the balances of these items giving rise to either negative or positive cash flow from operations. The Bank will continue to fund its operations and meet contractual obligations as they become due from cash on hand and from managing the amount of deposits it receives as compared to the amount of loans it funds.

### *Contractual Obligations*

Contractual obligations as disclosed in the Bank's MD&A and audited consolidated financial statements for the year ended October 31, 2016, have not changed significantly as at July 31, 2017.

### *Capital Assets*

The Bank's operations are not dependent upon significant amounts of capital assets to generate revenue. Currently, the Bank does not have any commitments for capital expenditures or for significant additions to its level of capital assets.

## **Summary of Quarterly Results**

(\$CDN thousands except per share amounts)	2017			2016			2015	
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
<b>Results of operations:</b>								
Total interest income	\$ 17,584	\$ 17,463	\$ 18,586	\$ 17,462	\$ 17,628	\$ 17,346	\$ 17,226	\$ 16,685
Yield on assets (%)	4.14%	4.14%	4.24%	4.09%	4.13%	4.14%	4.11%	4.15%
Interest expense	6,833	6,884	7,441	7,396	7,792	7,986	8,084	7,724
Cost of funds (%)	1.61%	1.63%	1.70%	1.73%	1.82%	1.91%	1.93%	1.92%
Net interest income	10,751	10,579	11,145	10,066	9,836	9,360	9,142	8,961
Net interest margin (%)	2.53%	2.51%	2.54%	2.36%	2.31%	2.23%	2.18%	2.23%
Non-interest income	12	(453)	287	320	343	285	325	384
Total revenue	10,763	10,126	11,432	10,386	10,179	9,645	9,467	9,345
Provision (recovery) for credit losses	38	(582)	303	422	24	213	212	319
Non-interest expenses	7,012	6,220	6,458	6,779	6,654	6,472	6,051	6,562
Income before restructuring charges and income taxes	3,713	4,488	4,671	3,185	3,501	2,960	3,204	2,464
Restructuring charges	-	1,575	470	549	98	445	-	-
Income before income taxes	3,713	2,913	4,201	2,636	3,403	2,515	3,204	2,464
Income tax provision (recovery)	1,031	809	(7,663)	740	947	708	893	(306)
Net income	\$ 2,682	\$ 2,104	\$ 11,864	\$ 1,896	\$ 2,456	\$ 1,807	\$ 2,311	\$ 2,770
Income per common share								
Basic	\$ 0.10	\$ 0.07	\$ 0.56	\$ 0.07	\$ 0.09	\$ 0.06	\$ 0.09	\$ 0.11
Diluted	\$ 0.10	\$ 0.07	\$ 0.56	\$ 0.07	\$ 0.09	\$ 0.06	\$ 0.09	\$ 0.11

The financial results for each of the last eight quarters are summarized above. Total interest income and net interest income in the current quarter reflect higher interest income and fees earned on the real estate and purchased receivables portfolios combined with a reduction in the Bank's cost of funds over the previous quarter and partially offset by a reduction in credit card income resulting from the sale of the Bank's credit card portfolio in the previous quarter.

Non-interest income reported for the previous quarter reflects the impact of the sale of the credit card portfolio

Restructuring charges for the quarter totaled \$nil compared to \$1.6 million last quarter and \$98,000 for the same period a year ago. Restructuring charges recorded in the last quarter relate to termination benefits incurred as a function of the sale of the credit card portfolio and the Bank's corporate reorganization as well as costs associated with the Bank's corporate rebranding and strategic review that resulted in the Amalgamation.

The provision for income taxes in each of the quarters reflects the statutory income tax rate of approximately 27% applied to earnings in the Bank. The provision for income taxes in the first quarter of 2017, and fourth quarter of 2015 includes positive income tax adjustments relating to a change in the estimate of previously unrecognized deferred income tax assets of the Bank.

## ***Basis of Presentation***

### ***Non-GAAP and Additional GAAP Measures***

#### ***Yield***

Yield is calculated as interest income (as presented in the Consolidated Statements of Income) divided by average total assets. Yield does not have a standardized meaning prescribed by IFRS and, therefore, may not be comparable to similar measures presented by other financial institutions.

#### ***Cost of Funds***

Cost of funds is calculated as interest expense (as presented in the Consolidated Statements of Income) divided by average total assets. Cost of funds does not have a standardized meaning prescribed by IFRS and, therefore, may not be comparable to similar measures presented by other financial institutions.

#### ***Income before Restructuring Charges and Income Taxes***

Income before restructuring charges and income taxes is equal to total revenue less the provision for credit losses and less non-interest expenses, as presented in the Consolidated Statements of Income.

#### ***Net Interest Income and Net Interest Margin or Spread***

Most banks analyze profitability by net interest income (as presented in the Consolidated Statements of Income) and net interest margin or spread. Net interest margin or spread is calculated as net interest income divided by average total assets. Net interest margin or spread does not have a standardized meaning prescribed by IFRS and, therefore, may not be comparable to similar measures presented by other financial institutions.

### ***Basel III Common Equity Tier 1, Tier 1, Total Capital Adequacy and Leverage Ratios***

Basel III Common Equity Tier 1, Tier 1, total capital adequacy and leverage ratios are determined in accordance with guidelines issued by the Office of the Superintendent of Financial Institutions (*Canada*) (OSFI).

### ***Book Value per Common Share***

Book value per common share is defined as Shareholders' Equity less amounts relating to preferred shares recorded in equity, divided by the number of common shares outstanding.

### ***Return on Average Common Equity***

Return on average common equity is defined as annualized net income less amounts relating to preferred share dividends, divided by average common shareholders' equity which is average shareholders' equity less amounts relating to preferred shares recorded in equity.

### ***Significant Accounting Policies and Use of Estimates and Judgments***

Significant accounting policies are detailed in Note 3 of the Bank's 2016 Audited Consolidated Financial Statements. There have been no material changes in accounting policies since October 31, 2016.

In preparing the consolidated financial statements, management has exercised judgment and developed estimates in applying accounting policies and generating reported amounts of assets and liabilities at the date of the financial statements and income and expenses during the reporting periods. Areas where significant judgment was applied were in the assessments of impairment of financial instruments and recognition of deferred income tax assets.

Estimates were developed in the calculation of the allowance for credit losses and the measurement of deferred income taxes.

It is reasonably possible, on the basis of existing knowledge, that actual results may vary from that expected in the generation of these estimates. This could result in material adjustments to the carrying amounts of assets and/or liabilities affected in the future.

Estimates and their underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are applied prospectively once they are recognized.

The policies discussed below are considered particularly significant as they require management to make estimates or judgements, some of which may relate to matters that are inherently uncertain.

### ***Loans***

Loans are initially measured at fair value plus incremental direct transaction costs. Loans are subsequently measured at amortized cost, net of allowance for credit losses, using the effective interest method. On a monthly basis, the Bank assesses whether or not there is any objective evidence to suggest that the carrying value of the loans may be impaired. Impairment assessments are facilitated through the identification of loss events and assessments of their impact on the estimated future cash flows of the loans.

A loan is classified as impaired when, in management's opinion, there has been deterioration in credit quality to the extent that there is no longer reasonable assurance as to the timely collection of the full amount of principal and interest. Loans, except credit cards, where interest or principal is contractually past due 90 days are automatically recognized as impaired, unless management determines that the loan is fully secured, in the process of collection and the collection efforts are reasonably expected to result in either repayment of the loan or restoring it to current status. All loans, except credit cards, are classified as impaired when interest or principal is past due 180 days, except for loans guaranteed or insured by the Canadian government, provinces, territories, or a Canadian government agency, which are classified as impaired when interest or principal is contractually 365 days in arrears.

As loans are classified as loans and receivables and measured at amortized cost, an impairment loss is measured as the difference between the carrying amount and the present value of future cash flows discounted using the effective interest rate computed at initial recognition, if future cash flows can be reasonably estimated. When the amounts and timing of cash flows cannot be reasonably estimated, the carrying amount of the loan is reduced to its estimated net realizable value based on either:

- (i) the fair value of any security underlying the loan, net of expected costs of realization, or,
- (ii) observable market prices for the loan.

Impairment losses are recognized in income or loss. If, in a subsequent period, the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was first recognized, then a recovery of a portion or all of the previously recognized impairment loss is adjusted through income or loss to reflect the net recoverable amount of the impaired loan.

Real estate held for resale is recorded at the lower of cost and fair value, less costs to sell.

### *Allowance for Credit Losses*

The Bank maintains an allowance for credit losses which, in management's opinion, is adequate to absorb all credit related losses in its loan portfolio. The allowance for credit losses consists of both individual and collective allowances and is reviewed on a monthly basis. The allowance is included in loans on the Consolidated Balance Sheets.

The Bank considers evidence of impairment for loans at both an individual asset and collective level. All individually significant loans are assessed for impairment first. All individually significant loans found not to be specifically impaired and all loans which are not individually significant are then collectively assessed for impairment.

The collective allowance is determined by separating loans into categories that are considered to have common risk elements and reviewing factors such as current portfolio credit quality trends, exposure at default, probability of default and loss given default rates and business and economic conditions. The collective allowance may also be adjusted by management using its judgment taking into account other observable and unobservable factors.

### *Corporate Income Taxes*

Current income taxes are calculated based on taxable income at the reporting period end. Taxable income differs from accounting income because of differences in the inclusion and deductibility of certain components of income which are established by Canadian taxation authorities. Current income taxes are

measured at the amount expected to be recovered or paid using statutory tax rates at the reporting period end.

The Bank follows the asset and liability method of accounting for deferred income taxes. Deferred income tax assets and liabilities arise from temporary differences between financial statement carrying values and the respective tax base of those assets and liabilities. Deferred income tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years when temporary differences are expected to be recovered or settled.

Deferred income tax assets are recognized in the consolidated financial statements to the extent that it is probable that the Bank will have sufficient taxable income to enable the benefit of the deferred income tax asset to be realized. Unrecognized deferred income tax assets are reassessed for recoverability at each reporting period end.

The realization of the deferred income tax asset is dependent upon the Bank being able to generate taxable income during the carry-forward period sufficient to offset the income tax losses and deductible temporary timing differences. While management is of the opinion that it is probable that the Bank will be able to realize the deferred income tax asset, there is no guarantee the Bank will be able to generate sufficient taxable income during the carry-forward period. The realization of the deferred income tax asset is dependent upon the Bank being able to generate taxable income in future years sufficient to offset the income tax losses.

### *Future Change in Accounting Policies*

#### **Financial instruments (IFRS 9)**

In July 2014, the International Accounting Standards Board (IASB) issued the final revised IFRS 9 standard which addresses classification, measurement and impairment of financial instruments and hedge accounting. IFRS 9 specifies that financial assets be classified into one of three categories: financial assets measured at amortized cost, financial assets measured at fair value through profit or loss or financial assets measured at fair value through other comprehensive income. The standard also includes an expected credit loss model and a general hedging model.

IFRS 9 will be mandatorily effective for the Bank's fiscal year beginning on November 1, 2018, although early adoption is permitted. In January 2015, OSFI determined that Domestic Systemically Important Banks (D-SIBs) should adopt IFRS 9 for their annual periods beginning November 1, 2017, while early adoption is permitted but not required for other federally regulated Canadian banks with October year ends such as the Bank. The Bank has assembled a multi-disciplinary implementation team comprised of key management personnel across a range of the Bank's operational areas and has retained the services of external consultants with expertise in IFRS 9. Having established a time and implementation framework, the Bank's implementation team has commenced assessing the expected impact of IFRS 9 on the Bank's operations, including, but not limited to the Bank's accounting policies and procedures, credit and impairment risk models as well as on the Bank's business and information technology systems, processes and procedures. The Bank plans to adopt IFRS 9 on November 1, 2018.

#### **Leases (IFRS 16)**

In January 2016, the IASB issued IFRS 16, requiring most leases to be recorded on the balance sheet. For lessees, most operating leases other than short-term or low-value leases will be capitalized, and will result in a balance sheet increase in lease assets and lease liabilities, and a decrease in operating lease

expenses and increase in financing costs and amortization expense on the income statement. The new standard will not impact lessor accounting beyond additional disclosures. The new standard is effective for the Bank's fiscal year beginning November 1, 2019 with early adoption permitted if IFRS 15 *Revenue from Contracts with Customers* is also applied. The Bank is currently reviewing IFRS 16 to determine the impact of adoption on its consolidated financial statements.

### ***Controls and Procedures***

During the quarter ended July 31, 2017, there were no changes in the Bank's internal controls over financial reporting, that have materially affected, or are reasonably likely to materially affect, the Bank's internal controls over financial reporting.

### ***Forward-Looking Statements***

The statements in this management's discussion and analysis that relate to the future are forward-looking statements. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, many of which are out of our control. Risks exist that predictions, forecasts, projections and other forward-looking statements will not be achieved. Readers are cautioned not to place undue reliance on these forward-looking statements as a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements. These factors include, but are not limited to, the strength of the Canadian economy in general and the strength of the local economies within Canada in which we conduct operations; the effects of changes in monetary and fiscal policy, including changes in interest rate policies of the Bank of Canada; global commodity prices, the effects of competition in the markets in which we operate; inflation; capital market fluctuations; the timely development and introduction of new products in receptive markets; the impact of changes in the laws and regulations regulating financial services; changes in tax laws; technological changes; unexpected judicial or regulatory proceedings; unexpected changes in consumer spending and savings habits; and our anticipation of and success in managing the risks implicated by the foregoing. For a detailed discussion of certain key factors that may affect our future results, please see our annual MD&A for the year ended October 31, 2016.

The foregoing list of important factors is not exhaustive. When relying on forward-looking statements to make decisions, investors and others should carefully consider the foregoing factors and other uncertainties and potential events. The forward-looking information contained in the management's discussion and analysis is presented to assist our shareholders in understanding our financial position and may not be appropriate for any other purposes. Except as required by securities law, we do not undertake to update any forward-looking statement that is contained in this management's discussion and analysis or made from time to time by the Bank or on its behalf.

#### **FOR FURTHER INFORMATION PLEASE CONTACT:**

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