Consolidated Financial Statements of

VERSABANK

Years ended October 31, 2019 and 2018

VERSABANK

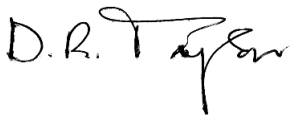
Consolidated Balance Sheets
As at October 31, 2019 and 2018

(thousands of Canadian dollars)

	2019	2018
Assets		
Cash and cash equivalents (note 5)	$ 139,145	$ 129,781
Securities (note 6)	10,061	10,017
Loans, net of allowance for credit losses (note 7)	1,594,288	1,631,026
Other assets (note 8)	41,887	38,306
	$ 1,785,381	$ 1,809,130
Liabilities and Shareholders' Equity		
Deposits (note 10)	$ 1,399,889	$ 1,437,431
Subordinated notes payable (note 11)	4,881	9,844
Securitization liabilities (note 12)	33,366	33,310
Other liabilities (note 13)	107,082	104,978
	1,545,218	1,585,563
Shareholders' equity:		
Share capital (note 14)	182,094	182,094
Retained earnings	58,069	41,473
Accumulated other comprehensive income	-	-
	240,163	223,567
	$ 1,785,381	$ 1,809,130

The accompanying notes are an integral part of these Consolidated Financial Statements.

On behalf of the Board:



David R. Taylor
President and Chief Executive Officer

Hon. Thomas A. Hockin
Chairman of the Board

VERSABANK

Consolidated Statements of Comprehensive Income
Years ended October 31, 2019 and 2018

(thousands of Canadian dollars, except per share amounts)

	2019	2018
Interest income:		
Loans	$ 84,875	$ 78,509
Cash and securities	3,430	2,405
	88,305	80,914
Interest expense:		
Deposits and other	33,653	28,557
Subordinated notes	755	858
	34,408	29,415
Net interest income	53,897	51,499
Non-interest income	22	186
Total revenue	53,919	51,685
Provision for (recovery of) credit losses (note 7(b))	(298)	334
	54,217	51,351
Non-interest expenses:		
Salaries and benefits	15,174	14,337
General and administrative	8,792	9,697
Premises and equipment	2,430	2,304
	26,396	26,338
Income before income taxes	27,821	25,013
Income taxes (note 16)	7,625	6,939
Net income	$ 20,196	$ 18,074
Other comprehensive income (loss), net of tax		
Net unrealized gains (losses) on fair value through OCI assets[(1)(2)]	-	(4)
Comprehensive income	$ 20,196	$ 18,070
Basic and diluted income per common share (note 17)	$ 0.85	$ 0.75
Weighted average number of common shares outstanding	21,123,559	21,123,559

(1) 2018 net unrealized losses based on assets held as available-for-sale.
(2) Net of income tax benefit of $nil (2018 - $1).

The accompanying notes are an integral part of these Consolidated Financial Statements.

VERSABANK

Consolidated Statements of Changes in Shareholders' Equity
Years ended October 31, 2019 and 2018

(thousands of Canadian dollars)

	2019	2018
Common shares (note 14):		
Balance, beginning and end of year	$ 152,612	$ 152,612
Preferred shares (note 14):		
Series 1 preferred shares		
Balance, beginning and end of year	$ 13,647	$ 13,647
Series 3 preferred shares		
Balance, beginning and end of year	$ 15,690	$ 15,690
Contributed surplus (note 14):		
Balance, beginning and end of year	$ 145	$ 145
Total share capital	$ 182,094	$ 182,094
Retained earnings:		
Balance, beginning of year	$ 41,473	$ 26,443
Impact of adopting IFRS 9 (note 25)	78	–
Balance, beginning of year, restated	41,551	–
Net income	20,196	18,074
Dividends paid on common and preferred shares	(3,678)	(3,044)
Balance, end of year	$ 58,069	$ 41,473
Accumulated other comprehensive income, net of taxes:		
Balance, beginning of year	$ –	$ 4
Other comprehensive loss	–	(4)
Balance, end of year	$ –	$ –
Total shareholders' equity	$ 240,163	$ 223,567

The accompanying notes are an integral part of these Consolidated Financial Statements.

VERSABANK

Consolidated Statements of Cash Flows
Years ended October 31, 2019 and 2018

(thousands of Canadian dollars)

		2019		2018
Cash provided by (used in):				
Operations:				
Net income	$	20,196	$	18,074
Adjustments to determine net cash flows:				
Items not involving cash (note 18)		(45,849)		(43,603)
Interest received		85,143		77,260
Interest paid		(33,675)		(27,681)
Change in operating assets and liabilities:				
Loans		40,328		(106,795)
Deposits		(38,125)		59,804
Change in other assets and liabilities		(8,238)		8,037
		19,780		(14,904)
Investing:				
Purchase of securities		–		(10,017)
Proceeds from sale and maturity of securities		–		255
Purchase of property, plant and equipment		(242)		(993)
		(242)		(10,755)
Financing:				
Repayment of subordinated notes		(10,000)		–
Issuance of subordinated notes		4,875		–
Dividends paid		(3,678)		(3,044)
Income taxes paid		(1,371)		(1,425)
		(10,174)		(4,469)
Increase (decrease) in cash and cash equivalents		9,364		(30,128)
Cash and cash equivalents, beginning of year		129,781		159,909
Cash and cash equivalents, end of year (note 5)	$	139,145	$	129,781

The accompanying notes are an integral part of these Consolidated Financial Statements.

1. Reporting entity:

VersaBank (the "Bank") operates as a Schedule 1 bank under the *Bank Act (Canada)* and is regulated by the Office of the Superintendent of Financial Institutions ("OSFI"). The Bank, whose shares trade on the Toronto Stock Exchange, provides commercial lending services to selected niche markets in Canada.

The Bank is incorporated and domiciled in Canada, and maintains its registered office at Suite 2002, 140 Fullarton Street, London, Ontario, Canada, N6A 5P2.

2. Basis of preparation:

These Consolidated Financial Statements have been prepared in accordance with the *Bank Act (Canada).* The Superintendent of Financial Institutions Canada (the "Superintendent" or "OSFI"), has instructed that the financial statements are to be prepared in accordance with International Financial Reporting Standards ("IFRS"). The significant accounting policies used in the preparation of these consolidated financial statements, including the accounting requirements of the Superintendent, are summarized below. These accounting policies conform, in all material respects, to IFRS.

a) Statement of compliance:

These Consolidated Financial Statements have been prepared in accordance with IFRS as issued by the International Accounting Standards Board ("IASB").

b) Date authorized for issuance:

These Consolidated Financial Statements were approved and authorized for issue by the Board of Directors of the Bank on November 26, 2019.

c) Basis of measurement:

These Consolidated Financial Statements have been prepared on the historical cost basis except for securities designated as fair value through other comprehensive income (2018 - available for sale) which are measured at fair value in the Consolidated Balance Sheets.

d) Functional and presentation currency:

These Consolidated Financial Statements are presented in Canadian dollars which is the Bank's functional currency.

2. Basis of preparation – continued:

e) Use of estimates and judgments:

In preparing these 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 judgement was applied include the business model applied for the classification and measurement of financial instruments, assessing significant increases in credit risk on financial assets and in the selection of relevant forward looking information as described in note 3 – Financial instruments. Estimates are applied in the determination of the allowance for losses on financial assets 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.

3. Significant accounting policies:

The significant accounting policies used in the preparation of these Consolidated Financial Statements were applied consistently to all years presented, except for changes to the accounting for financial instruments resulting from the adoption of IFRS 9 – *Financial instruments* and revenue recognition from the adoption of IFRS 15 – *Revenue from contracts with customers*, and are summarized below:

a) Principles of consolidation:

The Bank holds 100% of the common shares of DRT Cyber Inc., VersaVault Inc., 11409891 Canada Inc. and VersaJet Inc. The Consolidated Financial Statements include the accounts of these subsidiaries.

All significant intercompany accounts and transactions have been eliminated.

b) Revenue recognition:

Interest income on securities and loans is recognized in net interest income using the effective interest rate method over the expected life of the instrument. Interest income earned but not yet collected on securities and loans is included in the respective securities and loans categories on the Consolidated Balance Sheets.

Interest income is recognized on impaired loans and is accrued using the rate of interest used to discount the future cash flows for purposes of measuring the impairment loss. Loan fees integral to the yield on the loan are amortized to interest income using the effective interest method; otherwise, the fees are recorded in non-interest income.

3. Significant accounting policies – continued:

b) Revenue recognition – continued:

Revenues from contracts with customers (IFRS 15)

IFRS 15 establishes a comprehensive framework for determining whether, how much, and when, revenue is recognised. It replaced IAS 18 Revenue, IAS 11 Construction Contracts and related interpretations. The new standard became effective for the Bank's fiscal year beginning November 1, 2018. The amount of non-interest fees and other income earned by the Bank is not significant and therefore not materially impacted by the adoption of this standard.

c) Financial instruments:

The Bank adopted IFRS 9 – *Financial instruments* ("IFRS 9") in the current year replacing IAS 39 – *Financial instruments – Recognition and Measurement.* This has resulted in changes in accounting policies related to the classification and measurement and impairment of financial assets, which includes the introduction of an expected credit loss ("ECL") impairment methodology and associated model for all financial assets and certain off-balance sheet loan commitments and guarantees. There are no significant changes in accounting policies for financial liabilities, derivative instruments and derecognition of financial assets and liabilities. This change in accounting policy was adopted retrospectively, with no restatement of comparatives. New disclosures have been provided for the current year, where applicable, while comparative year disclosures are consistent with those made in prior years. Refer to Note 25 – Transition to IFRS 9 for the impact to the opening balance sheet as at November 1, 2018.

Classification and Measurement

Under IFRS 9, all financial assets must be classified at initial recognition as a function of the financial asset's contractual cash flow characteristics and the business model under which the financial asset is managed. All financial assets are initially measured at fair value, and are classified and subsequently measured at amortized cost, fair value through profit or loss or fair value through other comprehensive income. Financial assets are required to be reclassified when the business model under which they are managed has changed. Any reclassifications are applied prospectively from the reclassification date. All financial liabilities are measured at amortized cost unless elected otherwise.

Debt instruments

Financial assets that are debt instruments are categorized into one of the following measurement categories:

- amortized cost;
- fair value through other comprehensive income ("FVOCI");
- fair value through profit and loss ("FVTPL").

3. Significant accounting policies – continued:

c) Financial instruments – continued:

The characterization of a debt instrument's cashflows is determined through a solely payment of principal and interest ("SPPI") test. The SPPI test is conducted to identify whether the contractual cash flows of a debt instrument are in fact solely payments of principal and interest and are consistent with a basic lending arrangement. In the context of the SPPI test, "Principal" is defined as the fair value of the debt instrument at origination or initial recognition, which may change over the life of the instrument as a function of a number of variables including principal repayments, prepayments, or amortization of a premium/discount. In the context of the SPPI test "Interest" is defined as the consideration for the time value of money and credit risk. The rationale for the SPPI test is to ensure that debt instruments that include structural features that are incongruent with a basic lending arrangement, such as conversion options, are classified as, and measured at FVTPL.

The key business activities or attributes that are considered by the Bank in the definition of the business model for the purpose of classifying financial instruments are as follows:

- the business purpose of the portfolio;
- the level of typical sales activity in the portfolio; and,
- the nature of the risks that are being managed in the administration of the portfolio.

Debt instruments measured at amortized cost

Debt instruments with contractual cash flows that meet the SPPI test and are managed on a hold to collect basis are measured at amortized cost. These financial instruments are recognized initially at fair value plus direct and incremental transaction costs, and are subsequently measured at amortized cost, using the effective interest rate method, net of an allowance for credit losses. The effective interest rate is the rate that discounts estimated future cashflows through the expected life of the instrument to the gross carrying amount of the instrument. Amortized cost is calculated as a function of the effective interest rate, taking into account any discount or premium on acquisition, transaction costs and fees. Amortization of these costs is included in interest income in the consolidated statement of income.

Debt instruments measured at FVOCI

Debt instruments measured at FVOCI have contractual cash flows that meet the SPPI test and are managed on a hold to collect and for sale basis. FVOCI debt instruments are measured initially at fair value, plus direct and incremental transaction costs. Subsequent to initial recognition, unrealized gains and losses on debt instruments measured at FVOCI are recorded in other comprehensive income ("OCI"). Premiums, discounts and related transaction costs

3. Significant accounting policies – continued:

c) Financial instruments – continued:

are amortized over the expected life of the instrument to interest income in the consolidated statement of income using the effective interest rate method.

Impairment of debt instruments measured at FVOCI is calculated using the expected credit loss approach. The allowance does not reduce the carrying amount of the asset in the consolidated balance sheet, which remains at its fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortized cost is recognized in OCI with a corresponding charge to net provision for credit losses in the consolidated statement of income.

Cumulative gains and losses previously recognized in OCI, including accumulated allowances, are transferred from AOCI to the consolidated statement of income when the debt instrument is sold.

Debt instruments measured at FVTPL

Trading financial instruments are mandatorily measured at FVTPL as they are held for trading purposes or are part of a managed portfolio with a pattern of short-term profit taking. Non-trading financial instruments are also mandatorily measured at fair value if their contractual cash flow characteristics do not meet the SPPI test or if they are managed together with other financial instruments on a fair value basis. Trading and non-trading financial instruments mandatorily measured at FVTPL are re-measured at fair value as at the consolidated balance sheet date. Gains and losses realized on disposition and unrealized gains and losses from changes in fair value are included in non-interest income as gains (losses) from financial instruments measured/designated at FVTPL. Interest income and dividends earned on trading and non-trading financial instruments are included in interest income.

Equity instruments

Equity instruments are measured at FVTPL unless an irrevocable designation is made, at initial recognition to measure them at FVOCI. Gains or losses from changes in the fair value of equity financial instruments designated at FVOCI, including any related foreign exchange gains or losses, are recognized in OCI. In contrast to asset-for-sale equity securities under IAS 39, amounts recognized in OCI will not be subsequently recycled to profit or loss, with the exception of dividends. Dividends received are recorded in interest income in the consolidated statement of income. Cumulative gains or losses upon derecognition of the equity instrument will be transferred within equity from AOCI to retained earnings.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

Financial assets and liabilities designated at FVTPL

Financial assets and financial liabilities classified in this category are those that have been designated at FVTPL by the Bank on initial recognition.

Financial assets are designated at FVTPL if doing so eliminates or significantly reduces an accounting mismatch which would otherwise arise.

Financial liabilities are designated at FVTPL when one of the following criteria is met:

- The designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- The financial liability contains one or more embedded derivatives which significantly modifies the cash flows otherwise required.

Financial assets and financial liabilities designated at FVTPL are recorded in the consolidated balance sheet at fair value. For assets designated at FVTPL, changes in fair value are recognized as other income in the consolidated statement of income. For liabilities designated at fair value through profit or loss, all changes in fair value are recognized as other income in the consolidated statement of income, except for changes in fair value arising from changes in the Bank's own credit risk which are recognized in OCI. Amounts recognized in OCI are not subsequently reclassified to the consolidated statement of income upon derecognition of the liabilities.

Classification and Measurement under IAS 39 for fiscal 2018

Upon initial recognition, all financial instruments were measured at fair value. Subsequent to initial recognition financial instruments were classified into various categories. The Bank grouped all financial assets into one of the following classification categories: held-to-maturity, loans and receivables or available-for-sale. All financial liabilities were measured at amortized cost.

Financial assets that were classified as held-to-maturity, loans and receivables and financial liabilities were measured at amortized cost using the effective interest method. Available-for-sale financial assets were measured at fair value with unrealized gains and losses, net of tax, recognized in other comprehensive income.

Cash and cash equivalents were classified as held-to-maturity.

Securities were either classified as held-to-maturity or available-for-sale.

Loans were classified as loans and receivables and were initially measured at fair value plus incremental direct transaction costs. Loans were subsequently measured at amortized cost, net of allowance for credit losses, using the effective interest method.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

Impairment – Allowance for Credit Losses

The Bank must maintain an allowance for credit losses that is adequate, in management's opinion, to absorb all credit related losses in the Bank's lending and treasury portfolios. The Bank's allowance for credit losses is estimated using the ECL methodology and is comprised of expected credit losses recognized on all financial assets that are debt instruments, classified either as amortized cost or as FVOCI, and on all loan commitments and financial guarantees that are not measured at FVTPL.

Expected credit losses represent unbiased and probability-weighted estimates that are modeled as a function of a range of possible outcomes as well as the time value of money, and reasonable and supportable information about past events, current conditions and forecasts of future economic conditions, or more specifically forward-looking information ("FLI") (see *Forward-Looking Information* below).

The Bank's ECL or impairment model estimates 12 months of expected credit losses, ("TMECL") for performing loans that have not experienced a significant increase in credit risk, ("SICR") since initial recognition. Additionally, the ECL impairment model estimates lifetime expected credit losses, ("LTECL") on performing loans that have experienced a SICR since initial recognition. Further, individual allowances are estimated for loans that are determined to be credit impaired.

Under the ECL methodology, loans or other financial instruments that have not experienced a SICR since initial recognition are designated as stage 1, while loans or financial instruments that have experienced a SICR since initial recognition are designated as stage 2, and loans or financial instruments that are determined to be credit impaired are designated as stage 3.

Assessment of significant increase in credit risk

At each reporting date, the Bank assesses whether or not there has been a SICR for loans since initial recognition by comparing, at the reporting date, the risk of default occurring over the remaining expected life against the risk of default at initial recognition.

The determination of a SICR is a function primarily of loan product type and the associated risk profile of same. The principal factors considered in making this determination include relative changes in the Bank's internal risk rating assignment, the loan's internal watchlist status, and the loan's delinquency status.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

Quantitative models may not always be able to capture all reasonable and supportable information that may indicate a SICR. As a result, qualitative factors may be assessed to supplement such a gap. Examples include changes in adjudication criteria for a particular group of borrowers or changes in portfolio composition.

With regards to delinquency and monitoring, there is a rebuttable presumption that the credit risk of a loan or other financial instrument has increased since initial recognition when contractual payments are more than 60 days delinquent. The Bank chose to use 60 days delinquency as an appropriate indicator of increased credit risk as it serves as a stable early warning indicator that the cashflows associated with the loan or other financial instrument under consideration may be in jeopardy and may not be realized by the Bank under the contractual repayment terms.

Expected credit loss model - Estimation of expected credit losses

Expected credit losses are an estimate of a loan's expected cash shortfalls discounted at the effective interest rate, where a cash shortfall is the difference between the contractual cash flows that are due to the Bank and the cash flows that the Bank actually expects to receive. The ECL calculation is a function of the credit risk parameters; probability of default, loss given default, and exposure at default associated with each loan, sensitized to future market and macroeconomic conditions through the incorporation of FLI derived from multiple economic forecast scenarios, including baseline, upside, and downside scenarios.

For clarity:

- The probability of default ("PD") for a loan or a financial instrument is an estimate of the likelihood of default of that instrument over a given time horizon;
- The loss given default ("LGD") for a loan or financial instrument is an estimate of the loss arising in the case where a default of that instrument occurs at a given time or over a given period; and
- The exposure at default ("EAD") for a loan or financial instrument is an estimate of the Bank's exposure derived from that instrument at a future default date.

The Bank's ECL model develops contractual cashflow profiles for loans as a function of a number of underlying assumptions and a broad range of input variables. The expected cashflow schedules are subsequently derived from the contractual cashflow schedules, adjusted for incremental default amounts, forgone interest, and recovery amounts.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

The finalized contractual and expected cashflow schedules are subsequently discounted at the effective interest rate to determine the expected cash shortfall or expected credit losses for each individual loan or financial instrument.

Individual allowances are estimated for loans and other financial instruments that are determined to be credit impaired and that have been designated as stage 3. A loan is classified as credit impaired when the Bank becomes aware that all of, or a portion of the contractual cashflows associated with the loan may be in jeopardy and as a result may not be realized by the Bank under the repayment schedule set out in the contractual terms associated with the loan. More specifically, loans for which interest or principal is contractually past due 90 days are automatically recognized as impaired.

Forward-Looking Information

The IFRS 9 standard requires consideration of past events, current market conditions and reasonable, supportable information about future economic conditions that is available without undue cost and effort in the estimation of the expected credit losses for loans. More specifically, under IFRS 9 expected credit losses represents an unbiased, probability-weighted estimate of the present value of cash shortfalls (i.e., the weighted average of credit losses, with the respective risks of a default occurring in a given time period used as the weights). Additionally, IFRS 9 stipulates that future economic conditions are to be based on an unbiased, probability-weighted assessment of possible future outcomes. The estimation and application of forward-looking information in an attempt to capture the impact of future economic conditions requires significant judgement.

The Bank has elected to incorporate the impact of future economic conditions, or more specifically forward looking information into the estimation of expected credit losses at the credit risk parameter level. This is accomplished via the credit risk parameter models and proxy datasets that the Bank utilizes to develop PD and LGD term structure forecasts for its loans. The Bank has sourced credit risk modeling systems and forecast economic data from a well-established, third party for the purpose of computing forward-looking risk parameters under multiple economic scenarios that consider both market-wide and idiosyncratic factors and influences. These systems are integrated with the Bank's internally developed ECL models. Given that the Bank has experienced very limited historical losses and, therefore, does not have available statistically significant loss data inventory for use in developing forward looking expected credit loss trends, the integration of unbiased, third party forward-looking risk parameter modeling systems is particularly important for the Bank in the context of the estimation of expected credit losses.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

The Bank utilizes macroeconomic indicator data derived from three macroeconomic scenarios, those being a baseline scenario, an upside scenario, and a downside scenario in order to mitigate volatility in the estimation of expected credit losses as well as to satisfy the IFRS 9 requirement that future economic conditions are to be based on an unbiased, probability-weighted assessment of possible future outcomes. More specifically, the macroeconomic indicators set out in the three scenarios are used as inputs for the credit risk parameter models utilized by the Bank to sensitize the individual, PD and LGD term structure forecasts to the respective macroeconomic trajectory set out in each of the scenarios. The weighted average of the individual, sensitized PD and LGD values that comprise each individual term structure forecast is subsequently computed to define unbiased PD and LGD term structure forecasts, which in turn are applied as inputs to the Bank's internal ECL model in the estimation of expected credit losses for the Bank's loans. Macroeconomic indicator data derived from the baseline, upside and downside scenarios is also utilized in the development of credit risk parameter proxy datasets and applied to the Bank's consumer loan and small and medium enterprise (SME) loan portfolios.

The macroeconomic indicator data utilized by the Bank for the purpose of sensitizing PD and LGD term structure data to forward economic conditions include, but are not limited to: real GDP, the national unemployment rate, long term interest rates, the consumer price index, and the price of oil. These specific macroeconomic indicators were selected in an attempt to ensure that the spectrum of fundamental macroeconomic influences on the key drivers of the credit risk profile of the Bank's balance sheet, including: corporate, consumer and real estate market dynamics; corporate, consumer and SME borrower performance; geography; as well as collateral value trajectories, are appropriately captured and incorporated into the Bank's forward macroeconomic sensitivity analysis.

Modified Financial Instruments

If the terms of a financial instrument are modified or an existing financial instrument is replaced with a new one, an assessment is made to determine if the financial instrument should be derecognized. Where the modification does not result in derecognition, the date of origination continues to be used to determine SICR. Where modification results in derecognition, the modified financial instrument is considered to be a new instrument.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

Allowance for credit losses under IAS 39 for fiscal 2018

The Bank maintained an allowance for credit losses which, in management's opinion, was adequate to absorb all credit related losses in its loan portfolio. The allowance for credit losses consisted of both individual and collective allowances and was reviewed on a monthly basis.

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

The collective allowance was determined by separating loans into categories that were 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 was also adjusted by management, as required, using its judgment taking into account other observable and unobservable factors.

Fair value of financial instruments

Estimates of fair value are developed using a variety of valuation methods and assumptions. The Bank follows a fair value hierarchy to categorize the inputs used to measure fair value for its financial instruments. The fair value hierarchy is based on quoted prices in active markets (Level 1), models using inputs other than quoted prices but with observable market data (Level 2), or models using inputs that are not based on observable market data (Level 3).

Valuation models may require the use of inputs, transaction values derived from models and input assumptions sourced from pricing services. Valuation inputs are either observable or unobservable. The Bank looks to external readily observable market inputs when available and may include certain prices and rates for shorter-dated Canadian yield curves and bankers acceptances. Unobservable inputs may include credit spreads, probability of default and recovery rates.

Hedge Accounting

The Bank has elected, as permitted, to continue to apply the hedge accounting requirements of IAS 39.

3. Significant accounting policies – continued:

c) Financial instruments – continued:

Transfer of financial assets:

The Bank may enter into transactions in which it transfers assets to a third party to obtain alternate sources of funding. The Bank assesses whether substantially all of the risks and rewards of the asset have been transferred to determine if they qualify for derecognition. In the event that the Bank continues to be exposed to substantially all of the repayment, interest rate and/or credit risk associated with the asset, the asset(s) would not qualify for derecognition and would be reflected on the Bank's Consolidated Balance Sheet.

Derivatives and embedded derivatives:

Derivatives are measured at FVTPL under IFRS 9, except to the extent that they are designated in a hedging relationship.

Certain derivatives embedded in other financial instruments are treated as separate derivatives when their economic characteristics and risks are not closely related to the host contract and the combined contract is not carried at fair value. Identified embedded derivatives are separated from the host contract and are recorded at fair value.

d) Property and equipment:

Property and equipment is carried at cost less accumulated amortization and impairment. Amortization on property and equipment is calculated primarily using the straight-line method over the useful life of the equipment which typically ranges between 5 and 20 years.

Property and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amounts may not be recoverable. Amortization expense and impairment write-downs are included in premises and equipment expense in the Consolidated Statements of Income.

e) Income taxes:

Current income taxes are calculated based on taxable income for the reporting period. 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.

3. Significant accounting policies – continued:

e) Income taxes – continued:

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.

Current and deferred income taxes are recorded in income for the period, except to the extent that the tax arose from a transaction that is recorded either in Other Comprehensive Income or Equity, in which case the income tax on the transaction will also be recorded either in Other Comprehensive Income or Equity. Accordingly, current and deferred income taxes are presented in the Consolidated Financial Statements as a component of income, or as a component of Other Comprehensive Income.

f) Employee benefits:

i) Short-term benefits:

Short-term employee benefit obligations are recognized as employees render their services and are measured on an undiscounted basis.

A liability is recognized for the amount expected to be paid under a short-term cash bonus plan if the Bank has an obligation to make such payments as a result of past service provided by the employee and the obligation can be estimated reliably.

ii) Share-based payment transactions:

<u>Equity-settled stock options</u>

Employee stock options are measured using the Black-Scholes pricing model which is used to estimate the fair value of the options at the date of grant. Inputs to the Black-Scholes model include the closing share price on the grant date, the exercise price, the expected option life, the expected dividend yield, the expected volatility and the risk-free interest rate. Once the expected option life is determined, it is used in formulating the estimates of expected volatility and the risk-free rate. Expected future volatility is estimated using a historical volatility look-back period that is consistent with the expected life of the option.

The fair value of options which vest immediately are recognized in full as of the grant date, whereas the fair value of options which vest over time are recognized over the vesting period using the graded method which incorporates management's estimates of the options which are not expected to vest. The effect of a change in the estimated number of options expected to vest is a change in estimate and the cumulative effect of the change is recognized prospectively once the estimate is revised.

3. Significant accounting policies – continued:

f) Employee benefits – continued:

The fair value of stock options granted is recorded in salaries and benefits expense in the Consolidated Statements of Income and in Share Capital as a component of Contributed Surplus in the Consolidated Balance Sheets. When options are exercised, the consideration received and the estimated fair value previously recorded in Contributed Surplus is recorded as Share Capital.

The Bank's stock option plan is described in note 15.

g) Share capital:

The Bank's share capital consists of common shares, preferred shares and contributed surplus.

i) Share issuance costs:

Costs directly incurred with raising new share capital are charged against equity. Other costs are expensed as incurred.

ii) Contributed surplus:

Contributed surplus consists of the fair value of stock options granted since inception, less amounts reversed for exercised stock options. If granted options vest and then subsequently expire or are forfeited, no reversal of contributed surplus is recognized.

h) Segment reporting:

The Bank does not present segmented information in its Consolidated Financial Statements as it has determined that its operations fall into one segment, Banking, and further, that it operates primarily in one geographic region, Canada.

4. Future changes in accounting policies:

There have been a number of standards and amendments that have been issued by the IASB that were not effective for the Bank's fiscal year end of October 31, 2019 and therefore have not been applied in preparing these consolidated financial statements. The following standard is expected to be applicable to the Bank:

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, a decrease in operating lease expenses, and an 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. The Bank is currently reviewing IFRS 16 to determine the impact of adoption on its consolidated financial statements however, an initial review suggests that the adoption of IFRS 16 will not likely have a material impact.

5. Cash and cash equivalents:

Cash and cash equivalents are comprised of deposits with regulated financial institutions.

6. Securities:

a) Portfolio analysis:

(thousands of dollars)

		2019		2018[1]
Securities measured at FVOCI				
Securities issued or guaranteed by:				
Canadian federal government	$	5,038	$	5,037
Canadian provincial governments		5,023		4,980
	$	10,061	$	10,017

(1) 2018 amounts are recorded as available-for-sale securities as per IAS 39.

6. Securities - continued:

b) Maturities and yields:

(thousands of dollars)

	2019	Yield	2018[1]	Yield
Securities measured at FVOCI				
Within 3 months	$ 10,061	2.01%	$ –	–
3 months - 1 year	–	–	–	–
1 years - 2 years	–	–	10,017	2.01%
2 years - 5 years	–	–	–	–
	$ 10,061	2.01%	$ 10,017	2.01%

(1) 2018 amounts are recorded as available-for-sale securities as per IAS 39.

c) Unrealized gains and losses on securities:

(thousands of dollars)

	2019				2018			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities measured at FVOCI [1]								
Securities issued or guaranteed by:								
Canadian federal	$ 5,038	$ –	$ –	$ 5,038	$ 5,037	$ –	$ –	$ 5,037
Canadian provinces	5,023	–	–	5,023	4,980	–	–	4,980
Total	$ 10,061	$ –	$ –	$ 10,061	$ 10,017	$ –	$ –	$ 10,017

(1) 2018 amounts are recorded as available-for-sale securities as per IAS 39.

There were no impairment charges during the years ended October 31, 2019 and October 31, 2018 related to the Bank's securities portfolio.

6. Securities – continued:

d) Fair value hierarchy:

Securities measured at FVOCI are classified into the fair value hierarchy as follows:

(thousands of dollars)

2019	Total	Level 1	Level 2	Level 3
Securities measured at FVOCI				
Securities issued or guaranteed by:				
Canadian federal government	$ 5,038	$ 5,038	$ –	$ –
Canadian provincial governments	5,023	5,023	–	–
Total securities measured at FVOCI	$ 10,061	$ 10,061	$ –	$ –

(thousands of dollars)

2018	Total	Level 1	Level 2	Level 3
Available-for-sale securities				
Securities issued or guaranteed by:				
Canadian federal government	$ 5,037	$ 5,037	$ –	$ –
Canadian provincial governments	4,980	4,980	–	–
Total available-for-sale securities	$ 10,017	$ 10,017	$ –	$ –

7. Loans, net of allowance for credit losses:

a) Portfolio analysis:

(thousands of dollars)

	2019	2018
Commercial real estate	$ 509,564	$ 594,627
Non-commercial real estate	44,608	91,517
Corporate and public sector	40,670	50,922
Structured finance	994,842	889,822
	1,589,684	1,626,888
Allowance for credit losses	(2,119)	(2,759)
Accrued interest	6,723	6,897
Total loans, net of allowance for credit losses	$ 1,594,288	$ 1,631,026

The allowance for credit losses relates to the following loan portfolios:

(thousands of dollars)

	As at October 31, 2019			
	Stage 1	Stage 2	Stage 3	Total
Commercial real estate	$ 448,322	$ 54,989	$ 6,253	$ 509,564
ECL allowance	1,557	209	-	1,766
EL %	0.35%	0.38%	- %	0.35%
Non-commercial real estate	$ 44,608	$ -	$ -	$ 44,608
ECL allowance	86	-	-	86
EL %	0.19%	- %	- %	0.19%
Corporate and public sector	$ 40,670	$ -	$ -	$ 40,670
ECL allowance	38	-	-	38
EL %	0.09%	- %	- %	0.09%
Structured finance	$ 991,735	$ 3,092	$ 15	$ 994,842
ECL allowance	229	-	-	229
EL %	0.02%	- %	- %	0.02%
Loans	$ 1,525,335	$ 58,081	$ 6,268	$1,589,684
Total ECL allowance	1,910	209	-	2,119
Total EL %	0.13%	0.36%	- %	0.13%

The Bank holds security against the majority of its loans in the form of either mortgage interests over property, other registered securities over assets, guarantees and holdbacks on loan and lease receivables included in the structured finance portfolio (note 13).

7. Loans – continued:

b) Allowance for credit losses:

The following table provides a reconciliation of the Bank's ECL allowance by lending asset category for the year ended October 31, 2019:

(thousands of dollars)

	Stage 1	Stage 2	Stage 3	Total
Commercial real estate				
Balance at beginning of period	**$ 1,257**	**$ 348**	**$ -**	**$ 1,605**
Transfer in (out) to Stage 1	56	(56)	-	**-**
Transfer in (out) to Stage 2	(65)	70	(5)	**-**
Transfer in (out) to Stage 3	-	(177)	177	**-**
Net remeasurement of loss allowance	(131)	48	(563)	**(646)**
Loan originations	624	-	-	**624**
Derecognitions and maturities	(184)	(24)	-	**(208)**
Provision for (recovery of) credit loses	300	(139)	(391)	(230)
Write-offs	-	-	-	-
Recoveries	-	-	391	391
Balance at end of period	**$ 1,557**	**$ 209**	**$ -**	**$ 1,766**
Non-commercial real estate				
Balance at beginning of period	**$ 151**	**$ -**	**$ -**	**$ 151**
Transfer in (out) to Stage 1	-	-	-	**-**
Transfer in (out) to Stage 2	-	-	-	**-**
Transfer in (out) to Stage 3	-	-	-	**-**
Net remeasurement of loss allowance	(78)	-	-	**(78)**
Loan originations	14	-	-	**14**
Derecognitions and maturities	(1)	-	-	**(1)**
Provision for (recovery of) credit loses	(65)	-	-	(65)
Write-offs	-	-	-	-
Recoveries	-	-	-	-
Balance at end of period	**$ 86**	**$ -**	**$ -**	**$ 86**
Corporate and public sector				
Balance at beginning of period	**$ 81**	**$ -**	**$ 400**	**$ 481**
Transfer in (out) to Stage 1	2	(2)	-	**-**
Transfer in (out) to Stage 2	(1)	1	-	**-**
Transfer in (out) to Stage 3	-	-	-	**-**
Net remeasurement of loss allowance	(46)	1	227	**182**
Loan originations	2	-	-	**2**
Derecognitions and maturities	-	-	-	**-**
Provision for (recovery of) credit loses	(43)	-	227	184
Write-offs	-	-	(627)	(627)
Recoveries	-	-	-	-
Balance at end of period	**$ 38**	**$ -**	**$ -**	**$ 38**
Structured finance				
Balance at beginning of period	**$ 415**	**$ 1**	**$ -**	**$ 416**
Transfer in (out) to Stage 1	68	(68)	-	**-**
Transfer in (out) to Stage 2	(161)	161	-	**-**
Transfer in (out) to Stage 3	-	-	-	**-**
Net remeasurement of loss allowance	(4,651)	(47)	-	**(4,698)**
Loan originations	5,919	-	-	**5,919**
Derecognitions and maturities	(1,361)	(47)	-	**(1,408)**
Provision for (recovery of) credit loses	(186)	(1)	-	(187)
Write-offs	-	-	-	-
Recoveries	-	-	-	-
Balance at end of period	**$ 229**	**$ -**	**$ -**	**$ 229**
Total balance at end of period	**$ 1,910**	**$ 209**	**$ -**	**$ 2,119**

7. Loans – continued:

The following table provides the allowance for credit losses under IAS 39 for the year ended October 31, 2018:

(thousands of dollars)

	Collective	Individual	2018 Total Allowance
Balance, beginning of year	$ 2,225	$ 200	$ 2,425
Provision (recovery) for credit losses	134	200	334
Write-offs	-	-	-
Balance, end of year	$ 2,359	$ 400	$ 2,759

For additional details on the reconciliation of allowance for credit losses balance from IAS 39 to IFRS 9 see note 25 – Transition to IFRS 9.

c) Maturities and yields:

(thousands of dollars)

	Floating	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Over 5 years	2019 Total	2018 Total
Total loans	$ 435,521	$ 44,434	$ 96,860	$ 161,917	$ 698,523	$ 152,429	$ 1,589,684	$ 1,626,888
Average effective yield	6.13%	6.01%	4.62%	4.52%	4.96%	4.43%	5.19%	5.29%

Average effective yields are based on book values and contractual interest rates, adjusted for the amortization of any deferred income and expenses.

d) Impaired loans:

At October 31, 2019, impaired loans were $6.3 million (2018 - $627,000).

8. Other assets:

(thousands of dollars)

	2019	2018
Accounts receivable	$ 437	$ 489
Funds held for securitization liabilities (note 12)	17,073	6,078
Prepaid expenses and other	4,840	4,949
Property and equipment (note 9)	7,911	8,390
Deferred income tax asset (note 16)	11,626	18,400
	$ 41,887	$ 38,306

9. Property and equipment:

(thousands of dollars)

	2019	2018
Cost	$ 16,380	$ 16,138
Accumulated amortization	(8,469)	(7,748)
	$ 7,911	$ 8,390

None of the Bank's property and equipment is subject to title restrictions, nor is any pledged as security for any of the Bank's liabilities.

Total amortization expense recorded for property and equipment for the year ended October 31, 2019 totalled $721,000 (2018 - $623,000).

10. Deposits:

(thousands of dollars)

Maturity period	Demand/ Floating	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Accrued Interest	2019 Total	2018 Total
Total deposits	$ 398,975	$ 180,640	$ 288,422	$ 205,284	$ 313,307	$ 13,261	$ 1,399,889	$ 1,437,431
Average effective interest rate	1.04%	2.00%	2.29%	2.39%	2.76%		2.00%	1.87%

Average effective interest rates are based on book values and contractual interest rates.

11. Subordinated notes payable:

(thousands of dollars)

	2019	2018
Ten year term, unsecured, non-viability contingent capital compliant, subordinated notes payable, principal amount of $5.0 million, effective interest rate of 10.41%, maturing 2029	$ 4,881	$ -
Ten year term, unsecured, callable, subordinated notes payable, principal amount of $10.0 million, effective interest rate of 8.77%, maturing 2021	$ -	$ 9,844
	$ 4,881	$ 9,844

In March 2019, the Bank redeemed the $10.0 million subordinate note payable. In the same month the Bank completed a private placement of non-viability contingent capital ("NVCC") compliant note payable in the principal amount of $5.0 million, of which $500,000 was issued to a related party (see note 22). Issue costs associated with the private placement were $125,000.

12. Securitization liabilities:

Securitization liabilities include amounts payable to counterparties for cash received upon initiation of securitization transactions, accrued interest on amounts payable to counterparties, and the unamortized balance of deferred costs and discounts that arose upon initiation of the securitization transactions. The amounts payable to counterparties bear interest at rates ranging from 3.55% - 3.95% and mature in 2020. Securitized insured mortgages and other assets with a carrying value of $33.1 million (2018 - $33.1 million) are pledged as collateral for these liabilities.

13. Other liabilities:

(thousands of dollars)

	2019	2018
Accounts payable and other	$ 3,983	$ 3,474
Cash collateral and amounts held in escrow	6,098	5,343
Holdbacks payable on loan and lease receivables	97,001	96,161
	$ 107,082	$ 104,978

14. Share capital:

a) Authorized:

Common shares:

The Bank is authorized to issue an unlimited number of voting common shares with no par value.

Series 1 Preferred shares:

The Bank is authorized to issue an unlimited number of Series 1 preferred shares with a par value of $10.00. These preferred shares are Basel III-compliant, non-cumulative five-year rate reset preferred shares which includes non-viability contingent capital ("NVCC") provisions which would require the preferred shares to be converted to common shares upon a trigger event (as defined by OSFI).

The holders of the Series 1 preferred shares were entitled to receive a non-cumulative fixed dividend in the amount of $0.70 annually per share, payable quarterly, as and when declared by the Board of Directors for the initial period ending October 31, 2019. In accordance with the Short Form Prospectus dated October 22, 2014 holders of the Series 1 preferred shares had the right, at their option, to convert any or all of their Series 1 preferred shares into an equal number of non-cumulative floating rate Series 2 preferred shares of the Bank, subject to certain conditions on October 31, 2019. Based on the number of Series 1 preferred shares tendered for conversion into Series 2 preferred shares, holders of Series 1 preferred shares retained their shares and no Series 2 preferred shares were issued on the Series 1 conversion date. For the five-year period commencing on November 1, 2019, the annual fixed dividend rate is 6.772%, which is equal to the five year Government of Canada Bond Yield quoted on October 2, 2019, plus 543 bps.

The Bank maintains the right to redeem, subject to the approval of OSFI, up to all of the outstanding Series 1 preferred shares on October 31, 2024 and on October 31 every five years thereafter at a price of $10.00 per share. Should the Bank choose not to exercise its right to redeem the Series 1 preferred shares, holders of these shares will have the right to convert their shares into an equal number of non-cumulative, floating rate Series 2 preferred shares. Holders of Series 2 preferred shares will be entitled to receive quarterly floating dividends, as and when declared by the Board of Directors, equal to the 90-day Government of Canada Treasury bill rate plus 543 basis points.

Upon the occurrence of a trigger event (as defined by OSFI), each Series 1 or 2 preferred shares will be automatically converted, without the consent of the holders, into common shares of the Bank. Conversion to common shares will be determined by dividing the preferred share conversion value ($10.00 per share plus any declared but unpaid dividends) by the common share value (the greater of (i) the floor price of $0.75 and (ii) the current market value price

14. Share capital – continued:

Series 1 Preferred shares - continued:

calculated as the volume weighted average trading price for the ten consecutive trading days ending on the day immediately prior to the date of the conversion).

Series 3 Preferred shares:

The Bank is authorized to issue an unlimited number of preferred shares, including Series 3 preferred shares with a par value of $10.00. These preferred shares are Basel III-compliant, non-cumulative six year rate reset preferred shares which includes non-viability contingent capital ("NVCC") provisions which would require the preferred shares to be converted to common shares upon a trigger event (as defined by OSFI).

The holders of the Series 3 preferred shares are entitled to receive a non-cumulative fixed dividend in the amount of $0.70 annually per share, payable quarterly, as and when declared by the Board of Directors for the initial period ending April 30, 2021. Thereafter, the dividend rate will reset every five years at a level of 569 basis points over the then five year Government of Canada bond yield.

The Bank maintains the right to redeem, subject to the approval of OSFI, up to all of the outstanding Series 3 preferred shares on April 30, 2021 and on April 30 every five years thereafter at a price of $10.00 per share. Should the Bank choose not to exercise its right to redeem the Series 3 preferred shares, holders of these shares will have the right to convert their shares into an equal number of non-cumulative, floating rate Series 4 preferred shares. Holders of Series 4 preferred shares will be entitled to receive quarterly floating dividends, as and when declared by the Board of Directors, equal to the 90-day Government of Canada Treasury bill rate plus 569 basis points.

Upon the occurrence of a trigger event (as defined by OSFI), each Series 3 or 4 preferred shares will be automatically converted, without the consent of the holders, into common shares of the Bank. Conversion to common shares will be determined by dividing the preferred share conversion value ($10.00 per share plus any declared but unpaid dividends) by the common share value (the greater of (i) the floor price of $0.75 and (ii) the current market value price calculated as the volume weighted average trading price for the ten consecutive trading days ending on the day immediately prior to the date of the conversion).

14. Share capital – continued:

b) Issued and outstanding:

(thousands of dollars)

	2019			2018		
	Shares		Amount	Shares		Amount
Common shares:						
Outstanding, beginning and end of year	21,123,559	$	152,612	21,123,559	$	152,612
Series 1 Preferred shares:						
Outstanding, beginning and end of year	1,461,460	$	13,647	1,461,460	$	13,647
Series 3 Preferred shares						
Outstanding, beginning and end of year	1,681,320	$	15,690	1,681,320	$	15,690
Contributed surplus:						
Balance, beginning and end of year		$	145		$	145
Total share capital		$	182,094		$	182,094

15. Stock-based compensation:

Equity-settled stock options:

The Bank has a stock option plan for its employees and officers. Options are granted at an exercise price set at the closing market price of the Bank's common shares on the day preceding the date on which the option is granted and are exercisable within ten years of issue. Options are usually granted with graded vesting terms. One third of the grant vests immediately, one third vests on the first anniversary of the grant date, and one third vests on the second anniversary of the grant date. In limited cases, some options are granted with immediate vesting terms.

For the year ended October 31, 2019, the Bank recognized stock-based compensation expense of $nil (2018 - $nil). As at October 31, 2019, the outstanding options totaled 42,934 compared to 43,851 a year ago. The options are fully exercisable into common shares at approximately $7.00 per share and expire between 2020 and 2023. No stock options were granted during the year ended October 31, 2019 or October 31, 2018.

16. Income taxes:

Income taxes, including both the current and deferred portions, vary from the amounts that would be computed by applying the aggregated statutory federal and provincial tax rate of 27% (2018 – 27%) to income before income taxes. Income taxes have been computed as follows:

(thousands of dollars)

	2019	2018
Income before income taxes	$ 27,821	$ 25,013
Income tax rate	27%	27%
Expected income tax provision	7,512	6,754
Tax rate differential	(53)	45
Other permanent differences	166	140
Income taxes	$ 7,625	$ 6,939

Income taxes is comprised solely of a deferred income tax provision.

The components of the recognized deferred income tax assets and related changes, as recognized in net income, equity or accumulated comprehensive income, are as follows:

(thousands of dollars)

	November 1, 2018	Recognized in net income	Recognized directly to equity	Recognized on transition to IFRS 9	October 31, 2019
Allowance for credit losses	$ 640	$ (46)	$ –	$ (28)	$ 566
Loss carry forwards	16,958	(7,543)	879	–	10,294
Share issue and financing costs	289	(127)	–	–	162
Deposit commissions	(782)	25	–	–	(757)
Other	1,295	66	–	–	1,361
Total deferred income tax assets	$ 18,400	$ (7,625)	$ 879	$ (28)	$ 11,626

16. Income taxes – continued:

(thousands of dollars)

	November 1, 2017	Recognized in net income	Recognized directly to equity	October 31, 2018
Allowance for credit losses	$ 639	$ 1	$ –	$ 640
Loss carry forwards	22,137	(6,060)	881	16,958
Share issue and financing costs	508	(219)	–	289
Deposit commissions	(828)	46	–	(782)
Other	2,002	(707)	–	1,295
Total deferred income tax assets	$ 24,458	$ (6,939)	$ 881	$ 18,400

The Bank is subject to Part VI.1 tax which is a 40% tax on dividends paid on taxable preferred shares under the Income Tax Act (Canada). The Part VI.1 tax of $879,000 (2018 - $880,000) and related deferred tax recovery is recorded through equity. Deferred tax expense related to comprehensive income of $nil (2018 - $1,000) are also reflected in equity.

At October 31, 2019, the Bank had income tax losses which can be carried forward to reduce taxable income in future years. These loss carry forwards of the Bank will expire, if unused, as follows:

(thousands of dollars)

2031	$ 56
2032	3,313
2033	13,983
2034	11,419
2035	9,145
2036	–
2037	–
2038	82
2039	562
	$ 38,560

In addition the Bank has approximately $9.5 million (2018 - $9.5 million) of capital loss carry forwards which may be applied against future capital gains and for which the deferred tax asset of $1.3 million (2018 - $1.3 million) has not been recognized.

17. Per share amounts:

Basic and diluted income per common share

(thousands of dollars except per share amounts)

	2019	2018
Net income	$ 20,196	$ 18,074
Preferred share dividends paid	(2,201)	(2,201)
Net income available to common shareholders	17,995	15,873
Weighted average number of common shares outstanding	21,123,559	21,123,559
Basic and diluted income per common share	$ 0.85	$ 0.75

Employee stock options do not have a dilutive impact. The Series 1 and Series 3 NVCC preferred shares are contingently issuable shares and do not have a dilutive impact.

18. Items not involving cash:

(thousands of dollars)

	2019	2018
Provision for (recovery of) credit losses	$ (298)	$ 334
Income taxes	7,625	6,939
Interest income	(88,305)	(80,914)
Interest expense	34,408	29,415
Amortization of property and equipment	721	623
	$ (45,849)	$ (43,603)

19. Nature and extent of risks arising from financial instruments:

Risk management involves the identification, ongoing assessment, managing and monitoring of material risks that could adversely affect the Bank. The Bank is exposed to credit risk, liquidity risk, and market risks.

Senior management is responsible for establishing the framework for identifying risks and developing appropriate risk management policies and procedures. The Bank's Board of Directors, either directly or indirectly through its committees, reviews and approves corporate policies, including specific reporting procedures. This enables them to monitor ongoing compliance with policies, delegate limits and review management's assessment of risk in its material risk taking activities. The Bank's Chief Internal Auditor provides a periodic review of policies and procedures to ensure they are appropriate, effective and being followed and that adequate controls are in place in order to mitigate risk to acceptable levels. The Chief Internal Auditor reports directly to the Audit Committee of the Board of Directors. In addition, the Bank has an ongoing risk and compliance

19. Nature and extent of risks arising from financial instruments – continued:

management program with the Chief Compliance Officer, who reports directly to the Board of Directors, and the Chief Risk Officer, who reports directly to the Risk Oversight Committee.

Credit Risk

Credit risk is the risk of loss associated with a borrower, guarantor, or counterparty's inability or unwillingness to fulfill its contractual obligations. The Bank is exposed to credit risk primarily as a result of its lending activities but also as a result of investing in securities. The Bank manages its lending activity credit risk using policies that have been recommended by the Chief Credit Officer and the Chief Risk Officer to the Risk Oversight Committee, which then recommends the policies to the Board of Directors for approval. These policies consist of approval procedures and limits on loan amounts, portfolio concentration, geographic concentration, industry concentration, asset category, loans to any one entity and associated groups, a risk rating policy that provides for risk rating each asset in its total asset portfolio, and early recognition of problem accounts with an action plan for each account. The Risk Oversight Committee reviews these policies on an ongoing basis.

The Bank manages its securities credit risk by applying policies that have been recommended by the Chief Credit Officer to the Risk Oversight Committee, which then recommends the policies to the Board of Directors for approval. These policies consist of approval procedures and restrictions in the selection of security dealers, restrictions in the nature of securities selected, and in setting securities portfolio concentration limits. The Risk Oversight Committee reviews these policies on an ongoing basis.

The Risk Oversight Committee, comprised entirely of independent directors, performs the following functions related to credit risk:

- Recommends policies governing management of credit risks to the Board of Directors for approval and reviews credit risk policies on an ongoing basis to ensure they are prudent and appropriate given possible changes in market conditions and corporate strategy.
- Concurs with credits exceeding the levels delegated to management, prior to commitment.
- Reviews, on a regular basis, watchlist accounts, impaired loans and accounts that have gone into arrears and expected credit loss analysis on a quarterly basis.

See note 6 for information relating to credit risk associated with securities and note 7 for information relating to credit risk associated with loans.

There was no material change in the Bank's processes for managing credit risk during the year.

Liquidity Risk

Liquidity risk is the risk that the Bank is unable to meet the demand for cash to fund obligations as they come due. The Bank is exposed to liquidity risk as a result of timing differences

19. Nature and extent of risks arising from financial instruments – continued:

in the cash flows of its lending activities, security investment activities and deposit taking activities. The Bank has established policies to ensure that its cash outflows and inflows are closely matched and that its sources of deposits are diversified between funding sources and over a wide geographic area. The Risk Oversight Committee recommends policies governing management of liquidity risk to the Board for approval and reviews liquidity policies on an ongoing basis. It receives and reviews quarterly securities portfolio reports and liquidity risk reports from management relating to its liquidity position. Additionally, an Asset Liability Committee, consisting of members of senior management, monitors liquidity risk, reviews compliance with policies and discusses strategies in this area.

See note 20 for information relating to liquidity risk associated with the Bank's asset and liability gaps in maturities.

There was no material change in the Bank's processes for managing liquidity risk during the year.

Market Risk

Market risk is the risk of a negative impact on the balance sheet and/or income statement resulting from changes or volatility in market factors such as interest rates or market prices. The Bank's principal market risk arises from interest rate risk as the Bank does not undertake any material foreign exchange or trading activities. The Risk Oversight Committee is charged with recommending policies that govern market risk to its Board of Directors for approval and with reviewing the policies on an ongoing basis.

Interest rate risk is the risk that a movement in interest rates could negatively impact spread, net interest income and the economic value of assets, liabilities and shareholders' equity. The Bank manages interest rate risk by employing a number of methods including income simulation analysis and interest rate sensitivity gap and duration analysis. Management prepares regular reports to the Board to allow for ongoing monitoring of the Bank's interest rate risk position. The Asset Liability Committee reviews the results of these analyses on a monthly basis and monitors compliance with limits set by corporate policy.

The management of interest rate risk also includes stress testing the Bank's financial assets and liabilities to various standard and non-standard interest rate scenarios. Standard scenarios that are considered include a 100 basis point (bps) parallel upward and downward shift in all yield curves applicable to the Bank.

19. Nature and extent of risks arising from financial instruments – continued:

An analysis of the Bank's sensitivity to an increase or decrease in market interest rates, assuming no asymmetrical movement in yield curves and a static balance sheet is as follows:

Interest Rate Position
(thousands of dollars)

	2019		2018	
	Increase 100 bps	Decrease 100 bps	Increase 100 bps	Decrease 100 bps
Sensitivity of projected net interest income during a 12 month period	$ 1,621	$ (1,613)	$ 2,829	$ (2,802)
Sensitivity of reported equity during a 60 month period	(3,669)	3,780	(2,707)	2,857
Duration difference between assets and liabilities (months)	1.3		0.5	

There was no material change in the Bank's processes for managing interest rate risk during the year.

As at October 31, 2019 and October 31, 2018 the Bank did not have any outstanding contracts to hedge fair value exposure attributed to interest rate risk. The Bank uses on-balance sheet strategies to manage its interest rate risk.

20. Interest rate and liquidity risk:

The Bank is exposed to interest rate risk as a consequence of the mismatch, or gap, between assets and liabilities scheduled to mature or reset on particular dates. The gaps, which existed at October 31, 2019 are as follows:

(thousands of dollars)

	Floating rate	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Over 5 years	Non-interest rate sensitive	Total
Assets								
Cash and cash equivalents	$ 139,145	$ –	$ –	$ –	$ –	$ –	$ –	$ 139,145
Effective rate	2.16%							
Securities	–	10,061	–	–	–	–	–	10,061
Effective rate		2.01%						
Loans	435,521	44,434	96,860	161,917	698,523	152,429	4,604	1,594,288
Effective rate	6.13%	6.01%	4.62%	4.52%	4.96%	4.43%		
Other	–	1,320	15,712	–	–	–	24,855	41,887
Effective rate		1.69%	1.78%					
Total assets	$ 574,666	$ 55,815	$ 112,572	$ 161,917	$ 698,523	$ 152,429	$ 29,459	$1,785,381
Liabilities								
Deposits	$ 398,975	$ 180,640	$ 288,422	$ 205,284	$ 313,307	$ –	$ 13,261	$1,399,889
Effective rate	1.04%	2.00%	2.29%	2.39%	2.76%			
Subordinated notes	–	–	–	–	–	4,881	–	4,881
Effective rate						10.41%		
Securitization liabilities	–	–	24,634	8,732	–	–	–	33,366
Effective rate			3.95%	3.55%				
Other	103,099	–	–	–	–	–	3,983	107,082
Effective rate	1.81%							
Equity	–	13,647	–	15,690	–	–	210,826	240,163
Effective rate		7.00%		7.00%				
Total liabilities and equity	$ 502,074	$ 194,287	$ 313,056	$ 229,706	$ 313,307	$ 4,881	$ 228,070	$1,785,381
October 31, 2019 gap	$ 72,592	$ (138,472)	$ (200,484)	$ (67,789)	$ 385,216	$ 147,548	$ (198,611)	$ –
Cumulative	$ 72,592	$ (65,880)	$ (266,364)	$ (334,153)	$ 51,063	$ 198,611	$ –	$ –
October 31, 2018 gap	$ 231,828	$ (167,780)	$ (210,735)	$ (193,385)	$ 390,897	$ 123,176	$ (174,001)	$ –
Cumulative	$ 231,828	$ 64,048	$ (146,687)	$ (340,072)	$ 50,825	$ 174,001	$ –	$ –

21. Fair value of financial instruments:

The amounts set out in the table below represent the fair value of the Bank's financial instruments:

(thousands of dollars)

	2019		2018	
	Book Value	Fair Value	Book Value	Fair Value
Assets				
Cash and cash equivalents	$ 139,145	$ 139,145	$ 129,781	$ 129,781
Securities	10,061	10,061	10,017	10,017
Loans	1,594,288	1,593,277	1,631,026	1,628,472
Other financial assets	17,510	17,510	6,567	6,567
Liabilities				
Deposits	$ 1,399,889	$ 1,403,816	$ 1,437,431	$ 1,412,286
Subordinated notes payable	4,881	5,000	9,844	10,000
Securitization liabilities	33,366	33,469	33,310	33,736
Other financial liabilities	107,082	107,082	104,978	104,978

Fair values are based on management's best estimates of market conditions and valuation policies at a certain point in time. The estimates are subjective and involve particular assumptions and matters of judgment and as such, may not be reflective of future fair values. The Bank's loans and deposits lack an available market as they are not typically exchanged. Therefore, they have been valued as described below and are not necessarily representative of amounts realizable upon immediate settlement.

The fair value amounts have been determined using the following valuation methods and assumptions:

- The fair values of securities are determined based on quoted market prices and internal and external valuation models that incorporate observable market data such as interest rates and credit spreads.
- The fair value of loans is based on net discounted cash flows using market interest rates and applicable credit spreads for borrowers.
- The fair value of deposits is determined based on discounted cash flows using market interest rates.
- The fair value of subordinated notes payable is determined by referring to current values for similar debt instruments.
- The fair value of securitization liabilities is determined based on discounted cash flows using market interest rates.
- The fair value of other financial assets and other financial liabilities is approximately equal to their book value due to the short-term nature of the instruments.

22. Related party transactions:

The Bank's Boards of Directors and Senior Executive Officers represent key management personnel. The Bank has loans to key management personnel. At October 31, 2019, amounts due from related parties totalled $1.4 million (2018 - $672,000). The interest rates charged on these loans are similar to those charged on an arms-length transaction. Interest income earned on related party loans for the year ended October 31, 2019 totalled $48,000 (2018 - $23,000). There were no provisions for credit losses related to loans issued to key management personnel (2018 - $nil).

In March 2019, the Bank issued a $500,000 subordinated note payable to key management personnel which bears an interest rate of 10% and matures in March 2029 (note 11).

Total compensation expense recognized for key management personnel for the year was $5.0 million (2018 - $4.9 million).

23. Commitments and contingencies:

a) Credit commitments:

The amount of credit related commitments represents the maximum amount of additional credit that the Bank could be obliged to extend. Under certain circumstances, the Bank may cancel loan commitments at its option. The amount with respect to the letters of credit are not necessarily indicative of credit risk as many of these arrangements are contracted for a limited period of usually less than one year and will expire or terminate without being drawn upon.

(thousands of dollars)

	2019	2018
Loan commitments	$ 261,366	$ 167,624
Letters of credit	48,074	42,530
	$ 309,440	$ 210,154

b) Lease commitments:

The Bank leases a number of premises under operating leases, with current leasing arrangements expiring between August 31, 2020 and December 31, 2045 with an option to renew the leases after the initial lease period. Lease payments are increased every three to five years to reflect market rates. The Bank does not have any material subleases.

23. Commitments and contingencies - continued:

b) Lease commitments (continued):

Total operating lease expense recognized for the year ended October 31, 2019 totalled $967,000 (2018 - $983,000)

Minimum future lease commitments are as follows:
(thousands of dollars)

		2019		2018
Within 1 year	$	898	$	741
Between 1 and 5 years		3,275		1,549
Greater than 5 years		2,635		1,017
Total lease commitments	$	6,808	$	3,307

c) Pledged assets:

In the ordinary course of business, assets are pledged against the following off-balance sheet items:

(thousands of dollars)

		2019		2018
Securitized contracts	$	4,130	$	4,082
Letters of credit		4,438		6,299
	$	8,568	$	10,381

24. Capital management:

a) Overview

The Bank's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence as well as to support future development of the business. The impact of the level of capital on shareholders' return is an important consideration and the Bank recognizes the need to maintain a balance between the higher returns that might be possible with greater leverage and the advantages and security afforded by a more robust capital position.

OSFI sets and monitors capital requirements for the Bank. Capital is managed in accordance with policies and plans that are regularly reviewed and approved by the Board of Directors and take into account forecasted capital requirements and financial market conditions.

24. Capital management – continued:

a) Overview (continued):

The goal is to maintain adequate regulatory capital for the Bank to be considered well capitalized, protect consumer deposits and provide capacity to support organic growth as well as to capitalize on strategic opportunities that do not otherwise require accessing the public capital markets, all the while providing a satisfactory return to shareholders. The Bank's regulatory capital is comprised of share capital, retained earnings and unrealized gains and losses on fair value through other comprehensive income securities (2018 - available-for-sale securities) (Common Equity Tier 1 capital), preferred shares (Additional Tier 1 capital) and the qualifying amount of subordinated notes (Tier 2 capital).

The Bank monitors its capital adequacy and related capital ratios on a daily basis and has policies setting internal maximum and minimum amounts for its capital ratios. These capital ratios consist of the leverage ratio and the risk-based capital ratios.

During the year ended October 31, 2019, there were no material changes in the Bank's management of capital.

b) Risk-Based Capital Ratio:

The Basel Committee on Banking Supervision has published the Basel III rules supporting more stringent global standards on capital adequacy and liquidity (Basel III). 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 2.50% capital conservation buffer. The only available transition allowed by OSFI for capital ratios is related to the 10 year phase out of non-qualifying capital instruments.

OSFI also requires banks to measure capital adequacy in accordance with guidelines for determining risk adjusted capital and risk-weighted assets including off-balance sheet credit instruments as specified in the Basel III regulations. Based on the deemed credit risk for each type of asset, assets held by the Bank are assigned a weighting of 0% to 150% in the determination of the Bank's risk-based capital ratios.

24. Capital management – continued:

b) Risk-Based Capital Ratio – continued:

The Bank's risk-based capital ratios are calculated as follows:

(thousands of dollars)

	2019	2018
Common Equity Tier 1 (CET1) capital		
Directly issued qualifying common share capital	$ 152,757	$ 152,757
Retained earnings	58,069	41,473
Accumulated other comprehensive income	-	-
CET1 before regulatory adjustments	210,826	194,230
Regulatory adjustments applied to CET1	(13,281)	(20,175)
Total Common Equity Tier 1 capital	$ 197,545	$ 174,055
Additional Tier 1 capital		
Directly issued qualifying Additional Tier 1 instruments	$ 29,337	$ 29,337
Total Tier 1 capital	$ 226,882	$ 203,392
Tier 2 capital		
Directly issued capital instruments	$ 5,000	$ 10,000
Tier 2 capital before regulatory adjustments	5,000	10,000
Regulatory adjustments applied to Tier 2	-	(6,000)
Total Tier 2 capital	$ 5,000	$ 4,000
Total regulatory capital	$ 231,882	$ 207,392
Total risk-weighted assets	$1,501,435	$ 1,502,549
Capital ratios		
CET1 ratio	13.16%	11.58%
Tier 1 capital ratio	15.11%	13.54%
Total capital ratio	15.44%	13.80%

24. Capital management – continued:

c) Leverage ratio:

The leverage ratio is a supplementary measure to the risk-based capital requirements and is defined as the ratio of Tier 1 capital to the Bank's total exposures. The Bank calculates its leverage ratio as follows:

(thousands of dollars)

	2019	2018
On-balance sheet assets	$ 1,785,381	$ 1,809,130
Assets amounts deducted in determining the Basel III Tier 1 capital	(13,281)	(20,175)
Total on-balance sheet exposures	1,772,100	1,788,955
Off-balance sheet exposure at gross notional amount	309,440	210,154
Adjustments for conversion to credit equivalent amount	(190,023)	(123,345)
Off-balance sheet exposures	119,417	86,809
Tier 1 Capital	226,882	203,392
Total exposures	1,891,517	1,875,764
Leverage Ratio	11.99%	10.84%

The Bank was in compliance with OSFI's leverage ratio expectations for the periods reported.

25. Transition to IFRS 9:

Reconciliation from IAS 39 to IFRS 9

The following table provides the impact of the transition to IFRS 9 on the Consolidated Balance Sheets at transition date, November 1, 2018. The impact is derived from the reclassification and remeasurement of the Bank's financial instruments:

- Reclassification: These adjustments reflect the movement of balances between categories on the Consolidated Balance Sheet with no impact to shareholders' equity. There is no change to the carrying value of the balances as a result of the reclassification.
- Remeasurement: These adjustments, which include expected credit losses, reflect the changes to the carrying value of each item on the Consolidated Balance Sheets through shareholders' equity.

25. Transition to IFRS 9 - continued:

The following table shows the transition from IAS 39 to IFRS 9 classification and measurement as at November 1, 2018:

(thousands of dollars)	IAS 39 Classification	IFRS 9 Classification	IAS 39 Carrying Amount	Reclassification	Remeasurement	IFRS 9 Carrying Amount
Financial assets						
Securities	Available-for-sale	FVOCI	$ 10,017	$ -	$ -	$ 10,017
Loans						
Commercial real estate	Amortized Cost	Amortized Cost	595,263	-	126	595,389
Non-commercial real estate	Amortized Cost	Amortized Cost	91,891	-	(61)	91,830
Corporate and public sector	Amortized Cost	Amortized Cost	50,960	-	58	51,018
Structured finance	Amortized Cost	Amortized Cost	892,912	-	(17)	892,895
			1,631,026	-	106	1,631,132
Remaining financial assets[1]	Amortized Cost	Amortized Cost	136,348	-	-	136,348
Total financial assets			1,777,391	-	106	1,777,497
Total share capital			$ 182,094	$ -	$ -	$ 182,094
Accumulated other comprehensive income			-	-	-	-
Retained earnings[2]			41,473	-	78	41,551
Total shareholders' equity			$ 223,567	$ -	$ 78	$ 223,645

[1] Remaining financial assets include cash and accounts receivable.

[2] The adjustment to retained earnings reflects the after-tax impact of the IFRS 9 remeasurement of allowance for credit losses (note 16).

25. Transition to IFRS 9 - continued:

Reconciliation of allowance for credit losses balance from IAS 39 to IFRS 9

The following table reconciles the closing allowance for credit losses for financial assets in accordance with IAS 39 as at October 31, 2018 to the opening allowance for credit losses as at November 1, 2018. The amounts presented below are included in the figures presented in Note 7.

(thousands of dollars)	Allowance for credit losses under IAS 39 as at October 31, 2018	Remeasurement	Allowance for credit losses under IFRS 9 as at November 1, 2018
Commercial real estate	$ 1,731	$ (126)	$ 1,605
Non-commercial real estate	90	61	151
Corporate and public sector	539	(58)	481
Structured finance	399	17	416
Total Allowance For Credit Losses	$ 2,759	$ (106)	$ 2,653