

# **Equity Financial Trust Company**

**BASEL III PILLAR 3 DISCLOSURES**

**DECEMBER 31, 2017**

## 1. Nature of operations

Equity Financial Trust Company (“EFT” or the “Company”) is a federally regulated trust company and a wholly owned subsidiary of Equity Financial Holdings Inc. (“EQI”). EFT serves the Canadian mortgage market by offering residential first mortgage loans to customers who are seeking an alternative mortgage solution because they do not meet the conventional underwriting standards of the major Canadian banks. The Company is domiciled in Canada, with its registered office located at 100 King Street West, Suite 4610, Toronto, Ontario. The Company has applied to convert EFT to a Schedule I bank. The conversion application is subject to regulatory approval from the Office of the Superintendent of Financial Institutions Canada (“OSFI”) and the Minister of Finance, Canada, and there can be no assurance as to when or if these approvals will be received.

## 2. Capital

The Company’s Senior management team is responsible for managing the Company’s capital, and the main objectives are to ensure the longevity of its capital to support continued operations and to provide shareholders’ return on equity. To achieve these objectives, the Company manages capital to meet regulatory requirements, to ensure sufficient resources are available to meet day-to-day operating requirements, to allow it to enhance existing systems and develop new systems and, to have the financial ability to expand the scope of its operations and services. EFT is subject to the regulatory capital requirements governed by OSFI.

EFT’s Capital Management Policy governs the quantity and quality of its capital, ensuring it meets minimum regulatory capital requirements, is consistent with the Company’s risk appetite framework, and supports the Company’s strategic objectives. Management’s internal capital adequacy assessment process is integral to the Company’s capital planning activities and incorporates a stress testing program that evaluates the impact of potential scenarios on income and capital. Regulatory capital requirements addressed by the policy include the leverage ratio and risk-based capital ratios (Common Equity Tier 1 (“CET 1”), Tier 1 and Total Capital).

Regulatory capital and capital ratios calculations are based on the Capital Adequacy Requirements Guidelines issued by OSFI. The guidelines are based on Basel III: A global regulatory framework for more resilient banks and banking systems – A Revised Framework (“Basel III”). To measure compliance with minimum risk based capital ratio requirements, capital is calculated on the “all-in” basis, which includes all applicable deductions required by 2018 in the current period.

The leverage ratio is currently defined as Tier 1 capital divided by the total exposure measure. The exposure measure is the sum of: (a) on-balance sheet exposures; (b) derivative exposures; (c) securities financing transaction exposures; and (d) off-balance sheet items. Federally regulated deposit-taking institutions are expected to have Basel III leverage ratios that meet or exceed 3%. In addition, OSFI has established leverage ratio targets on a confidential and institution by institution basis. The Company has disclosed the leverage ratio and its components under “Regulatory Disclosures” on the Equity Financial Trust website.

## 3. Credit Risk

Credit risk is the risk of loss resulting from the failure of a borrower or counterparty to honour its financial or contractual obligations. The nature of the Company’s mortgage lending operations creates an exposure to credit risk resulting from possible defaults in payment by borrowers. The Company oversees the management of credit risk through its Enterprise Risk Management Committee (“ERMC”), which is comprised of members of senior management. The ERMC meets regularly to review risk factors in the mortgage portfolio and periodically considers

and recommends adjustments to the credit risk limits in the Board approved credit lending policy.

As part of the underwriting process, the Company relies heavily upon information supplied by both borrowers and third parties. If any of this information is intentionally or negligently misrepresented and the misrepresentation is not detected before completing the transaction, the credit risk associated with the transaction may be increased. If house prices increase at a faster rate than incomes, fewer borrowers will be able to qualify for mortgage financing at their desired level. In addition, some borrowers may be tempted to overstate their incomes in an attempt to meet lender credit and debt service requirements. While underwriting, risk and compliance policies and procedures are in place to monitor and manage credit risk, there can be no absolute assurances to prevent credit risk from having an adverse effect on the Company's profitability and financial condition.

The mortgage portfolio consists of uninsured residential mortgages. As a result, the Company's primary credit risk relates to the potential for financial loss resulting from the failure of a borrower to fully honour their financial or contractual obligations, such as the failure to repay principal and/or interest on the mortgage. The portfolio consists of residential mortgages originated under lending programs designed to serve customers who are seeking an alternative solution because they have limited access to traditional financing. There is a higher risk of default associated with these customers than with traditional borrowers. The typical customer includes borrowers with a thin or challenged credit history or who are self employed. Because the Company serves customers who are unable to meet the conventional underwriting standards of the major Canadian banks, interest is charged at higher rates than those charged by those lenders. The factors used in determining borrowers' creditworthiness may be subject to change over time. An increase in loan losses beyond those expected and provided for could have a material adverse effect on the Company's operating results and financial condition. The Company mitigates this risk primarily by conducting diligence on each borrower and by dealing with known and reputable mortgage brokers. In addition, as an uninsured residential mortgage lender, credit risk also results from reliance on the maintenance of collateral values. The Company is therefore selective in the types of property accepted as collateral, the reliance on the appraisal of the property, and its geographic location.

Although subject to change with Board approval, the Company predominantly lends to borrowers in urban and suburban areas of Ontario. Although these lending areas are among Canada's largest housing markets, a significant economic shock to the regional economy could have a disproportionately adverse impact on the mortgage portfolio, in light of the general economic conditions and credit risks discussed above, compared to the impact for a lender with a more regionally or nationally diversified mortgage portfolio. As an added precaution against loss, the Company lends only in neighbourhoods where the Company believes there is clear evidence that properties are highly marketable as evidenced by such indicators as days-on-market.

#### 4. Liquidity Risk

Liquidity risk is defined as the possibility the Company will be unable to generate or maintain sufficient cash or cash equivalents, in a timely manner, to meet its commitments as they become due.

Managing liquidity risk requires management to maintain sufficient liquid assets on hand at all times to pay cash obligations, in a timely manner, such as maturing deposits and deposit interest, new mortgage commitments, accounts payables, accrued liabilities and other business obligations.

The Company has established a liquidity management framework which includes the following:

- A Board-approved policy that quantifies EFT's liquidity risk tolerance and minimum liquidity requirements;
- A monitoring and risk control framework that forecasts cash inflows and outflows and contractual liquidity commitments for short and long-term horizons;

- Requirements for the diversification of funding sources;
- The maintenance of a liquidity reserve consisting of cash and cash equivalents, including high-liquid quality assets (“HQLA”);
- Daily reporting that measures compliance with Board-approved limits;
- Periodic stress testing of liquidity assumptions and forecasts, which may include company-specific liquidity shocks, exogenous systemic disruptions, or combinations of both; and
- A liquidity contingency plan that considers a number of scenarios according to which EFT’s liquidity operations could be disrupted and details what actions will be followed under each scenario.

The Asset-Liability Committee (“ALCO”) is comprised of members of senior management and is charged with monitoring the Company’s liquidity exposures. ALCO periodically reviews liquidity policies and procedures as appropriate to evolving business requirements and makes recommendations for policy amendments to the Board as required. ALCO also reviews the results of periodic stress tests and may direct management to temporarily alter its liquidity strategy accordingly.

The Company’s Board has established minimum liquidity requirement limits using two measures required under Basel III and included in OSFI’s Liquidity Adequacy Requirements Guideline (“LARG”):

- Liquidity Coverage Ratio (“LCR”): the ratio of the Company’s HQLA reserve to net cash inflows and outflows for a specified time horizon; and
- Net Stable Funding Ratio (“NSFR”): the ratio of the Company’s liabilities to assets adjusted by factors that represent their inherent stability or permanence, which will become effective in 2019.

These requirements are supplemented by additional supervisory monitoring metrics including the OSFI-designed Net Cumulative Cash Flow (“NCCF”).

The appropriateness of these limits is reviewed from time to time by ALCO in light of prevailing and anticipated business conditions.

## 5. Interest rate risk

Interest rate risk is defined as the possibility that changes in market interest rates will adversely affect the Company’s profitability and financial condition. Interest rate risk may be affected if an unduly large proportion of assets or liabilities have unmatched terms, interest rates or other attributes. The primary method of managing interest rate risk involves matching asset and liability maturity profiles, closely monitoring interest rates and acting upon any mismatch in a timely manner to ensure that any sudden or prolonged change in interest rates does not adversely affect net interest income. Any failure to appropriately match asset and liability maturity profiles could negatively impact operating results and financial condition of the Company. From time to time, the Company enters into derivative transactions to hedge interest rate risk. Where appropriate, hedge accounting is applied to minimize volatility in reported earnings from interest rate changes. All derivative contracts are over-the-counter contracts with highly rated Canadian financial institutions. The use of derivative products is governed by a Board-approved policy that permits the use of derivatives only for the purpose of hedging asset-liability mismatches.

## 6. Market risk

Market risk is the exposure to adverse changes in the value of financial assets. Market risk factors include price risk on available-for-sale securities. The Company mitigates this risk by investing only in high-quality, liquid assets

guaranteed by the Government of Canada, its provinces or municipalities and actively monitoring investments.

Table 1: Regulatory Capital

		As at	
(\$000s, except percentage amounts)		December 31, 2017	December 31, 2016
	Line No.	All-in	All-in
Common Equity Tier 1 capital: Instruments and reserves			
Directly issues qualifying common share capital plus related stock surpluses	1	\$ 36,056	\$ 35,123
Retained earnings	2	59,316	53,408
Accumulated other comprehensive loss	3	(453)	-
<b>Common Equity Tier 1 capital before regulatory adjustments</b>	6	<b>94,919</b>	88,531
<b>Common Equity Tier 1 capital: Regulatory adjustments</b>			
Total regulatory adjustments to Common Equity Tier 1	28	(3,647)	(3,409)
<b>Common Equity Tier 1 capital (CET1)</b>	29	<b>91,272</b>	85,122
Tier 1 capital	45	91,272	85,045
Total capital	59	91,272	85,045
Total risk-weighted assets	60	468,540	311,373
<b>Capital ratios</b>			
Common Equity Tier 1 (as percentage of risk-weighted assets)	61	19.5%	27.3%
Tier 1 (as percentage of risk-weighted assets)	62	19.5%	27.3%
Total capital (as percentage of risk-weighted assets)	63	19.5%	27.3%
<b>OSFI all-in target</b>			
Common Equity Tier 1 capital all-in target ratio	69	7.0%	7.0%
Tier 1 capital all-in target ratio	70	8.5%	8.5%
Total capital all-in target ratio	71	10.5%	10.5%

Note: Line item numbers reference the Pillar III Modified Capital Disclosure Requirements issued by OSFI.

Table 2: Leverage Ratio

(\$000s, except percentage amounts)	Line No.	As at	
		December 31, 2017	December 31, 2016
<b>On-balance sheet exposures</b>			
On-balance sheet items	1	\$ 1,237,626	\$ 835,138
Asset amounts deducted in determining Basel III "all-in" Tier 1 capital	2	(3,647)	(3,409)
<b>Total on-balance sheet exposure</b>	3	<b>1,233,979</b>	<b>831,729</b>
<b>Derivative exposures</b>			
Replacement cost	4	-	-
Add-on amounts for PFE	5	193	123
Total derivatives exposure	11	193	123
<b>Other off-balance sheet exposures</b>			
Off-balance sheet exposure at gross notional amount	17	174,385	73,064
Adjustment for conversion to credit equivalent amounts	18	139,508	58,451
<b>Off-balance sheet items</b>	19	<b>34,877</b>	<b>14,613</b>
Tier 1 capital	20	91,272	85,045
Total exposures	21	1,269,049	846,465
Basel III leverage ratio	22	7.2%	10.0%

Note: Line item numbers reference the Basel III Leverage Ratio Framework and Disclosure Requirements issued by OSFI.