



**HOME CAPITAL GROUP INC.**

CANADA'S ONE-STOP MORTGAGE LENDER




# **RESPONSIBLE LEADERSHIP SUPERIOR RESULTS**

**ANNUAL REPORT 2012**



# Business Profile

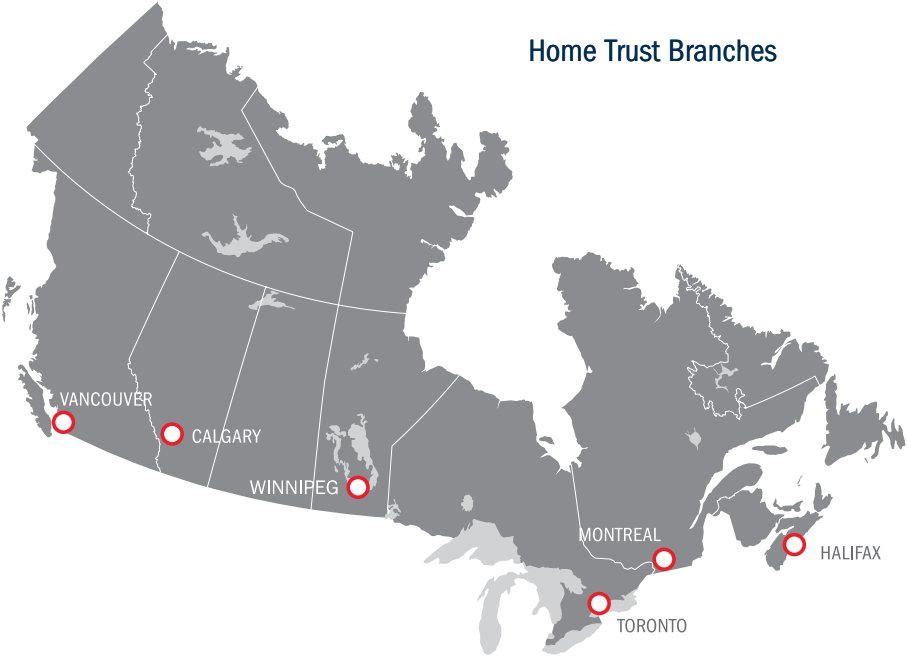
**Home Capital Group Inc.**, together with its operating subsidiary Home Trust Company, has developed a track record of success as Canada’s leading alternative lender. Building on the demonstrated strength of its core residential mortgage lending business, the Company also offers complementary lending services, as well as highly competitive deposit investment products.

 <p><b>MORTGAGE LENDING</b></p> <p>Home Trust is one of Canada’s leading mortgage lenders, focusing on homeowners who typically do not meet all the lending criteria of traditional financial institutions. By offering a range of mortgage products, Home Trust is uniquely positioned to provide financial solutions to meet the needs of thousands of Canadians. With a proprietary lending approach, comprehensive borrower profiling and flexible alternative options, Home Trust is a one-stop shop for borrowers and mortgage brokers. Home Trust is also a provider of commercial first mortgages to high-quality borrowers in selected markets across Canada.</p>	 <p><b>CONSUMER LENDING</b></p> <p>Home Trust’s Equityline Visa program brings the advantages to cardholders of accessing the equity they have built in their homes together with the features and convenience of a Gold Visa card. The Company also offers deposit-secured credit cards for individuals who wish to build or re-establish a positive credit history and preferred unsecured Visa cards to current mortgage customers with good credit history. Home Trust’s Retail Credit Services provides installment financing for customers making purchases from established businesses. PSiGate, a wholly owned subsidiary, offers electronic card-based payment services to merchants who conduct business primarily on the Internet.</p>	 <p><b>DEPOSIT INVESTMENTS</b></p> <p>Home Trust provides a broad range of deposit investment services including certificates of deposit, guaranteed investment certificates, registered retirement savings plans, registered retirement income funds, tax free savings accounts and high interest savings accounts. The Company has developed an extensive customer base and fostered strong relationships with hundreds of deposit brokers and investment dealers across the country. With efficient, personal service and competitive rates, Home Trust offers a number of solutions to meet the long-term and short-term needs of investors looking to diversify their portfolios.</p>
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## MISSION STATEMENT

Home Capital’s mission is to deliver superior shareholder value by focusing on well-defined niches in the Canadian lending and deposit-taking marketplace that generate above average returns, have acceptable residual risk profiles and are not adequately served by traditional financial institutions, while protecting the depositors and operating within regulatory guidelines and the Company’s risk appetite.

## Home Trust Branches



# Financial Highlights

Summary of Data for 10 Year Review

For the years ended December 31 (000s, except per share amounts)

	<b>2012</b>	2011	2010 IFRS
Total assets	\$ <b>18,800,079</b>	17,696,471	15,518,818
Total assets under administration	\$ <b>19,681,750</b>	17,696,471	15,518,818
Total loans	\$ <b>16,904,435</b>	16,089,648	14,091,755
Total loans under administration	\$ <b>17,786,106</b>	16,089,648	14,091,755
Securitized residential mortgages	\$ <b>6,450,682</b>	8,243,350	8,116,636
Deposits	\$ <b>10,136,599</b>	7,922,124	6,595,979
Shareholders' equity	\$ <b>968,213</b>	774,785	628,585
Revenue	\$ <b>887,685</b>	790,274	687,249
Net income	\$ <b>221,983</b>	190,080	154,752
Book value of common shares	\$ <b>27.96</b>	22.38	18.14
Earnings per share – basic	\$ <b>6.40</b>	5.48	4.46
Earnings per share – diluted	\$ <b>6.38</b>	5.46	4.45

In 2011, Home Capital Group Inc. implemented International Financial Reporting Standards (IFRS) with a transition date of January 1, 2010. Figures for 2010 have been restated on an IFRS basis. Figures for 2009 and prior years are on a former Canadian Generally Accepted Accounting Principles (GAAP) basis.

## 25.5%

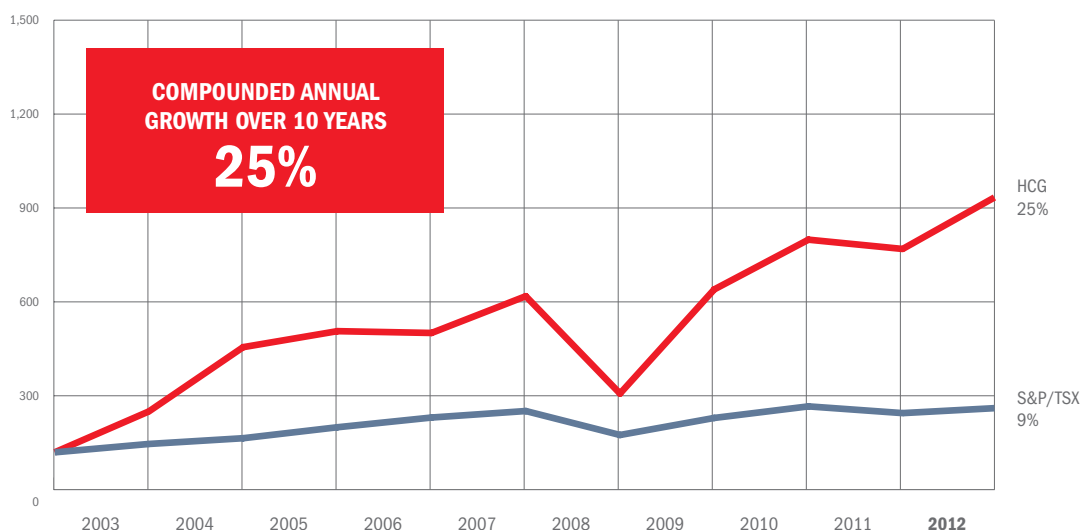
Return on equity was 25.5%, exceeding 20% for the 15th consecutive year

## \$222.0 million

Net income for 2012 was \$222.0 million, an increase of 16.8% over 2011

### Ten-year Cumulative Total Return on \$100 Investment

Comparison between S&P/TSX Composite Index (S&P/TSX) and Home Capital Group Inc. (HCG)  
December 31, 2002–December 31, 2012



#### HCG Stock Price Performance

\$16.63	\$31.25	\$34.75	\$34.05	\$41.90	\$19.80	\$41.85	\$51.79	\$49.10	\$59.07
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Closing Price as of December 31

Share prices have been restated to reflect two-for-one stock split on January 29, 2004.

2010 GAAP	2009	2008	2007	2006	2005	2004	2003
7,712,239	7,360,874	5,809,713	4,975,093	3,902,316	3,284,829	2,568,513	1,897,176
15,878,772	11,508,585	8,423,971	6,434,548	5,009,878	4,085,013	3,069,253	2,212,307
5,861,722	5,468,540	4,531,568	4,045,571	3,328,858	2,813,459	2,257,740	1,618,601
14,028,255	9,616,251	7,145,826	5,505,026	4,436,420	3,613,643	2,758,480	1,933,732
-	-	-	-	-	-	-	-
6,522,850	6,409,822	5,102,781	4,413,984	3,443,640	2,901,515	2,269,157	1,666,788
742,280	590,288	432,753	348,040	276,866	218,885	162,207	121,166
533,937	489,179	454,695	368,881	282,549	234,704	181,839	141,365
180,944	144,493	108,687	90,241	67,815	60,861	44,551	29,507
21.42	17.00	12.57	10.08	8.10	6.44	4.80	3.61
5.21	4.19	3.15	2.62	1.99	1.80	1.33	0.88
5.20	4.15	3.13	2.59	1.95	1.72	1.27	0.86

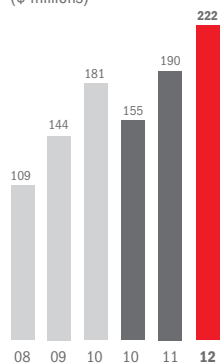
**\$16.90** billion

Total loans grew by 5.1% over 2011 to reach \$16.90 billion at the end of 2012

**\$6.38**

Diluted earnings per share were \$6.38 for the year, an increase of 16.8% over 2011

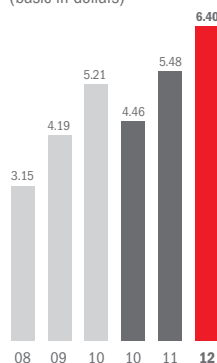
Net Income  
(\$ millions)



**16.8%** ▲

Home Capital reported a 16.8% increase in net income over the \$190.1 million attained in 2011, reaching \$222.0 million for the year ended 2012.

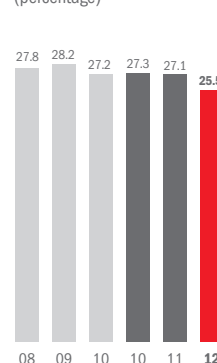
Earnings per Share  
(basic in dollars)



**16.8%** ▲

Basic earnings per share rose to \$6.40 for the year ended December 31, 2012, a 16.8% increase over the \$5.48 reported for 2011.

Return on Equity  
(percentage)



**25.5%** ▲

Home Capital surpassed 20% return on equity for the 15th consecutive year and 25% ROE for the 10th successive year, reaching 25.5% at December 31, 2012.

## Report to Shareholders

In 2012 we celebrated a quarter century of growth and prosperity with another year of record financial and operating performance. Despite a number of challenges in our markets and economic uncertainty around the world, our consistent and stable growth is the result of a relentless focus on our proven strategies and our core competencies. We believe this focus will continue to build on the progress demonstrated in 2012, and will serve our shareholders well in the years to come.

# HOME CAPITAL HAS A STRONG TEAM AT THE HELM. WHAT SETS HOME CAPITAL'S LEADERSHIP APART?

# Q

**OUR SENIOR LEADERSHIP TEAM IS EXPERIENCED AND KNOWLEDGEABLE, WITH A BROAD UNDERSTANDING OF OUR BUSINESS AND OUR INDUSTRY, AND A "ROLL UP THE SLEEVES" PHILOSOPHY. WE WORK HARD AT IDENTIFYING KEY PRIORITIES WHILE CHALLENGING AND DEVELOPING PEOPLE TO REACH AND EXCEED BUSINESS GOALS. WE HAVE ATTRACTED AND RETAINED SOME OF THE BEST PEOPLE IN THE INDUSTRY, PROVIDING OPPORTUNITIES FOR GROWTH AND PROMOTION FROM WITHIN THE COMPANY AND BRINGING IN EXTERNAL EXPERTISE WHEN NEEDED. WITH OUR ONGOING TRAINING, DEVELOPMENT AND SUCCESSION PLANNING PROGRAMS, WE ARE CONFIDENT WE HAVE THE RIGHT PEOPLE IN THE RIGHT PLACES. WE KNOW THAT STRONG LEADERS NEED A STRONG FORCE BEHIND THEM, AND WE HAVE A TEAM OF ENTHUSIASTIC EMPLOYEES WHO BRING DRIVE, COMMITMENT AND ENERGY TO WORK EVERY DAY. OUR GREATEST ASSET IS OUR PEOPLE.**

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### Another Year of Record Performances

Once again, in 2012 a rigorous focus on our strategic priorities and core competencies allowed us to capitalize on stable economic conditions in Canada to generate strong operating and financial performance. Despite a slowing housing market in many of our geographic regions, new and tighter lending rules mandated during the year, and challenging economic climates in both the United States and Europe, we enjoyed solid traditional loan growth and consistent margins that resulted in another year of record profitability.

At Home Capital, our proven and tested value-enhancing strategies have been designed to ensure we deliver solid results through all phases of the economic cycle. Since the Company's founding over twenty-five years ago, our focus has been on generating steady and sustainable growth in earnings while at the same time maintaining a stable risk profile with a strong financial position and industry-leading capital ratios. Each year we establish a set of objectives to benchmark our performance, and in 2012 we met or exceeded the majority of these goals:

- > Net income rose 16.8%, within our target of 13% to 18% growth;
- > Diluted earnings per share were up 16.8% in 2012, within our objective of 13% to 18% growth; and
- > Return on equity was 25.5% for 2012, well in excess of the Company's minimum performance objective of 20% for the fifteenth consecutive year and surpassing 25% for the tenth successive year.

Our total loan portfolio grew by 5.1% and the total portfolio of loans administered, including off-balance sheet securitized assets, increased by 10.5% in 2012 – strong performance but below our target of 13% to 18% for the year. The lower rate of growth was the result of our strategic decision to accelerate the planned reduction of our insured loans with the objective of repositioning our asset base toward the more profitable traditional mortgage offerings. As a result, the majority of the growth in our loans portfolio in 2012 came from our traditional, higher yielding non-securitized mortgage business. We continue to experience strong demand for our traditional product offerings and, as we have increased this segment of our business, we have also improved the risk profile, with average credit scores up from last year and lower loan to value ratios. We look for this segment of our business to continue to grow and generate increased profitability in the years ahead.

With the decision to reduce our insured mortgage portfolio, originations under our secured *Accelerator* program declined to \$804.7 million in 2012 from \$1.10 billion last year. However, insured mortgages remain one of our key products and help to fulfill our mandate to provide a true full-service, one-stop shop for the Canadian mortgage industry. We look for the insured segment of our mortgage originations to return to growth in the quarters ahead.

Reflecting our cautious approach, and in anticipation of new guidelines introduced in 2012 limiting home equity lines of credit, we reduced marketing, approvals and advances under our *Equityline Visa* program during the year. With a review and confirmation of the new guidelines proposed later in the year, we are confident we can now resume prudent growth in this segment of our business within the mandate of our risk tolerance and the new guidelines.

Along with our growth and increased profitability, we enhanced the quality and strength of our capital base yet again in 2012 while reducing our risk exposure. At year-end Home Trust remained well capitalized with solid Tier 1 and Total capital ratios of 17.01% and 20.68%, respectively, well above our minimum annual targets. The credit quality of our loan portfolio also remained strong with non-performing loans representing only 0.33% of the total portfolio as at December 31, 2012, well within our expected and acceptable range. Our strong capital base and conservative risk profile are reflected in the continuing solid credit ratings awarded by Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service.

With our strong performance in 2012, and our positive outlook on the future, we were pleased to announce an 18% increase in our common share dividends in November to \$1.04 on an annual basis, the fifteenth common share dividend increase over the last eight years, and a reflection of our commitment to enhancing long-term shareholder value.

### **Focused on Our Strategic Priorities**

A key reason for our growth and success in 2012, and indeed over the twenty-five years since our founding, is our relentless focus on our core competencies and our well-defined strategic priorities.

Our first priority is to build and maintain Canada's leading alternative financial institution. By serving those segments of the Canadian financial services market that we believe are unserved and underserved, we have built an established and growing market niche, and we will continue to offer a full line of products that meet the needs of borrowers and brokers while targeting our high-value alternative mortgage segment. We also continue to expand our geographic footprint, opening a new office in Winnipeg in 2012, while maintaining high levels of service for all of our clients.

Our second priority is to maintain a strong and conservative balance sheet and financial position so that we can continue to generate strong returns for our shareholders through both good times and bad. Our continuing conservative capital ratios, our prudent risk profile, and our strong liquidity position all bode well for the future. We also continue to maintain stable and flexible sources to fund our growth, including our deposit broker network, the securitization and capital markets, and our new high interest savings account and direct deposit initiatives launched in 2012.

## **HOW HAS HOME CAPITAL LEVERAGED TECHNOLOGY AND INNOVATION TO INVEST IN THE FUTURE?**

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**OVER THE PAST FEW YEARS, HOME CAPITAL HAS STRENGTHENED ITS BUSINESS BY ENHANCING ITS INFRASTRUCTURE AND IMPLEMENTING LEADING EDGE TECHNOLOGIES TO SUPPORT THE COMPANY'S GROWTH AND PRODUCTIVITY. IN 2011, WE EMPLOYED A NEW CORE BANKING SYSTEM, OPTIMIZING BUSINESS PROCESSES, DRIVING OPERATIONAL EFFICIENCIES AND SUPPORTING SUPERIOR CUSTOMER SERVICE. IN ADDITION, WE HAVE IMPLEMENTED SOLUTIONS TO AUGMENT OUR REGULATORY COMPLIANCE, FINANCIAL REPORTING AND RISK MANAGEMENT PRACTICES. WE ARE CURRENTLY INSTITUTING A TRANSFORMATIONAL DATA MANAGEMENT SYSTEM THAT WILL SUPPORT THE COMPANY'S MOVE TO A FULLY DIGITAL BUSINESS, AND WE CONTINUE TO EXPLORE OPPORTUNITIES TO INCREASE BUSINESS FLEXIBILITY AND ENHANCE OPERATIONAL EFFECTIVENESS. HOME CAPITAL HAS THE SYSTEMS IN PLACE TO SUPPORT ITS BUSINESS AND IS WELL POSITIONED FOR FUTURE GROWTH AND PROFITABILITY.**

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Our third priority is to build on our operational excellence by continuing to invest in corporate governance, risk management and customer service processes and systems. During 2012 we enhanced our risk management, compliance and internal audit capabilities with experienced and talented new people, and enhanced processes. To accommodate our growth, during the first quarter of the year we expanded into our newly renovated facilities in our Toronto headquarters, adding 24,500 square feet of office and meeting space.

Our strategic priorities are underpinned by the Company's risk appetite and ability to mitigate risk. Risk management is an essential component of Home Capital's strategy, contributing directly to the Company's profitability and consistently high return on equity. The Board of Directors is accountable for establishing the overall vision, mission, objectives and strategies of the Company and setting the Company's risk appetite and risk-bearing capacity. Your Board is committed to supporting a balance between managed and defined risk and reward to deliver consistent results.

To further strengthen the Board, Ms. Diana Graham will stand as a nominee for election to the Board at the upcoming Annual Meeting. Ms. Graham brings extensive risk management experience to the Board, including governance, credit, operational, market and enterprise risk management, both in the United States and Canada, most recently retiring from the position of Chief Risk Officer at a Canadian financial institution. We are confident that Ms. Graham's significant experience and depth of knowledge will be assets to the Board and the Company.

# Q HOME CAPITAL HAS RECORDED ANOTHER YEAR OF SUPERIOR PERFORMANCE. HOW HAS THE COMPANY PRODUCED GREAT RESULTS FOR SO MANY YEARS?

WE CONTINUE TO FOCUS ON THE FUNDAMENTALS OF OUR BUSINESS, REMAINING TRUE TO OUR CORE VISION WHILE DEVELOPING PRODUCT OFFERINGS THAT ENHANCE OUR POSITION AS A LEADER IN THE ALTERNATIVE LENDING MARKET IN CANADA. TO COMPLEMENT THIS FOCUS, WE HAVE A NIMBLE AND ENTREPRENEURIAL CULTURE, AND ADAPT QUICKLY TO MEET THE NEEDS OF OUR CUSTOMERS, MORTGAGE BROKERS AND OTHER STAKEHOLDERS, AND THE CHANGING MARKETS AND ECONOMIC ENVIRONMENT, ALLOWING US TO BUILD ON OUR COMPETITIVE ADVANTAGE, EVEN DURING CHALLENGING ECONOMIC TIMES. WITH PRUDENT LENDING STRATEGIES, A ROBUST RISK MANAGEMENT FRAMEWORK, SOLID BUSINESS ESSENTIALS AND RIGOROUS PROCESSES, HOME CAPITAL GENERATES CONSISTENTLY STRONG FINANCIAL RESULTS AND CREATES VALUE FOR ALL SHAREHOLDERS.

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## Twenty-Five Years and Growing

In 2012 we celebrated our twenty-fifth year in business. Home Capital has grown from 12 employees in one office, \$3 million in equity and \$50 million in total assets to where we now employ more than 600 highly experienced and talented people in six offices across Canada. Our asset base has grown to almost \$19 billion and total assets under administration have grown to almost \$20 billion, with shareholders' equity standing at \$968 million as at December 31, 2012. Most importantly, our shareholders have benefitted from the growth and success of the Company. Over the last 10 years alone, Home Capital's shareholders have received a compound annual return of 25%, significantly higher than the 9% return for the Toronto Stock Exchange during the same period.

Looking ahead, we believe we can continue to deliver solid growth and strong operating performance for our shareholders. While real estate markets may soften somewhat in 2013 as the result of continued global economic uncertainty and the tightening of mortgage requirements introduced in 2012, we believe supply and demand will remain in balance and the slowdown in activity will lead to a healthier market supported by continued low interest rates, stable employment and solid housing affordability. As a result, we will continue to focus on growing our traditional alternative mortgage business and other retail products while increasing our presence in targeted urban and suburban growth markets across the country.

With this positive outlook in mind, we have established the following objectives for 2013:

- > 13% to 18% growth in total net earnings;
- > 13% to 18% growth in diluted earnings per share;
- > 10% to 15% growth in total loans under administration; and
- > 20% return on shareholders' equity.

In closing, we want to thank everyone at Home Capital for their hard work, dedication and commitment over the years. We have demonstrated that by sticking to our core competencies and focusing on our strategic priorities, we can successfully build our business to meet the needs of Canadians and delivers superior returns to our shareholders through both good times and bad. We are confident we can continue to build on this progress in the years ahead, and look forward to an exciting, profitable and rewarding future.



**Dr. Kevin P.D. Smith**  
*Chair of the Board*



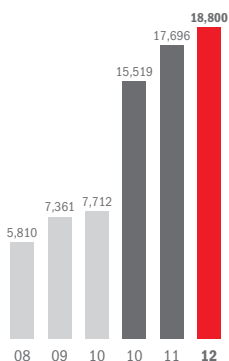
**Gerald M. Soloway**  
*Chief Executive Officer*

# Proven Results

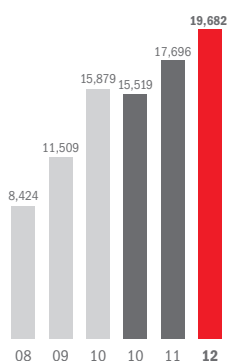
## GROWTH

Home Capital sustained its strength in key financial measurements. The Company's core business activities generated strong results, contributing to asset growth of 6.2% and an increase in total revenue of 12.3%.

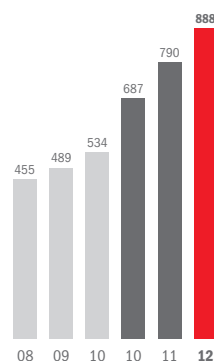
**Assets**  
(\$ millions)



**Total Assets Including Assets under Administration**  
(\$ millions)



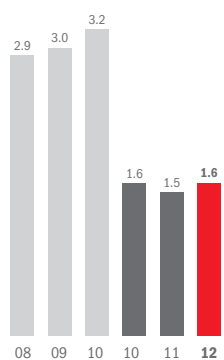
**Revenue**  
(\$ millions)



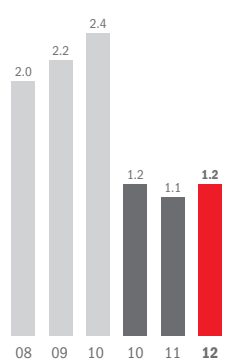
## RETURNS

The Company recorded pre-tax return on assets of 1.6% and after-tax return on assets of 1.2%, while shareholders' equity increased to \$968.2 million, a 25.0% rise from the previous year.

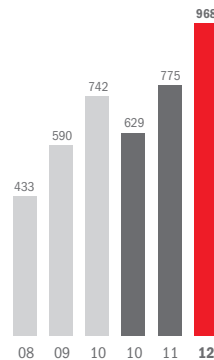
**Pre-tax Return on Assets**  
(percentage)



**After-tax Return on Assets**  
(percentage)



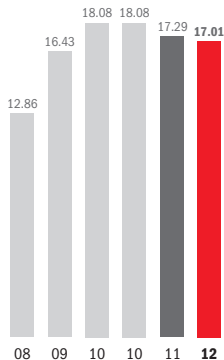
**Shareholders' Equity**  
(\$ millions)



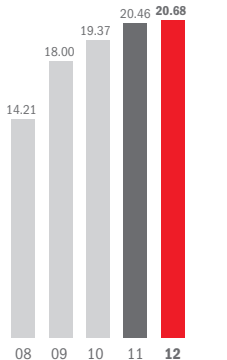
## RISK

Home Capital continued to surpass all applicable regulatory and related standards. The level of impaired loans is comparable to that of large, traditional financial institutions. Home Capital's robust risk management framework is a key component of the Company's philosophy.

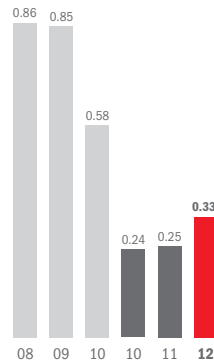
**Tier 1 Capital to Risk-Weighted Assets**  
(percentage)



**Total Capital to Risk-Weighted Assets**  
(percentage)



**Net Impaired Loans of Loan Portfolio**  
(percentage)



■ Former Canadian GAAP Basis   ■ IFRS Basis   ■ IFRS Basis

## Performance vs. Target

### RETURN ON EQUITY

Home Capital again exceeded 20% in return on equity, reaching 25.5% for the year ended December 31, 2012, representing the 15th consecutive year in which the Company surpassed 20% ROE.

#### TARGET:

20% return on equity

Return on equity at

# 25.5%

for the year ended  
December 31, 2012

### EARNINGS

The Company reported net earnings of \$222.0 million for the year ended December 31, 2012, representing a 16.8% increase over the \$190.1 million achieved in 2011.

#### TARGET:

13% to 18% increase  
in total net earnings

Increase in earnings of

# 16.8%

over 2011

### EARNINGS PER SHARE

Diluted earnings per share rose to \$6.38 at December 31, 2012, a 16.8% increase over the \$5.46 recorded for 2011.

#### TARGET:

13% to 18% increase in diluted earnings  
per share

Diluted earnings per share grew

# 16.8%

over 2011

### TOTAL LOANS

Total loans grew to \$16.90 billion by December 31, 2012, an increase of 5.1% over the \$16.09 billion recorded on December 31, 2011.

#### TARGET:

13% to 18% increase in total loans

Total loans increased

# 5.1%

over year-end 2011

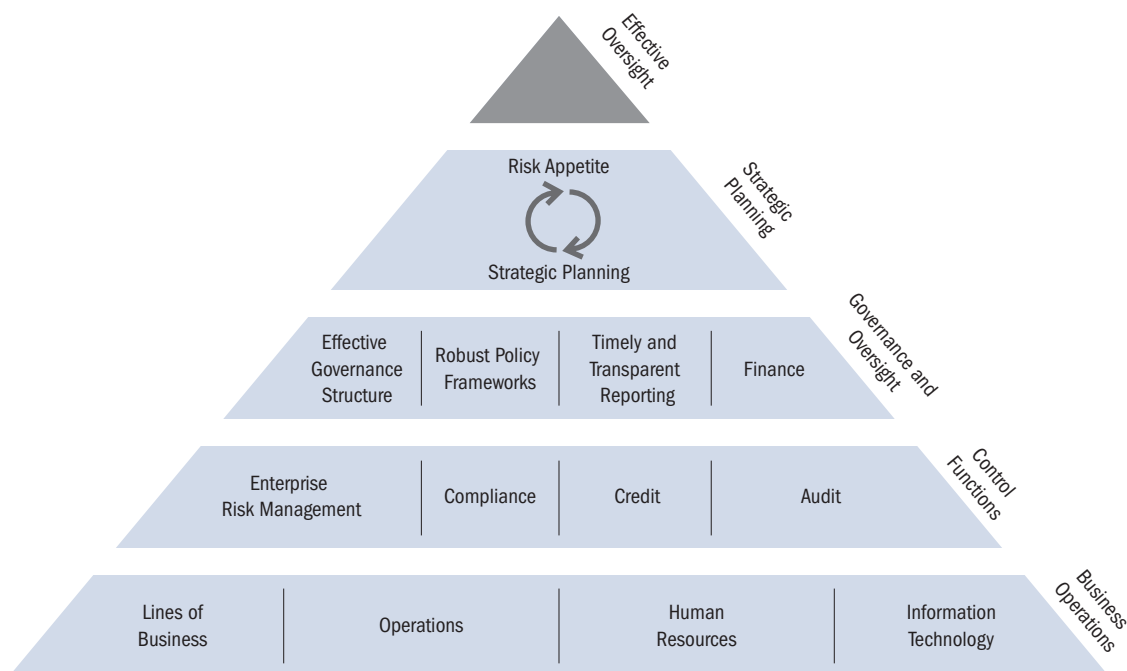
# Corporate Governance at Home Capital

**Home Capital recognizes the importance** of strong and effective corporate governance. As a publicly traded company, Home Capital has governance standards that reflect best practices, are consistent with the corporate governance guidelines set out by the Toronto Stock Exchange and are compliant with applicable rules adopted by the Canadian Securities Administrators.

The Board of Directors of Home Capital ensures that appropriate structures and procedures are in place so that it can independently and effectively oversee the Company’s strategy, risk profile and operations. The Company continually looks for ways to improve its corporate governance policies and procedures, and the Governance, Nominating and Conduct Review Committee is responsible for reviewing Home Capital’s corporate governance practices on at least an annual basis. Home Capital and its wholly owned subsidiary, Home Trust, also proactively adopted the new Corporate Governance Guidelines issued by the Office of the Superintendent of Financial Institutions in January of 2013, and will implement them well ahead of the deadline.

The Board reviews and approves Home Trust’s strategic and financial plans and risk appetite at least annually. Throughout the year, the Board receives strategic updates from each of the principal business groups and risk updates from the Enterprise Risk Management department.

The Board is responsible for the stewardship of Home Capital and for the supervision of the management of the business affairs of the Company, including creating a culture of integrity throughout the Company. All employees, officers and directors are subject to Home Capital’s Code of Business Conduct and Ethics, which requires the highest standards of ethical behaviour in all dealings on behalf of the Company.



## Did you know?

Home Trust has over 600 full-time employees in branches from Vancouver to Halifax

More than 50% of employees participate in Home Capital’s Employee Share Ownership Plan

### **Highlights of Home Capital's corporate governance framework include:**

- > Eight of nine directors are independent, the Chairs and all members of each of the Board Committees are independent, and the roles of CEO and Chairman of the Board are separate
- > The Company maintains a minimum share ownership requirement for directors, the Chief Executive Officer and other designated executive officers to ensure alignment with the interests of all shareholders
- > The Board has adopted a Shareholder Rights Plan to preserve the fair treatment of all shareholders in the event of a take-over bid
- > The Board and its Committees function under charters that specify their roles, accountabilities and responsibilities
- > The Chair of the Governance, Nominating and Conduct Review Committee conducts an annual Board evaluation survey to assess the effectiveness of the Board and its Committees, as well as the effectiveness of each director through a self-evaluation and one-on-one meetings with the Chairman of the Board
- > Home Capital provides an orientation program for new directors as well as conducting internal education sessions
- > The Board is responsible for approving the Company's risk appetite, strategic plan and related processes annually
- > The Board reviews and approves all critical risk policies, delegations of authorities, and Company-wide limits
- > The Board of Directors holds in-camera meetings of the independent directors at every Board meeting, and with the Chief Financial Officer, Chief Risk Officer, Chief Credit Officer, Head of Internal Audit, Chief Compliance Officer and Chief Anti-Money Laundering Officer, and external auditors no less than quarterly

The Board of Directors is assisted in its oversight of the business by four Committees of the Board and by independent oversight functions within the business that report directly to the Board and its Committees.

### **Audit Committee**

The Audit Committee assists the Board in its oversight role with respect to:

- > the quality and integrity of its financial reporting;
- > the qualifications, independence, performance and compensation of the external auditor;
- > the effectiveness of the Company's internal controls, including the effectiveness of its internal audit and compliance functions;
- > oversight of employee complaints and concerns; and
- > the Company's capital management position, in conjunction with the Risk and Capital Committee.

The Chief Financial Officer, Chief Compliance Officer and Chief Anti-Money Laundering Officer, and the Senior Vice President of Internal Audit report to the Audit Committee independently and meet in camera at least quarterly.

### **Risk and Capital Committee**

The Risk and Capital Committee assists the Board in its oversight role with respect to:

- > setting the Company's overall risk appetite and risk management framework, including risk limits;
- > assessing and managing the Company's overall risk profile;
- > reviewing, approving and regularly assessing the effectiveness of the Company's risk and capital policies;
- > the Company's capital management strategies, in conjunction with the Audit Committee; and
- > reviewing the Company's adherence to the Company's risk and capital policies and procedures.

The Chief Risk Officer and the Chief Credit Officer report to the Risk and Capital Committee independently and meet in camera at least quarterly.

Employees raised more than \$60 thousand for various charities and held toy and food bank drives through the year, showing their commitment to a range of charitable causes and social programs

Our employees can serve customers in over 40 languages

## Corporate Governance at Home Capital (continued)

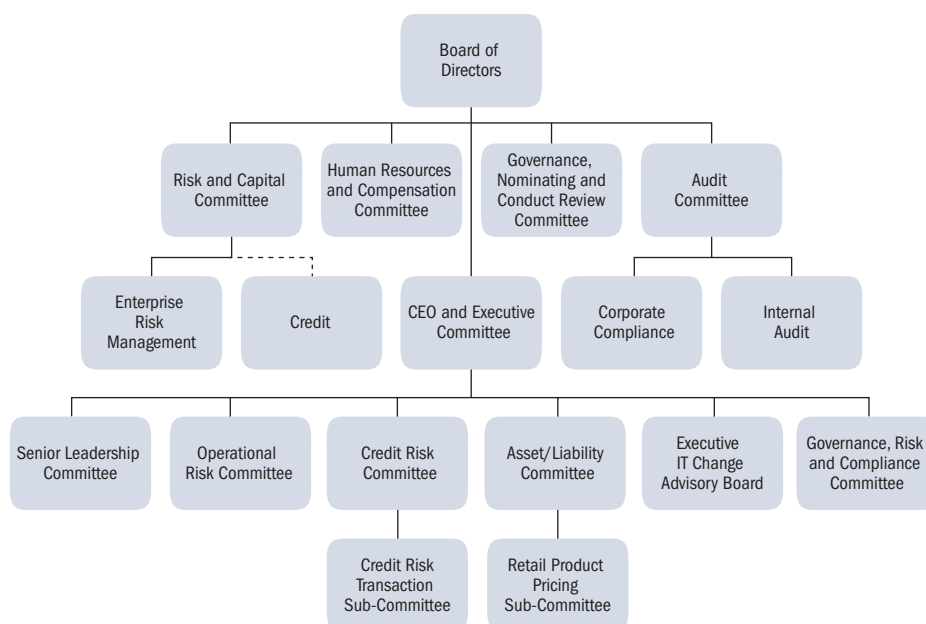
### Governance, Nominating and Conduct Review Committee

The Governance, Nominating and Conduct Review Committee assists the Board in its oversight role with respect to:

- > identification of suitable Board candidates;
- > the quality and effectiveness of the Company's corporate governance policies and practices;
- > evaluation of the contributions of individual directors;
- > review of conflicts of interest, related party transactions, disclosure of information; and
- > director orientation and continuing education.

### Human Resources and Compensation Committee

The Human Resources and Compensation Committee assists the Board in its oversight role with respect to the Company's human resources policies and programs, succession planning and the management of compensation-related risk.



Home Capital sees robust corporate governance principles and practices not only as a critical matter of regulatory compliance, but also as a competitive advantage in its core market. For more information about corporate governance at Home Capital, please refer to Home Capital's Management Information Circular. The Circular contains detailed information about directors and management, as well as the Company's Statement of Corporate Governance Practices.

### [www.homecapital.com](http://www.homecapital.com)

The Company's website contains information about corporate governance at Home Capital, including the Statement of Corporate Governance Practices, Charters of the Board of Directors and Board Committees, Position Descriptions, Director Compensation and Independence Standards, Code of Business Conduct and Ethics, and Shareholder Rights Plan.

The Company has established two scholarships – the Home Capital Scholarship in Honour of John J. Ruffo at the University of Toronto Rotman School of Management and the Debbie Simon Award for Excellence in Human Resources at George Brown College (Toronto)

More than 10% of employees have been with the Company for over 10 years

## Environmental Responsibility at Home Capital

# ENVIRONMENTAL COMMITMENT



Home Capital is committed to implementing environmentally sustainable business practices that reduce our impact on the environment and encourage our employees to make green choices.

The Company participates in a number of programs to reduce energy consumption and greenhouse gas emissions, and has implemented initiatives that promote green practices and motivate employees to reduce, reuse and recycle.

The Company's Environmental Committee has adopted a holistic approach to raising environmental awareness among employees across the country, supporting changes that make a difference in the Company's environmental impact.

### Some highlights of Home Capital's green activities in 2012 include:

- > Commencing the migration to a leading enterprise information management solution to digitize operational processes, enabling the Company to embrace digital documents and reduce the amount of paper we use
- > Partnering with our landlord in the "Race to Reduce" initiative to reduce energy use and improve air quality at our head office location in Toronto
- > Working with an engineering firm to conduct an on-site audit of office space and equipment, and implementing recommendations to further reduce our energy consumption
- > Ensuring that the meeting rooms and offices currently being built in our expanded office space in Toronto will have auto shut-off of lights, with the objective of implementing this energy reduction switch in all our meeting rooms and offices in Toronto
- > Implementing technology to receive faxed documents electronically to desktop computers to further reduce paper usage
- > Continuing to participate in comprehensive composting, recycling and waste disposal programs in our offices
- > Diverting electronic waste from garbage through ongoing donations of obsolete computer equipment
- > Participating in the annual Toronto 20-Minute Makeover, during which a number of employees headed outdoors to collect litter and clean up the surrounding neighbourhood

Employees are encouraged to turn off desktop electronic devices and lighting when they are not in use, reduce paper consumption by using available electronic communication methods, and use teleconferencing when applicable to reduce the need for travel.

The office tower that accommodates Home Trust's main branch in Toronto has been LEED (Leadership in Energy and Environmental Design) Gold certified. LEED provides building owners and operators with a concise framework for identifying and implementing practical and measurable green building design, construction, operations and maintenance solutions. The building also won the Building Owners and Managers Association (BOMA) of Greater Toronto Outstanding Building of the Year award (TOBY).

Home Capital remains dedicated to reducing the Company's environmental impact by encouraging employee awareness, supporting business practices and participating in initiatives that benefit the environment in practical and meaningful ways.

Home Trust's Social Committee hosted numerous events for charitable causes in 2012, fostering community involvement, teambuilding and fellowship among employees

Over 640,000 customers trust Home Trust with their mortgage, credit card, retail credit or investment needs

# Management's Discussion and Analysis

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## MANAGEMENT'S DISCUSSION AND ANALYSIS

*This Management's Discussion and Analysis (MD&A) is provided to enable readers to assess the financial condition and results of operations of Home Capital Group Inc. (the "Company" or "Home Capital") for the year ended December 31, 2012. The discussion and analysis relates principally to the Company's subsidiary Home Trust Company (Home Trust), which provides residential mortgage lending, non-residential mortgage lending, consumer lending and deposit-taking services. This MD&A should be read in conjunction with the audited consolidated financial statements and notes. Unless otherwise indicated, this MD&A has been prepared in accordance with International Financial Reporting Standards (IFRS), which are Generally Accepted Accounting Principles (GAAP), and all amounts are presented in Canadian dollars. This MD&A is current as of February 13, 2013. A glossary of terms and Non-GAAP measures used in this MD&A and financial statements is presented on pages 71 to 72 of this report.*

*The Company's continuous disclosure materials, including interim filings, annual Management's Discussion and Analysis and audited consolidated financial statements, Annual Information Form, Notice of Annual Meeting of Shareholders and Proxy Circular are available on the Company's website at [www.homecapital.com](http://www.homecapital.com), and on the Canadian Securities Administrators' website at [www.sedar.com](http://www.sedar.com).*

### Caution Regarding Forward-looking Statements

From time to time Home Capital makes written and verbal forward-looking statements. These are included in the Annual Report, periodic reports to shareholders, regulatory filings, press releases, Company presentations and other Company communications. Forward-looking statements are made in connection with business objectives and targets, Company strategies, operations, anticipated financial results and the outlook for the Company, its industry, and the Canadian economy. These statements regarding expected future performance are "financial outlooks" within the meaning of National Instrument 51-102. Please see the risk factors, which are set forth in detail in the Risk Management section of this report, as well as its other publicly filed information, which are available on the System for Electronic Document Analysis and Retrieval (SEDAR) at [www.sedar.com](http://www.sedar.com), for the material factors that could cause the Company's actual results to differ materially from these statements. These risk factors are material risk factors a reader should consider, and include credit risk, funding and liquidity risk, structural interest rate risk, operational risk, investment risk, strategic and business risk, reputational risk and regulatory and legal risk along with additional risk factors that may affect future results. Forward-looking statements can be found in the Report to the Shareholders and the Outlook sections in the Annual Report. Forward-looking statements are typically identified by words such as "will," "believe," "expect," "anticipate," "estimate," "plan," "forecast," "may," and "could" or other similar expressions.

By their very nature, these statements require the Company to make assumptions and are subject to inherent risks and uncertainties, general and specific, which may cause actual results to differ materially from the expectations expressed in the forward-looking statements. These risks and uncertainties include, but are not limited to, global capital market activity, changes in government monetary and economic policies, changes in interest rates, inflation levels, general economic conditions, legislative and regulatory developments, competition and technological change. The preceding list is not exhaustive of possible factors.

These and other factors should be considered carefully and readers are cautioned not to place undue reliance on these forward-looking statements. The Company does not undertake to update any forward-looking statements, whether written or verbal, that may be made from time to time by it or on its behalf, except as required by securities laws.

Assumptions about the performance of the Canadian economy in 2013 and its effect on Home Capital's business are material factors the Company considers when setting its objectives and outlook. In determining expectations for economic growth, both broadly and in the financial services sector, the Company primarily considers historical and forecasted economic data provided by the Canadian government and its agencies. In setting and reviewing the outlook and objectives for 2013, management's expectations assume:

- > The Canadian economy will produce modest growth in 2013 with stable to modestly improving employment conditions in most regions. The economy will continue to be heavily influenced by the economic conditions in the United States and global markets. Inflation will generally be within the Bank of Canada's target of 1% to 3%.
- > The Bank of Canada has indicated that increases to its target overnight interest rate are not imminent and, as such, the Company is assuming the rate will remain at its current level for most of 2013. This is expected to continue to support low mortgage interest rates.
- > The housing market will remain stable with balanced supply and demand conditions in most regions supported by continued low interest rates, stable to improving employment, and immigration. There will be declines in housing starts and resale activity with stable to modestly declining prices throughout most of Canada.
- > Consumer debt levels will remain serviceable by Canadian households.

# Management's Discussion and Analysis

## BUSINESS PROFILE

Home Capital is a holding company that operates primarily through its principal, federally regulated subsidiary, Home Trust, which offers insured deposits, residential and non-residential mortgage lending and consumer lending. The Company's subsidiary Payment Services Interactive Gateway Inc. (PSiGate) provides payment card services. Licensed to conduct business across Canada, Home Trust has offices in Ontario, Alberta, British Columbia, Nova Scotia, Quebec and Manitoba.

### Business Model and Risk Taking

The Company is primarily a residential mortgage lender, with ancillary commercial mortgage lending, consumer lending and payment card services. The lending operations can be divided between uninsured lending and insured lending.

#### *Uninsured Lending*

Lending to borrowers who have difficulty qualifying for mortgage loans at Canada's chartered banks (non-prime) has been the core of the Company's business over the past 25 years. This core or traditional business generally involves lending to self-employed individuals, individuals who are relatively new residents of Canada and individuals who have experienced credit difficulties, generally related to specific circumstances which are not expected to reoccur. By their nature, loans to these groups of individuals generally do not qualify for mortgage insurance.

The Company measures the risk associated with this class of lending through careful underwriting on an individual loan basis, applying its proprietary methodologies. The risk associated with this class of lending is managed through extended real estate appraisal processes, reduced loan to value lending ratios and timely monitoring of performance, matched with diligent collection processes. Over the past 25 years, the Company has consistently observed that this class of loans has performed well and the interest rate charged is sufficient to absorb funding costs, credit losses and operating expenses, and provide attractive shareholder returns, while providing appropriate protection for the Company's depositors.

In addition to single family residential loans, the Company's uninsured loan portfolios include commercial mortgages and loans to consumers that are secured by collateral real estate mortgages, charges against home fixtures or cash deposits. These groups of loans carry higher rates of interest and have also performed well, providing enhanced shareholder returns.

The uninsured classes of lending are generally funded by fixed-term deposits from retail investors sourced through deposit brokers and financial advisors. The majority of these deposits are received through channels that are controlled by several of the major Canadian banks. The Company is a member of the Canadian Deposit Insurance Corporation (CDIC) and its deposits qualify for insurance to the limits set by CDIC. Competition for fixed-term deposits is highly rate sensitive.

#### *Insured Lending*

The Company's insured (prime) lending business was developed as an extension of its non-prime lending business, aimed at serving customers of the core business who subsequently qualified for insured lending. Market and economic factors led to the expansion of this business in the period extending from 2008 to 2010, with this lending class becoming more than one-half of the overall lending portfolio. During this period, margins available to prime lenders were attractive and the business could be operated with minimal capital. In 2011, changes to the financial accounting standards for deposit-taking institutions resulted in much greater capital requirements. This change was coincident with a period of declining margins in this market sector, as competition for borrowers intensified. Although there is no expectation of credit losses in this class of lending, the current margins are frequently not sufficient to provide attractive returns to the capital required to support this business. Consequently, the Company has reduced its activity in this loan class.

Insured lending includes single family homes and multi-unit residential properties. This lending is generally funded by securitizing underlying loan portfolios and selling the resulting insured mortgage-backed securities (MBS) through programs sponsored by the Canadian Mortgage and Housing Corporation (CMHC). The Company has good access to these markets and participates on an ongoing basis. To manage risk in this class, the Company carefully follows the standards set by the insurers, which are complemented by the Company's own procedures such as individual loan adjudication.

The competition for prime loans involves all of the major Canadian lending institutions and many other participants. The market is highly rate sensitive and the current rate environment is very low, resulting in relatively low margins for all lenders.

## Business Segments and Portfolios

The Company divides its business into three segments. These segments and the related activities and portfolios are described below.

### *Mortgage Lending*

This segment comprises single family residential lending and multi-unit residential lending as well as non-residential lending. The single-family residential portfolio includes the Company's traditional or "Classic" mortgage loans and Accelerator mortgages. The Company's traditional mortgage portfolio consists of mortgages with loan to value ratios of 80% or less, where the focus is on serving selected segments of the Canadian financial services marketplace that are not the focus of the major financial institutions. Accelerator mortgages are insured, with loan to value ratios generally exceeding 80% at the time of origination, and are generally securitized and sold through CMHC-sponsored MBS and Canada Mortgage Bond (CMB) programs.

Multi-unit residential lending includes both insured and uninsured mortgage loans. Non-residential lending includes store and apartment mortgages and commercial mortgages.

### *Consumer Lending*

Consumer lending includes Visa lending and other consumer retail lending for durable household goods, such as water heaters and larger-ticket home improvement items. Consumer retail lending loans are supported by holdbacks or guarantees from the distributors of such items and/or collateral charges on real property. The Company's Equityline Visa product, secured by real property, represents almost all of the Visa portfolio. The Company also offers cash secured Visa products and preferred unsecured Visa cards to current mortgage customers with good credit history. The consumer lending segment includes the operations of PSiGate, the Company's subsidiary involved in payment processing.

### *Other*

In addition to its operating segments, the Company accounts for treasury portfolio and general corporate activities.

## VISION, MISSION, OBJECTIVES AND VALUES

During the year, the Company updated and refined its statements of vision, mission, objectives and values.

**It is the vision of the Company to be recognized as the leading alternative lender in the Canadian financial market place.**

The Company's mission is to deliver superior shareholder value by focusing on well-defined niches in the Canadian lending and deposit-taking marketplace that generate above average returns, have acceptable residual risk profiles and are not adequately served by traditional financial institutions, while protecting the depositors and operating within regulatory guidelines and the Company's risk appetite.

The Company's progress toward its objectives will be measured by:

- > A return on common equity of at least 20%
- > Capital aligned with the risk profile of the business and the needs of the Company's depositor base

The Company has a set of values that are integral to its day-to-day business. These values are the cornerstone of Home Capital's vision and play a key role in the Company achieving both its strategic and financial performance goals:

- > Respect, trust and integrity
- > The highest level of customer service to our clients and business partners
- > A nimble, entrepreneurial culture with our enthusiasm, teamwork and desire for continuous improvement
- > Community and environmental improvement through fundraising, community involvement and sustainable environmental initiatives

The Company's key long-term objective is to deliver superior shareholder value.

The Company seeks to achieve a return on common equity of at least 20%, and has exceeded this benchmark in each of the past 15 years. Management also seeks to align its capital with the risk profile of the business through an understanding of the nature and level of risk being taken and how these risks attract regulatory and risk-based capital.

# Management's Discussion and Analysis

## Risk-taking Philosophy

The Company's core strategy focuses on serving a large portion of the Canadian financial services market that traditionally has not been adequately served by larger financial institutions. The Company's strategy provides opportunity for higher returns but carries an inherently different risk profile than one serving the broader market and requires an integrated risk management strategy. The Company recognizes this risk and proactively seeks to reduce overall risk exposure to an acceptable level through:

- > Active Board and senior management oversight, monitoring and timely revision of corporate strategies, and risk appetite and risk mitigation activities;
- > Promotion of a sound risk management culture and awareness throughout the entire organization;
- > Adoption of a conservative financial risk profile, comprised of prudent levels of liquidity; capital levels in excess of regulatory and risk-based minimums; and reserves that account for all incurred losses;
- > Extensive, customized risk evaluation practices and controls at the transactional level executed by experienced personnel and supported by effective and efficient processes and technology;
- > Proactive, independent and timely monitoring and assessment of all risk exposures, regardless of the source, by the business, with enterprise risk management and Internal Audit acting as second and third lines of defense; and
- > Ongoing efforts to diversify funding sources.

The Company's acceptable business and risk-taking activities can be substantially characterized by the following:

- > The Company conducts business with individuals, other businesses and borrowers that are well understood, including, but not limited to, confirmation of identity, credit profile, employment and willingness and ability to repay debts;
- > New products/initiatives are subject to a new initiative review process and undertaken only after complete risk identification and control infrastructure has been established. All acquisitions will be subject to a due diligence process that ensures alignment with the Company's risk appetite;
- > For any material lending, the Company requires strong collateral against the loan, specifically where legal and equity rights can be held against the collateral asset. Unsecured credit exposures must fit within the Company's risk appetite framework and have appropriate risk management processes in place to mitigate the associated risk;
- > The Company conducts business in geographies that are well known and understood, particularly when lending against properties;
- > The Company employs various risk mitigation techniques and actions to reduce inherent business risks to acceptable residual levels, including trusted asset appraisals and valuations, limited loan to value lending, and risk-based pricing, among other mitigating factors;
- > The Company will not pursue profits through trading activities and will limit the use of derivatives for hedging purposes only; and
- > The Company will manage interest rate gaps within its risk appetite.

## 2012 PERFORMANCE AND 2013 STRATEGIES AND TARGETS

### 2012 Performance

The table below summarizes the Company's 2012 targets and performance.

**Table 1: 2012 Targets and Performance**

	For the year ended December 31, 2012			
	2012 Targets	Actual Results	Amount	Increase over 2011
Growth in net income	13%-18%	<b>16.8%</b>	<b>\$ 221,983</b>	<b>\$ 31,903</b>
Growth in diluted earnings per share	13%-18%	<b>16.8%</b>	<b>6.38</b>	<b>0.92</b>
Growth in total loans <sup>1</sup>	13%-18%	<b>5.1%</b>	<b>16,904,435</b>	<b>814,787</b>
Return on shareholders' equity	20.0%	<b>25.5%</b>		
Efficiency ratio (TEB) <sup>2</sup>	28.0%-34.0%	<b>27.7%</b>		
Capital ratios <sup>3</sup>				
Tier 1	Minimum of 13%	<b>17.01%</b>		
Total	Minimum of 14%	<b>20.68%</b>		
Provision as a percentage of gross loans	0.05%-0.15%	<b>0.09%</b>		

<sup>1</sup> Includes loans held for sale.

<sup>2</sup> See definition of Taxable Equivalent Basis (TEB) under the Non-GAAP Measures and Glossary section in this report.

<sup>3</sup> Based on the Company's wholly owned subsidiary, Home Trust Company.

The Company applies IFRS which are the GAAP for Canadian publicly accountable enterprises.

Non-GAAP measures are discussed in the Non-GAAP Measures and Glossary section located at the end of this MD&A.

The Company was successful in meeting or exceeding all of its performance targets in 2012 except for growth in total loans. The Company was able to achieve its profit objectives with lower loan growth by focusing on higher yielding core mortgages, balancing its profit objectives with maintaining strong capital ratios under the Basel II and upcoming Basel III frameworks. Total loans were also reduced during the year by \$896.0 million for loans that qualified for off-balance sheet treatment in 2012. Including these loans, growth was 10.5% over 2011.

## 2012 Strategies and Achievements

The Company employs three strategic priorities to achieve its long-term objectives:

Strategic Priority	2012 Strategies and Achievements
<b>Focused Marketplace Growth</b>	<p>Build and maintain Canada's leading alternative financial institution</p> <ul style="list-style-type: none"> <li>&gt; Sustained focus on underserved niches and market-leading position</li> <li>&gt; Continued to offer "one-stop" convenience to borrowers and brokers, while focusing on the high-value alternative mortgage segment</li> <li>&gt; Continued the expansion of the geographic footprint of the business with the opening of the Winnipeg office</li> <li>&gt; Maintained industry-leading service levels to clients and mortgage brokers</li> </ul>
<b>Prudent Balance Sheet Management</b>	<p>Improve the financial strength of the Company so that it is capable of absorbing market events and position the Company for strong shareholder returns</p> <ul style="list-style-type: none"> <li>&gt; Maintained a strong capital position, with a Tier 1 capital ratio of 17.01% at the end of 2012 and the increase in total capital of Home Trust, through earnings and the addition of \$56 million of subordinated debt from the resources of Home Capital</li> <li>&gt; Maintained the prudent credit risk profile of the loan portfolio, with improving credit scores and reduced loan to value ratios</li> <li>&gt; Maintained and managed strong liquidity positions; average liquid assets decreased during the course of the year as the Company balanced liquidity against investment returns</li> <li>&gt; Maintained a flexible supply of funding through the deposit broker network; continued to utilize funding through securitization markets; introduced a high interest savings account and launched a direct deposit initiative</li> </ul>
<b>Operational and Governance Excellence</b>	<p>Invest in robust corporate governance, risk management and efficient customer-focused processes and systems</p> <ul style="list-style-type: none"> <li>&gt; Initiated an executive level governance, risk and compliance committee</li> <li>&gt; Continued to achieve industry-leading returns on shareholders' equity</li> <li>&gt; Further enhanced risk measurement, monitoring and reporting capabilities</li> <li>&gt; Maintained a low level of credit losses through strong underwriting, active portfolio monitoring and collections activities</li> <li>&gt; Maintained leading cost efficiencies through tight cost controls</li> <li>&gt; Strengthened the capabilities of the risk management, compliance and internal audit functions with additional experienced staff and more robust processes</li> </ul>

## 2013 Strategic Priorities

Strategic priorities for 2013 will continue to include the three priorities previously noted, along with strategies that include greater diversification of the Company's sources of funding and the development of new complementary deposit products and related technology. Execution of these strategies will lower the overall business risk of the Company by reducing funding risk while continuing to grow the asset base and related interest and fee revenues.

# Management's Discussion and Analysis

## 2013 Performance Targets

The following table summarizes the Company's 2013 performance targets.

**Table 2: Targets for 2013**

	2013 Targets	Dollar Amounts
Growth in net income	13%-18%	\$250.8 million-\$261.9 million
Growth in diluted earnings per share	13%-18%	\$7.21 per share-\$7.53 per share
Growth in total loans under administration	10%-15%	\$19.56 billion-\$20.45 billion
Return on shareholders' equity	20.0%	
Efficiency ratio (TEB) <sup>1</sup>	28.0%-34.0%	
Provision as a percentage of gross loans	0.10%-0.18%	

<sup>1</sup> Refer to the definition of TEB under the Non-GAAP Measures and Glossary section of this report.

In 2012 the Company set its loans growth targets based on total on-balance loan growth. For 2013, the Company's target is based on loans under administration, which includes off-balance sheet loans reflecting the increased use of off-balance sheet transactions. The target for provision as a percentage of gross loans has increased as the proportion of uninsured loans has increased.

## 2013 Overall Outlook

Supported by the stable Canadian economy and healthy real estate market in 2012, the Company continued to reposition the lending portfolio to take advantage of the attractive returns available in the alternative mortgage space, the Company's traditional business. This business, which is within the Company's risk appetite, provides superior returns on the allocated capital. In 2013, the continued expansion of the traditional business will be accompanied by commensurate strengthening of governance, risk management and control processes, through further investment in tools, technology and people. The Company will continue to offer insured mortgages through the Accelerator program, supporting the Company's "one-stop" and "flexible lending solutions" strategies. The Company will also continue to increase its presence in suitable urban and suburban markets across Canada. Additional focus will be placed on growth of the Company's high margin non-residential and consumer lending portfolios within the Company's risk tolerance.

The Company expects supply and demand in the real estate market to remain balanced in 2013, with softening conditions in most markets when compared to the activity levels of recent years. The Company believes that uncertainty in global economic conditions will continue to pose risks to the Canadian economy. The tightening of mortgage underwriting requirements and changes in mortgage insurance qualification rules in 2012 can be expected to continue to dampen the level of activity in the real estate market in 2013. The Company believes that slowing housing activity will lead to healthier real estate markets overall that are supported by continued low interest rates, stable to improving employment, stable net immigration and good housing affordability. The Company expects continued strong demand for its traditional mortgage and other retail products, reflecting balanced real estate markets and increased market share.

In view of the continued uncertainty and risk within the global financial environment, the Company will continue to maintain relatively high levels of liquidity and low overall leverage, as measured by the assets to capital multiple (ACM), to provide safety and soundness for depositors. To support this conservative approach to liquidity and leverage, the Company will continue to pursue opportunities for revenue contributions from fees, loan sales and sales of residual interests in loan securitizations.

The Company expects that the rate of growth in the Company's non-securitized loan portfolio in 2013 will be relatively consistent with the growth rate experienced in 2012. The traditional mortgage business is expected to maintain strong net interest margin and net interest income levels, while net interest margins on securitized assets continue to decline as older securitization programs reach maturity. The decline primarily reflects a combination of two factors: spreads on new securitization transactions are generally lower than the spreads earned on the maturing programs, and the assets provided as replacement assets in the CMB program are generally lower yielding as compared to the maturing or discharging assets. While the Company actively hedges the CMB reinvestment risk, the structure of the hedges will become less effective as the programs mature. This dynamic will tend to put pressure on the overall net interest margin. The increased weighting of the Company's traditional uninsured mortgages will tend to offset this downward pressure, as the margins on these products are more favourable and risk levels are well within the Company's tolerance.

The Company will increase its marketing and sales activities related to the development of more diversified sources of deposits, and additional costs will be incurred in this initiative. Reductions in other areas and increases in net interest income will tend to mitigate these increases and other costs, and the Company expects that its efficiency ratio for 2013 will continue to be in the target range of 28% to 34%.

## FINANCIAL HIGHLIGHTS

**Table 3: Key Performance Indicators**

For the years ended December 31 (000s, except % and per share amounts)	2012 IFRS	2011 IFRS	2010 IFRS	2009 Cdn GAAP <sup>1</sup>	2008 Cdn GAAP <sup>1</sup>
<b>FINANCIAL PERFORMANCE MEASURES</b>					
Total revenue	\$ 887,685	\$ 790,274	\$ 687,249	\$ 489,179	\$ 454,695
Net income	221,983	190,080	154,752	144,493	108,687
Earnings per share – Basic	6.40	5.48	4.46	4.19	3.15
Earnings per share – Diluted	6.38	5.46	4.45	4.15	3.13
Dividends per share	0.90	0.76	0.66	0.58	0.50
Return on shareholders' equity	25.5%	27.1%	27.3%	28.2%	27.8%
Return on average total assets	1.2%	1.1%	1.2%	2.2%	2.0%
Net interest margin (TEB) <sup>2</sup>	2.09%	2.06%	2.07%	2.80%	2.90%
Net interest margin non-securitized assets (TEB) <sup>2</sup>	3.10%	3.04%	2.82%	-	-
Net interest margin securitized assets	0.93%	1.24%	1.23%	-	-
Efficiency ratio (non-interest expense as a % of net revenue)	28.1%	28.5%	30.0%	27.2%	28.5%
Efficiency ratio (TEB) (non-interest expense as a % of net revenue) <sup>2</sup>	27.7%	27.9%	29.3%	26.5%	28.0%
<b>FINANCIAL CONDITION MEASURES</b>					
Total assets	\$18,800,079	\$17,696,471	\$15,518,818	\$ 7,360,874	\$ 5,809,713
Total assets under administration <sup>3</sup>	19,681,750	17,696,471	15,518,818	11,508,585	8,423,971
Cash and securities-to-total assets	9.0%	7.9%	8.2%	21.5%	18.5%
Total loans <sup>4</sup>	\$16,904,435	\$16,089,648	\$14,091,755	\$ 5,468,540	\$ 4,531,568
Securitized loans on-balance sheet	6,450,682	8,243,350	8,116,636	-	-
Total loans under administration <sup>5</sup>	17,786,106	16,089,648	14,091,755	9,616,251	7,145,826
Tier 1 capital ratio <sup>6</sup>	17.01%	17.29%	18.08%	16.43%	12.86%
Total capital ratio <sup>6</sup>	20.68%	20.46%	19.37%	18.00%	14.21%
Assets to regulatory capital multiple <sup>6</sup>	13.98	14.44	10.50	12.70	13.70
<b>Credit quality</b>					
Provision for credit losses as a % of gross loans	0.09%	0.05%	0.07%	0.21%	0.15%
Net non-performing loans as a % of gross loans	0.33%	0.25%	0.24%	0.85%	0.86%
Allowance as a % of gross non-performing loans	57.0%	74.9%	88.1%	62.1%	66.7%

<sup>1</sup> Figures prior to 2010 represent previous Canadian GAAP balances and have not been restated to IFRS. Prior to 2010, all securitizations were off-balance sheet.

<sup>2</sup> See definition of Taxable Equivalent Basis (TEB) under Non-GAAP Measures in this report.

<sup>3</sup> Total assets under administration include total on-balance sheet assets and off-balance sheet loans.

<sup>4</sup> Total loans include loans held for sale.

<sup>5</sup> Total loans under administration include total loans and off-balance sheet loans.

<sup>6</sup> These figures relate to the Company's operating subsidiary, Home Trust Company. The figures prior to 2011 have not been restated to IFRS.

# Management's Discussion and Analysis

For the year ended December 31, 2012, the Company reported another year of increased net income at \$222.0 million or \$6.38 diluted earnings per share. Return on shareholders' equity was solid at 25.5% for the year. The efficiency ratio, on a taxable equivalent basis (TEB), remained favourable at 27.7%. Loan originations in the traditional portfolio increased year over year while Accelerator (insured) mortgage originations continued at a moderate pace and ancillary products continued to generate positive returns. The Company's total customer accounts, including all loan and deposit accounts, reached 587,356 at the end of 2012 compared to 524,064 last year. The Company maintained its prudent credit profile in the loan portfolio and its strong capital base. The Company's key financial highlights for 2012 are summarized below.

## Income Statement Highlights for 2012

- > Net income of \$222.0 million in 2012 increased by \$31.9 million or 16.8% from net income of \$190.1 million in 2011, reflecting higher loan balances in the traditional mortgage portfolio, improved net interest margins, continued low credit provisions and a consistently low efficiency ratio.
- > Diluted earnings per share increased to \$6.38, up \$0.92 or 16.8% from the diluted earnings per share of \$5.46 earned in 2011.
- > Return on average shareholders' equity of 25.5% for 2012 exceeded 20% for the fifteenth consecutive year.
- > Net interest income increased to \$381.5 million, up \$47.5 million or 14.2% over the \$334.0 million earned in 2011, reflecting higher average loan balances of \$17.39 billion compared to \$15.36 billion in 2011 combined with improved combined net interest margin of 2.09% compared to 2.06% in 2011.
- > Non-interest income was \$55.9 million in 2012 compared to non-interest income of \$34.9 million in 2011. Beginning in 2012 the Company participated in programs where mortgages qualify for off-balance sheet accounting and recognized \$8.1 million in gains on sale of such mortgages. Fees and other income also increased \$6.0 million on higher loan balances while net gains on derivatives of \$3.8 million in 2012 compared to \$7.2 million in losses in 2011. In 2012, gains and losses on derivatives were reduced by charges of \$3.6 million related to reversals of derivative gains recorded on CMB interest rates swaps prior to conversion to IFRS. In 2011, losses on derivatives included charges of \$3.3 million related to the restructuring of interest rate swaps. Net realized and unrealized losses on securities and mortgages were \$0.1 million compared to \$4.1 million in net gains in 2011.
- > Provisions for credit losses were \$14.7 million for the year, an increase over the \$7.5 million recorded last year. This represents 0.09% of gross loans, compared to 0.05% in 2011. This is well within tolerable levels and reflects the increased weighting of uninsured lending and higher associated write-offs and specific allowances. This loss ratio is well supported by the interest margins associated with this portfolio. Net write-offs were \$12.4 million for 2012, representing 0.07% of gross loans compared to \$10.7 million and 0.07% of gross loans in 2011.
- > Non-interest expenses, which include salaries, premises and other operating expenses, were \$122.7 million in 2012, up 16.9% over the \$105.0 million recorded in 2011 and in line with business growth. The increase reflects the Company's continued investment in people, business development, infrastructure and technology to support future asset and revenue growth. The Company's efficiency ratio (TEB) remains low at 27.7% compared to 27.9% in 2011, an indication of a high level of operating efficiency.

## Balance Sheet Highlights for 2012

- > The Company's total on-balance sheet assets reached \$18.80 billion, an increase of 6.2% compared to \$17.70 billion at the end of 2011. Total assets under administration, which includes \$0.88 billion of mortgages accounted for off-balance sheet, reached \$19.68 billion, an increase of 11.2% over 2011.
- > The Company sold residual interests in securitization transactions of \$662.2 million which reduced both the securitized mortgage loans and securitization liabilities upon sale. The underlying mortgages continue to be included in assets used in the calculation of the Company's ACM. The Company is awaiting further clarification from the Office of the Superintendent of Financial Institutions Canada (OSFI) on the regulatory treatment of these transactions.
- > Mortgage originations were \$6.01 billion in 2012 compared to the \$5.12 billion originated in 2011. The Company's originations reflect continued focus on the traditional mortgage portfolio which accounted for most of the increase in originations.
- > While the Company increased the traditional portfolio, it maintained the credit quality of the loan portfolio within its expectations. Net non-performing loans as a percentage of the gross loan portfolio ended the year at 0.33% compared to 0.25% one year ago reflecting the relatively higher proportion of uninsured mortgages in the portfolio. At the end of 2012, 97.6% of the loan portfolio was current compared to 97.3% at the end of 2011.



- > Liquid assets at December 31, 2012 were \$771.8 million, compared to \$808.2 million at December 31, 2011. The Company considers this a prudent level of liquidity, given the current level of operations and the Company's obligations.
- > Home Trust's capital levels were strong throughout 2012, as indicated by the Tier 1 and Total capital ratios of 17.01% and 20.68%, respectively, at December 31, 2012, compared to 17.29% and 20.46%, at the end of 2011. Home Trust's ACM ended 2012 at 13.98 compared to 14.44 at the end of 2011. During 2012 Home Trust increased its capital by \$56 million in subordinated debentures to further enhance its regulatory capital position and support growth objectives. This debt was sourced from Home Capital.
- > Deposit and securitization liabilities at December 31, 2012 were \$10.14 billion and \$7.34 billion, respectively, compared to \$7.92 billion and \$8.65 billion at December 31, 2011. Deposit liabilities grew more quickly than securitization liabilities as the traditional portfolio, which is typically funded with deposits, grew at a higher rate than the Accelerator portfolio, which is typically funded by way of securitization.

## FINANCIAL PERFORMANCE REVIEW

### Net Interest Income and Margin

Presented in Tables 4 and 5 are analyses of average rates, net interest income and net interest margin. Net interest income is the difference between interest and dividends earned on loans and investments and the interest paid on deposits and borrowings to fund those assets. The net interest margin is net interest income divided by the Company's average total assets. Dividend income has been converted to TEB (refer to the Non-GAAP Measures and Glossary section of this report for a definition of TEB), for comparison purposes.

**Table 4: Net Interest Margin**

	<b>2012</b>	2011
Net interest margin non-securitized interest earning assets (TEB)	<b>3.10%</b>	3.04%
Net interest margin non-securitized interest earning assets (non-TEB)	<b>3.05%</b>	2.96%
Net interest margin securitized assets	<b>0.93%</b>	1.24%
Total net interest margin (TEB)	<b>2.09%</b>	2.06%
Total net interest margin (non-TEB)	<b>2.07%</b>	2.01%
Spread of non-securitized loans over deposits only	<b>3.13%</b>	3.09%

Total net interest margin (TEB), including the securitized portfolio, was 2.09% for 2012 compared to 2.06% in 2011, reflecting higher net interest margin on non-securitized assets offset by lower net interest margins on the securitized portfolio. Additionally, the loan portfolio composition shifted over the year as the Company continued its focus on traditional products relative to insured mortgages. As such, over the period the portfolio weighting of securitized mortgages and pledged assets, which earn a lower net interest margin, decreased to 46.8% at December 31, 2012 from 55.7% at December 31, 2011.

The net interest margin on non-securitized assets (TEB) improved to 3.10% from 3.04% in 2011 on higher spreads earned on this book.

# Management's Discussion and Analysis

**Table 5: Net Interest Income**

(000s, except %)	2012			2011		
	Average Balance <sup>1</sup>	Income/Expense	Average Rate <sup>1</sup>	Average Balance <sup>1</sup>	Income/Expense	Average Rate <sup>1</sup>
<b>Assets</b>						
Cash resources and securities	\$ 807,022	\$ 18,190	2.25%	\$ 924,386	\$ 23,904	2.59%
Traditional single family residential mortgages	7,052,006	387,956	5.50%	4,737,363	265,881	5.61%
Accelerator single family residential mortgages	540,610	17,440	3.23%	450,364	15,398	3.42%
Multi-unit residential mortgages	111,762	5,013	4.49%	176,303	10,736	6.09%
Non-residential mortgages	985,089	61,229	6.22%	926,388	59,083	6.38%
Personal and credit card loans	568,785	54,084	9.51%	516,086	49,899	9.67%
Total non-securitized loans	9,258,252	525,722	5.68%	6,806,504	400,997	5.89%
Taxable equivalent adjustment	-	5,031	-	-	7,212	-
Total on non-securitized interest earning assets	10,065,274	548,943	5.45%	7,730,890	432,113	5.59%
Securitized loans and pledged assets	8,133,946	287,871	3.54%	8,558,429	330,491	3.86%
Other assets	260,470	-	-	259,259	-	-
<b>Total Assets</b>	<b>\$18,459,690</b>	<b>\$ 836,814</b>	<b>4.53%</b>	<b>\$16,548,578</b>	<b>\$ 762,604</b>	<b>4.61%</b>
<b>Liabilities and Shareholders' Equity</b>						
Deposits	\$ 9,004,518	\$ 230,006	2.55%	\$ 6,880,506	\$ 192,357	2.80%
Securitization liabilities	8,170,337	213,474	2.61%	8,592,908	224,719	2.62%
Other liabilities and shareholders' equity	1,284,835	6,831	0.53%	1,075,164	4,364	0.41%
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$18,459,690</b>	<b>\$ 450,311</b>	<b>2.44%</b>	<b>\$16,548,578</b>	<b>\$ 421,440</b>	<b>2.55%</b>
<b>Net Interest Income (TEB)</b>		<b>\$ 386,503</b>			<b>\$ 341,164</b>	
<b>Tax Equivalent Adjustment</b>		<b>(5,031)</b>			<b>(7,212)</b>	
<b>Net Interest Income per Financial Statements</b>		<b>\$ 381,472</b>			<b>\$ 333,952</b>	

<sup>1</sup> The average rate is an average calculated with reference to opening and closing monthly asset and liability balances.

Net interest income for 2012 increased 14.2% over 2011, reflecting an increase of \$1.91 billion or 11.5% in average asset balances and an increase in total net interest margin (TEB) of 3 basis points year over year.

The average yield on non-securitized loans declined to 5.68% from 5.89% in 2011 as mortgage rates declined but this was more than offset by a decline in average deposit rates to 2.55% from 2.80% in 2011. The declines in average rates primarily reflect lower average Government of Canada bonds yields in 2012 upon which deposit and traditional mortgage rates are set. While the Company's strategy is to manage the spread of deposits to traditional mortgages in the range of 3.0%, strong, increased demand for the Company's loan products within its credit standards helped improve the spread of non-securitized loans over deposits to 3.13% from 3.09% last year. The impact of lower average rates on cash and securities was reduced by the lower proportion of these assets in the portfolio.

The average rate for multi-unit residential and non-residential mortgage loans declined, reflecting the maturity of higher yielding loans and originations and renewals at current lower rates.

The net interest margin on securitized assets also declined year over year, reflecting the maturity of higher yielding MBS and CMB pools and the use of lower yielding assets as replacement assets in the CMB program.

The average rate earned on the consumer lending portfolio, principally comprising retail and credit card loans, declined marginally from 2011, reflecting a relative decline in average Equityline Visa balances which was due to uncertainty earlier in the year related to the application of new lending guidelines. Additionally, increases in the fully secured water heater receivables in the retail lending portfolio at lower average rates also lowered the overall rate on the portfolio. At the same time, total average assets increased over the period, leading to higher interest income from these products.

### 2013 Outlook for Net Interest Income

The Company expects net interest income to grow relative to loan portfolio growth in 2013. The Company will continue to carefully employ its growth strategy for the traditional mortgage portfolio, which should continue to favourably influence net interest income in 2013. Tempering this influence on net interest income will be the continued high proportion of insured securitized mortgages, which have lower interest margins.

The Company expects the net interest margin on non-securitized assets to remain relatively stable at 2012 levels but is prepared for modest declines and slight variations quarter over quarter. The Company's strategy is to manage the average spread between deposits and traditional mortgages at approximately 3.0%.

The Company anticipates declines in the net interest margin on the securitized portfolio in 2013 to rates relatively consistent with the fourth quarter of 2012, as older higher yielding pools mature and lower yielding assets are available as replacement assets. The Company is prepared for moderate volatility in the net interest margin trend depending on the replacement assets available and the level of interest rates.

Overall net interest margin is expected to remain stable as the relative proportion of non-securitized assets continues to increase.

The Company continually reviews pricing, funding costs and product structures to maximize spread returns, including diversification and growth of the consumer lending segment. The Company will continue to balance prudent liquidity with investment return options to optimize the risk/return relationship while considering economic and credit conditions.

### Non-interest Income

**Table 6: Non-interest Income**

(000s, except %)	2012	2011	Change
Fees and other income	\$ 43,994	\$ 37,997	15.8%
Securitization income	8,131	-	-
Net realized and unrealized (losses) gains on securities and mortgages	(71)	4,088	(101.7%)
Net realized and unrealized gain (loss) on derivatives	3,848	(7,203)	(153.4%)
<b>Total non-interest income</b>	<b>\$ 55,902</b>	<b>\$ 34,882</b>	<b>60.3%</b>

Fees and other income, which include mortgage and Visa account administration fees, net of direct servicing expenses, generally increase as the size of the loan portfolio increases. Fee income is also influenced by the overall mix of the portfolio and has grown at a slightly faster pace than the overall loan portfolio growth due to the focus on the Company's traditional mortgage portfolio.

Securitization income includes gains on the securitization and sale of certain insured multi-unit residential mortgages. The underlying loans have no prepayment privileges and the sales qualify for off-balance sheet accounting. The Company sold \$233.9 million of these mortgages for gains on sale of \$3.3 million in 2012. Also included in securitization income are gains on the sale of residual interests in certain National Housing Authority (NHA) MBS pools that also result in off-balance sheet accounting for the underlying insured mortgages. The Company sold the residual interests of \$662.2 million in insured mortgages in NHA MBS pools for gains on sale of \$4.8 million in 2012. The Company did not enter into similar transactions in 2011.

## Management's Discussion and Analysis

The Company recognized a net gain of \$1.8 million on the sale of certain available for sale securities in 2012, compared to gains of \$7.1 million in 2011. The Company takes advantage of improvements in securities markets and will rebalance the investment portfolio as market conditions warrant. The Company also recognized \$1.8 million in impairments through profit and loss on certain available for sale equity securities in 2012 compared to \$3.0 million in 2011.

Net realized and unrealized gain or loss on derivatives includes unrealized gains due to hedge ineffectiveness of \$3.5 million on the Company's fair value and cash flow interest rate hedges compared to \$0.3 million in unrealized losses in 2011 (please see the Derivatives and Hedging section of this MD&A for further discussion). In early 2011, the Company restructured certain derivative positions to achieve hedge accounting upon adoption of IFRS. Prior to the conversion to IFRS, the Company recognized an unrealized gain on the marking to market of its swap liabilities through derivative gains and losses. This gain amount is being charged to income as the liabilities mature. In the current year, charges of \$3.6 million reduced gains otherwise recorded on derivatives.

Net realized and unrealized gain or loss on derivatives also includes \$0.3 million in unrealized gains for fair value changes in interest rate swaps that are not designated in hedge accounting relationships compared to \$3.6 million in unrealized losses last year. On an economic basis, these losses are offset by gains in the fair value of other net assets, but such gains are not recorded through profit and loss. The Company expects that the amount and direction of fair value adjustments will vary from quarter to quarter depending on interest rate movements.

### 2013 Outlook for Non-interest Income

The Company anticipates that fees and other income will increase over 2012 levels in line with loan portfolio growth and some upward adjustments for cost changes.

The Company expects to continue to securitize and sell off-balance sheet insured multi-unit residential mortgages when returns are favourable and expects that these transactions will continue to add to profitability at levels relatively consistent with 2012. The Company also anticipates continuing to sell residual interests in insured, single family residential mortgages in 2013. The volume of sales of residual interests and resultant gains will ultimately depend on the final determination on the regulatory treatment of these transactions.

Through 2013, the Company will continue to record charges to income through derivative gains and losses related to the implementation of IFRS, as discussed above. Charges of approximately \$2.6 million will be recorded in the first quarter and \$3.2 million in the second quarter of 2013. The amounts in future periods will not be significant.

The Company will continue to hedge its interest rate risk associated with the loan commitments and replacement assets, through the use of bond forward contracts and interest rate swaps. The Company expects to continue to apply hedge accounting to most of such instruments, thus reducing earnings volatility from derivatives gains and losses. The impact of hedge accounting ineffectiveness and fair value changes on derivatives held outside of hedge accounting relationships is expected to continue to create some moderate volatility quarter over quarter in non-interest income that is dependent on interest rate movements.

## Non-interest Expenses

**Table 7: Non-interest Expenses**

(000s, except % and number of employees)

	2012	2011	Change
<b>Salaries and employee benefits</b>	<b>\$ 58,956</b>	\$ 52,523	12.2%
<b>Premises and equipment</b>			
Rent – premises	5,961	5,455	9.3%
Equipment rental and repairs	2,872	2,321	23.7%
	<b>8,833</b>	7,776	13.6%
<b>Other operating expenses</b>			
Consulting and professional services	12,717	12,135	4.8%
Outsourced services	9,591	9,228	3.9%
Computer services	5,202	4,874	6.7%
Advertising and business development	6,637	5,278	25.7%
General and administration	10,965	9,457	15.9%
Amortization and depreciation	9,834	3,731	163.6%
	<b>54,946</b>	44,703	22.9%
<b>Total non-interest expenses</b>	<b>\$ 122,735</b>	\$ 105,002	16.9%
Average balance sheet assets	<b>\$18,459,690</b>	\$16,548,578	
<b>As a % of balance sheet assets</b>	<b>0.66%</b>	0.63%	
<b>Efficiency ratio calculation</b>			
Net interest income	\$ 381,472	\$ 333,952	14.2%
Other income	55,902	34,882	60.3%
Total revenue, net of interest expense	437,374	368,834	18.6%
TEB adjustment	5,031	7,212	
Total revenue TEB, net of interest expense	\$ 442,405	\$ 376,046	17.6%
As a % of total revenue, net of interest expense	28.1%	28.5%	
As a % of total revenue TEB, net of interest expense	27.7%	27.9%	
Target efficiency ratio TEB	28.0%–34.0%	28.0%–34.0%	
Number of active employees	611	520	17.5%

The Company continued to operate at a low efficiency ratio in 2012, which was below the 2012 target range, reflecting continued low costs compared to revenues, net of interest expense. Non-interest expense as a percentage of balance sheet assets increased marginally year over year, primarily due to off-balance sheet treatment of some assets and indicates continued efficiency in administering assets. The Company manages expenses in a disciplined and measured manner and aligns its expense management strategy with its growth targets and strategic objectives. While carefully managing costs, the Company continues to increase its investment in governance, risk and control processes and resources, and added to the enterprise risk management, internal audit and compliance functions during the year.

Increased amortization and depreciation reflects the full year of amortization of the core banking system compared to one month in 2011.

To take advantage of the functionality and efficiencies of its new core banking system, the Company launched a centralized operations group and an organizational effectiveness initiative in 2011. The initiative has resulted in improved operational and product servicing efficiency. This has allowed the Company to make incremental investments in new technology and the governance, risk and control processes with little impact on overall efficiency ratios.

# Management's Discussion and Analysis

## 2013 Outlook for Non-interest Expenses

The Company expects continued low efficiency ratios within the Company's target range of 28.0% to 34.0% in 2013.

One of the Company's strategic objectives is to improve systems and processes to allow the Company's revenue to continue growing, without commensurate rates of growth in expenses and staff levels. Investment in technology is expected to continue in 2013 along with some increase in headcount in business functions and continued strengthening of governance, risk and control functions in line with business growth.

Additionally, the Company is planning for increased marketing and sales activities related to the development of more diversified sources of deposits, and additional costs will be incurred for this initiative.

Amortization of capitalized development costs associated with the core banking system commenced in late 2011. The Company will amortize these costs over the expected life of the system, which is 10 years.

## Provision and Allowance for Credit Losses

**Table 8: Provision for Credit Losses**

(000s, except % and basis points (bp))	2012	2011	Change
Collective provision	\$ 560	\$ 287	95.1%
Individual provision	14,160	7,232	95.8%
<b>Total provision</b>	<b>\$ 14,720</b>	<b>\$ 7,519</b>	<b>95.8%</b>
Provision as % of gross loans	0.09%	0.05%	4 bp
Net write-offs	\$ 12,381	\$ 10,673	16.0%
Net write-offs as % of gross loans	0.07%	0.07%	-

**Table 9: Net Non-performing Loans and Allowances**

(000s, except % and basis points (bp))	2012	2011	Change
Net non-performing loans	\$ 56,308	\$ 40,297	39.7%
Gross loans (excluding allowances)	16,885,233	16,091,162	4.9%
Net non-performing loans as % of gross loans	0.33%	0.25%	8 bp
Collective allowance	\$ 30,000	\$ 29,440	1.9%
Individual allowance	3,638	1,859	95.7%
<b>Total allowance</b>	<b>\$ 33,638</b>	<b>\$ 31,299</b>	<b>7.5%</b>

The provision for credit losses is charged to the income statement by an amount that brings the individual and collective allowances for credit losses to the level determined by management to be adequate to cover incurred losses, including losses that are not yet individually identifiable. Factors that influence the provisions for credit losses include the formation of new non-performing loans, the level of individual write-offs and management's assessment of the level of collective and individual allowances required based on available data, including the collateral supporting specific non-performing loans. In addition, management considers current and historical credit performance of the portfolio, external economic factors, the composition of the portfolio, and the overall growth in the loans portfolio.

Provisions as a percentage of gross loans of 0.09% are within the target range of 0.05% to 0.15%, and up from the 0.05% recorded in 2011. The increase reflects increases in individual provisions due to higher net write-offs in the mortgage portfolio and an increase in the amount of allowances set aside for specific non-performing mortgage loans. Net write-offs were up \$1.7 million, but as a percentage of gross loans remained low at 0.07%, the same as 2011. The level of individual allowances at the end of 2012 increased \$1.8 million over 2011, primarily reflecting an increase in non-performing mortgage loans. The amount set aside for individual allowances can be influenced by specific local real estate markets and the amount of time to sell when required.

Net non-performing loans as a percentage of gross loans increased to 0.33% at the end of 2012 from 0.25% at the end of 2011. The increase reflects a larger proportion of uninsured mortgages in the portfolio compared to prior years. The amount continues to include \$4.6 million in loans with identified irregularities related to advances to three condominium corporations, as discussed in prior periods.

The collective allowance balance at December 31, 2012 increased marginally over December 31, 2011 as the Company continues to observe strong credit performance in the loans portfolio and the Canadian economy performs well. The collective allowance represents more than two times the current year write-offs. Please see the Credit Risk section of this MD&A for further discussion.

## 2013 Outlook for Provision and Allowance for Credit Losses

The Company's provision for credit losses in 2013 will be influenced by the strength of the Canadian economy and the resulting impact on employment and housing markets. There remains uncertainty related to unemployment and the growth prospects for certain sectors of the economy, reflecting continued uncertainty in international markets; however, the Company continues to expect housing markets in most of the country to remain balanced in 2013. The Company also expects that Canadian consumers will continue to service and manage debt levels. While the Company is cautiously optimistic that credit losses will remain stable, it is prepared for volatility in this trend.

The Company's 2013 objective for the provision for credit losses is increased for 2013 to 0.10% to 0.18% of gross loans, reflecting the relatively higher proportion of traditional loans included in gross loans. Specific allowances will continue to be determined and reviewed monthly on an account-by-account basis. The collective allowance for credit losses reflects an ongoing assessment of the strength of the portfolio at any given time, and will continue to be reviewed at least on a quarterly basis.

## Taxes

**Table 10: Income Taxes**

(000s, except %)	2012	2011	Change
Current	\$ 82,176	\$ 66,270	24.0%
Deferred	(4,240)	(37)	11,359.5%
Total income taxes	\$ 77,936	\$ 66,233	17.7%
Effective income tax rate	25.99%	25.84%	

The provision for income taxes for 2012 amounted to \$77.9 million with an effective tax rate of 25.99% compared to \$66.2 million in 2011 with an effective rate of 25.84%. These effective rates are lower than the legislated federal and provincial rates primarily due to tax-exempt dividend income earned during the year. The increase in the effective rate in 2012 compared to 2011 primarily reflects the action by the Ontario government repealing previously announced reductions to corporate statutory rates.

The Company has capital losses of \$2.8 million (\$2.8 million in 2011), which are available to reduce capital gains in future years and have no expiry date. The Company has not recognized the tax benefit of these capital losses.

Note 16 to the consolidated financial statements included in this report provides more information about the Company's current income taxes, deferred income taxes and provisions for income taxes.

## 2013 Outlook for Taxes

The Company expects the effective income tax rate in 2013 to be within the range of 25.5% to 26.5%. The expected effective tax rate is lower than statutory rates due to tax-exempt dividend income the Company anticipates earning from its investment portfolio.

## Comprehensive Income

**Table 11: Comprehensive Income**

(000s, except %)	2012	2011	Change
Net income	\$ 221,983	\$ 190,080	16.8%
Net unrealized gains (losses) on securities available for sale, net of reclassifications to net income and taxes	4,573	(10,047)	(145.5%)
Net unrealized gains (losses) on cash flow hedges, net of reclassifications to net income and taxes	873	(5,050)	(117.3%)
Total other comprehensive income (loss)	5,446	(15,097)	(136.1%)
<b>Comprehensive income</b>	<b>\$ 227,429</b>	<b>\$ 174,983</b>	<b>30.0%</b>

Comprehensive income is the aggregate of net income and other comprehensive income (OCI). OCI includes changes in unrealized gains or losses on available for sale securities, transfers of previously unrealized net gains and losses to net income, once they have been realized, plus the impact of cash flow hedges and transfers to income of unrealized losses on investments considered impaired.

## Management's Discussion and Analysis

The Company recognized transfers to net income of \$0.1 million in net gains in 2012 compared to \$4.8 million in net gains in 2011 related to the sale of certain available for sale securities. Additionally, the Company recognized transfers to net income of net losses of \$1.8 million in 2012 and \$3.0 million in 2011 related to impairment of available for sale securities. OCI included \$6.5 million in unrealized gains in 2012 and \$8.6 million in unrealized losses in 2011 associated with changes in the fair value of available for sale securities.

OCI included \$0.4 million in net losses related to cash flow hedges in 2012 and \$7.4 million in 2011, which are deferred from recognition in income until the hedged cash flows occur. The Company transferred \$1.5 million in previously recorded losses to net interest income in 2012 and \$0.6 million in 2011 related to the amortization of cash flow hedges. (Please refer to the Derivatives and Hedging section of this MD&A and Note 19 to the consolidated financial statements for additional information about the Company's cash flow hedging programs).

### FINANCIAL POSITION REVIEW

**Table 12: Balance Sheet Accounts**

(000s, except %)	2012	2011	Change
Cash resources and restricted cash	\$ 439,287	\$ 665,806	(34.0%)
Available for sale securities	414,344	391,754	5.8%
Pledged securities	843,547	341,588	146.9%
Total cash resources and securities	1,697,178	1,399,148	21.3%
Loans held for sale	21,921	-	-
Loans			
Residential mortgages <sup>1</sup>	8,843,923	6,339,883	39.5%
Securitized residential mortgages <sup>2</sup>	6,450,682	8,243,350	(21.7%)
Non-residential mortgages	988,416	946,222	4.5%
Credit cards	327,517	386,912	(15.4%)
Other consumer retail loans	271,976	173,281	57.0%
Total loans	16,882,514	16,089,648	4.9%
Collective allowance for credit losses	(30,000)	(29,440)	1.9%
	16,852,514	16,060,208	4.9%
Other assets	228,466	237,115	(3.6%)
Total assets	\$18,800,079	\$17,696,471	6.2%
Deposits	\$10,136,599	\$ 7,922,124	28.0%
Senior debt	150,684	153,336	(1.7%)
Securitization liabilities	7,335,895	8,649,075	(15.2%)
	17,623,178	16,724,535	5.4%
Other liabilities	208,688	197,151	5.9%
Total liabilities	17,831,866	16,921,686	5.4%
Shareholders' equity	968,213	774,785	25.0%
Total liabilities and shareholders' equity	\$18,800,079	\$17,696,471	6.2%
Cash resources and securities as a % of total assets	9.0%	7.9%	
Loans as a % of total assets	89.8%	90.8%	

<sup>1</sup> At December 31, 2012, residential mortgages include \$154.3 million (2011 - \$182.7 million) in multi-unit residential mortgages on properties with over four units and builders' inventory.

<sup>2</sup> At December 31, 2012, securitized residential mortgages include \$1.94 billion (2011 - \$2.01 billion) in multi-unit residential mortgages on properties with over four units and builders' inventory.



**Table 13: Liquidity Resources**

(000s, except %)	2012	2011	Change
Total cash resources and securities per balance sheet	<b>\$ 1,697,178</b>	\$ 1,399,148	21.3%
Add: MBS included in residential mortgages	<b>365,078</b>	260,572	40.1%
	<b>2,062,256</b>	1,659,720	24.3%
Less: securities held for investments	<b>(309,513)</b>	(378,498)	(18.2%)
Less: restricted cash	<b>(137,424)</b>	(131,412)	4.6%
Less: pledged assets	<b>(843,547)</b>	(341,588)	146.9%
Eligible liquid assets at carrying value	<b>771,772</b>	808,222	(4.5%)
Eligible liquid assets at fair value	<b>\$ 771,993</b>	\$ 837,144	(7.8%)
Eligible liquid assets at carrying value as a % of total assets	<b>4.1%</b>	4.6%	(10.1%)

**Cash Resources and Securities**

Combined cash resources and securities as at December 31, 2012 increased by \$298.0 million compared to December 31, 2011. In addition to cash and securities, the Company maintains prudent liquidity by investing a portion of the liquid assets in Company originated MBS. Although these securities are available for liquidity purposes, they are classified as residential mortgages on the balance sheet, as required by GAAP. Securitization activity generally requires higher balances of liquid assets to support the accumulation of assets and subsequent exchange of cash.

Cash resources and restricted cash includes \$137.4 million in restricted cash (\$131.4 million in 2011). Restricted cash includes amounts pledged as collateral for the Company's securitization activities and interest rate swaps used in the CMB program, as well as reserve accounts associated with the retail lending portfolio and PSiGate operations.

The securities portfolio has increased by \$524.5 million since December 31, 2011. The portfolio includes \$843.5 million of assets pledged under the CMB program as replacement assets compared to \$341.6 million at December 31, 2011 representing 67.1% of the Company's securities in 2012 (46.6% in 2011). These assets include treasury bills and insured third-party MBS.

In addition to the securities pledged under the CMB program, the securities portfolio consists of bonds, common and preferred shares and mutual funds. At December 31, 2012, the preferred share portfolio was \$299.6 million or 23.8% of the Company's securities compared to \$368.5 million or 50.2% in 2011. The Company divested of most of its preferred shares of financial institutions in 2012 ahead of Basel III changes that require deductions of these investments from capital over a threshold. Investment-grade preferred shares represent 56.3% of the preferred share portfolio (65.5% in 2011). Bonds, common shares and mutual funds combined represent 9.1% of the Company's securities compared to 3.2% in 2011. The entire bond portfolio of \$104.8 million is investment grade.

The Company continues to invest in conservative assets while seeking appropriate returns. During the year, the Company took advantage of market opportunities and sold certain securities, realizing a net pre-tax gain of \$1.8 million compared to \$7.1 million during 2011.

Additional details related to the Company's securities portfolio can be found in Note 4 to the consolidated financial statements included in this report.

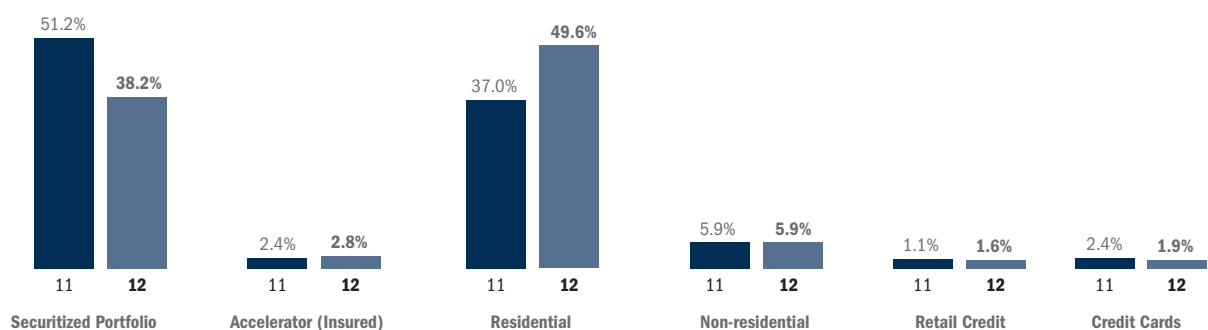
# Management's Discussion and Analysis

## 2013 Outlook for Cash Resources and Securities

The Company will continue to target a conservative level of liquid assets while maintaining financial flexibility. The securities portfolio should increase in line with growth in total assets. A significant proportion of excess funds arising through the Company's retail deposits' channel and securitization activities will be deployed into short-term, highly liquid investments while management continues to invest the balance in securities that provide attractive returns.

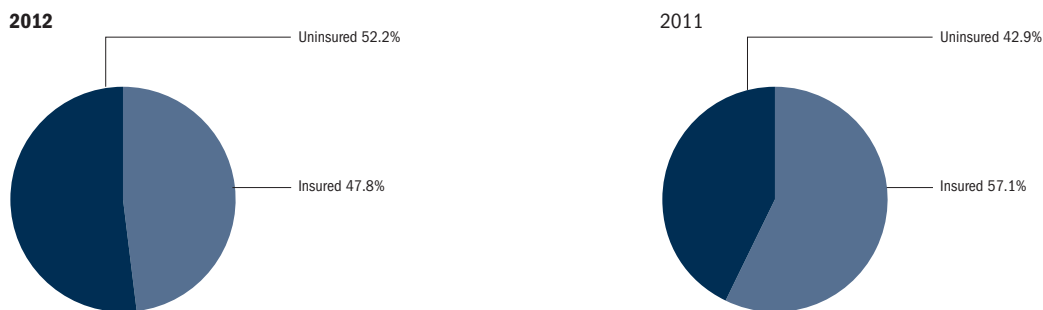
## Loans Portfolio

**Figure 1: Portfolio Composition by Product Type**

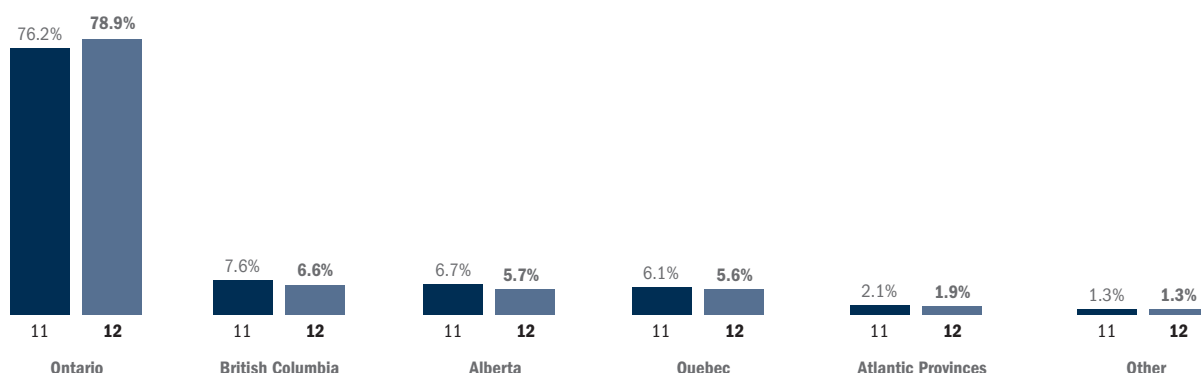


Securitized mortgages and residential mortgages include mortgages on multi-unit residential properties with over four units and builders' inventory.

**Figure 2: Insured versus Uninsured Mortgages Under Administration**



**Figure 3: Loan Portfolio Composition by Province**



The Company's loans portfolio consists of traditional uninsured residential mortgages, uninsured multi-unit residential mortgages, Accelerator insured residential mortgages, securitized insured residential mortgages and multi-unit residential mortgages, non-residential mortgages, credit cards and retail credit loans.

At December 31, 2012 the total on-balance sheet loans portfolio amounted to \$16.90 billion, up \$0.81 billion or 5.1% over the \$16.09 billion at December 31, 2011. The Company also had \$0.88 billion in off-balance sheet insured mortgages under administration at the end of 2012. Much of the loans portfolio growth was in the traditional mortgage portfolio consistent with the Company's strategy to increase focus on this more profitable residential portfolio.

As illustrated in Figure 1, the Company's residential lending represents the most significant component of the Company's loans portfolio, at 49.6% of the total on-balance sheet portfolio, compared to 37.0% in 2011. Insured mortgages continued to be a significant component of the Company's total on- and off-balance sheet mortgage portfolio in 2012, although the proportion declined from 2011. Loans held for sale and on-balance sheet Accelerator mortgages are generally held for future securitization.

The on-balance sheet securitized mortgage portfolio declined by \$1.79 billion in 2012 reflecting a net run-off of the securitized portfolio and the sale of residual interests related to \$662.2 million in securitized mortgages. Total securitized mortgages, including the off-balance sheet portfolio, declined \$911.0 million compared to 2011. The regulatory and accounting treatment of securitized insured mortgages, upon adoption of IFRS, introduced new capital constraints and effectively increased the cost of capital allocated to securitized insured mortgages. Consequently, the Company continued to scale back lending in this segment, optimizing the allocation of shareholders' equity, while remaining within the Company's risk appetite.

## Management's Discussion and Analysis

The residential mortgage portfolio increased by \$2.50 billion to \$8.84 billion from \$6.34 billion at the end of 2011, supported by the Company's strategy to increase focus on its traditional mortgage portfolio, which has been the Company's core business. Credit losses experienced in 2012 on the traditional portfolio are consistent with the Company's historical experience and are well supported by the profitability of this portfolio. The Company focused the portfolio's growth in its traditional target markets and employed additional caution in certain geographic areas where the housing and employment markets were relatively weaker.

The non-residential mortgage portfolio increased by \$42.2 million to \$988.4 million from \$946.2 million at the end of 2011. The Company continues to increase the loan balances in this segment while maintaining its relative proportion of the total on-balance sheet loan portfolio at about 6.0%. The Company will continue to manage this portfolio in a conservative manner and grow the portfolio when assets of appropriate quality within the Company's risk appetite are available. Included in the non-residential category are store and apartment structures, office buildings, residential and non-residential construction, retail stores, hotels and industrial properties.

The credit card loan portfolio declined by \$59.4 million to \$327.5 million from \$386.9 million at the end of 2011, reflecting the Company's caution in new issuances of Equityline Visa cards while the final implications of new underwriting guidelines were reviewed.

The Company's retail credit portfolio continues to be an integral part of the loans portfolio generating above average returns for the Company. The portfolio increased by 57.0% to \$272.0 million from \$173.3 million at the end of 2011. Water heater loans, a financing product introduced to the Company's portfolio in 2010, are the largest component of the retail lending portfolio, amounting to \$253.5 million or 89.4% of the retail loans outstanding at the end of 2012. The average size of a water heater loan is approximately \$1,000.

The Company, through past and continued expansion, provides mortgages and loans across Canada. The Company continues to re-enter certain of its previous markets outside Ontario, as well as entering new markets, to facilitate expansion plans intended to grow its geographic footprint. The Company's lending activities remained concentrated in the Ontario market in 2012 but included expansion into new Ontario markets through the mortgage broker channel. The reduction of loan exposures in western Canada reflected the Company's assessment of and response to weakening credit conditions that continued in 2012. The Company continues to employ strategies to increase its geographic diversification while remaining responsive to local economic conditions.

**Table 14: Mortgage Loan Advances by Type and Province**

(000s, except %)	2012	% of Total	2011	% of Total	Change
Traditional single family residential mortgages	\$ 4,556,379	75.8%	\$ 3,514,430	68.6%	29.6%
Accelerator single family residential mortgages	804,692	13.4%	1,103,555	21.6%	(27.1%)
Multi-unit residential mortgages	286,879	4.8%	137,005	2.7%	109.4%
Non-residential mortgages	210,228	3.5%	182,163	3.6%	15.4%
Store and apartment mortgages	118,689	2.0%	122,957	2.4%	(3.5%)
Warehouse commercial mortgages	28,500	0.5%	56,750	1.1%	(49.8%)
Total mortgage advances during the year	\$ 6,005,367	100.0%	\$ 5,116,860	100.0%	17.4%

(000s, except %)	2012	% of Total	2011	% of Total	Change
British Columbia	\$ 269,946	4.5%	\$ 234,229	4.6%	15.2%
Alberta	144,587	2.4%	176,957	3.5%	(18.3%)
Ontario	5,198,703	86.6%	4,400,136	85.9%	18.1%
Quebec	289,970	4.8%	230,474	4.5%	25.8%
Atlantic provinces	79,081	1.3%	70,800	1.4%	11.7%
Other	23,080	0.4%	4,264	0.1%	441.3%
Total mortgage advances during the year	\$ 6,005,367	100.0%	\$ 5,116,860	100.0%	17.4%

New mortgage production continued its weighting to the Company's traditional single family loans reflecting the focus on higher margin products within the Company's risk appetite. Non-residential and store and apartment originations, while a smaller proportion of overall mortgage production, remained an important complementary source of loan assets with attractive returns in 2012. The Company increases these portfolios when quality assets meeting the Company's risk standards are available. Multi-unit residential originations increased year over year as the Company began the securitization program, discussed previously, that qualified these mortgages for off-balance sheet accounting.

Mortgage production continued to favour Ontario, the Company's core market, with gains made in specific provinces on a dollar value basis. The Company was successful in increasing its presence in Manitoba, which is included in Other, and Quebec.

**Table 15: Consumer Lending Production**

(Amount in 000s)	2012		2011		Change	
	Number of New Accounts	Amount <sup>1</sup>	Number of New Accounts	Amount <sup>1</sup>	Number of New Accounts	Amount <sup>1</sup>
Visa	<b>5,303</b>	<b>\$ 82,709</b>	9,065	\$ 204,095	(41.5%)	(59.5%)
Water heaters	<b>116,297</b>	<b>164,669</b>	46,685	80,067	149.1%	105.7%
Other retail lending	<b>4,758</b>	<b>26,375</b>	5,322	25,708	(10.6%)	2.6%

<sup>1</sup> For Visa, the amount represents the authorized credit limits. For water heaters and other retail lending, the amount represents the loan balances outstanding.

Equityline Visa, which is fully secured by residential real estate, is the largest component of the Visa portfolio, representing 96.9% of total credit card loans. New Equityline Visa accounts declined over 2011 as the Company slowed originations during its consideration of new lending guidelines, as previously discussed.

Water heater loans continue to be the largest component of the consumer lending portfolio. The large growth in 2012 includes the acquisition of a water heater portfolio in 2012.

### 2013 Outlook for Loan Portfolios

The Company expects that the rate of growth in the Company's non-securitized loan portfolio in 2013 will be consistent with the pace of growth experienced in 2012. The shift towards the traditional mortgage business is expected to continue into 2013, with growth rates moderating in this portfolio as the Company achieves the balance in the portfolios to support sustained growth in earnings and returns on equity. The Company will continue to offer insured mortgages through the Accelerator insured mortgage program, supporting the "one-stop" and "flexible lending solutions" lender strategies. The Company will also continue to increase its geographic expansion, taking advantage of opportunities within its risk profile in Quebec, and eastern and western Canada.

Multi-unit residential mortgages are expected to continue to offer opportunities for securitization and off-balance sheet sales at about the same pace as in 2012.

Non-residential mortgages are expected to grow at a pace consistent with 2012 to maintain a consistent proportion in the total portfolio, if appropriate assets with attractive returns within the Company's risk appetite are available in the market.

Growth of the consumer loan portfolio at the current rate is expected for 2013. The Equityline Visa credit card portfolio will continue to be the primary contributor to the credit card loan portfolio supported by the "one-stop" bundled mortgage program and other marketing efforts. The Visa portfolio is expected to grow at a pace consistent with the overall loan portfolio. The Company anticipates continued growth in the water heater line of business and the Company generally expects growth rates in the consumer lending portfolio to be consistent or moderately higher when compared to 2012.

# Management's Discussion and Analysis

## Deposits, Senior Debt and Securitization Liabilities

**Table 16: Deposits, Senior Debt and Securitization Liabilities**

(000s, except %)	2012	2011	Change
Deposits payable on demand			
High-interest savings accounts	\$ 19,819	\$ -	-
Other deposits payable on demand	86,104	75,965	13.3%
	<b>105,923</b>	75,965	39.4%
Deposits payable on fixed dates			
Debenture investment certificates	8,399,655	6,897,351	21.8%
Short-term certificates and savings	1,259,739	656,803	91.8%
Registered retirement savings plans	186,515	162,274	14.9%
Registered retirement income funds	130,404	98,896	31.9%
Tax Free Savings Accounts	54,363	30,835	76.3%
	<b>10,030,676</b>	7,846,159	27.8%
Senior debt	<b>150,684</b>	153,336	(1.7%)
Securitization liabilities			
Mortgage-backed security liabilities	1,301,693	2,417,801	(46.2%)
Canada Mortgage Bond liabilities	6,034,202	6,231,274	(3.2%)
	<b>7,335,895</b>	8,649,075	(15.2%)
Total	<b>\$17,623,178</b>	\$16,724,535	5.4%

Deposits increased primarily to provide the funding for the non-securitized loan portfolio. The Company's deposit portfolio primarily comprises fixed term deposits, which represent 99.0% of all deposits, thereby reducing the risk of untimely withdrawal of funds by retail clients. The Company does not raise deposits through the wholesale market. In 2012 the Company launched a high interest savings account as part of its longer term strategy to diversify its sources of funding. (Please see Note 11 to the consolidated financial statements included in this report for a breakdown of the Company's deposit portfolio by remaining contractual term to maturity and yield.)

Securitization liabilities decreased from 2011 due to the net run-off of securitized insured mortgages and the sale of residual interests in NHA MBS securitizations that resulted in the derecognition of \$662.2 million in securitized insured mortgages and related securitization liabilities from the balance sheet.

### 2013 Outlook for Deposits and Securitization Liabilities

The Company will continue to source deposits from the public through investment dealers and deposit brokers and will place a renewed emphasis on growing its direct channel. The Company will seek to expand this network through agreements with additional deposit brokers, through growth of its newly launched high interest savings account, and by enhancing its direct channel sales and service capabilities.

The rate of growth of the deposit portfolio is expected to mirror the growth of the Company's non-securitized loan portfolio, while securitization will continue to support the current stock of insured mortgages. New originations and renewals of insured mortgages will continue to be funded by securitization. The Company will continue developing multiple sources of deposits to fund operations and liquidity reserves and this will remain a key objective for the Company.

## Other Assets and Liabilities

**Table 17: Other Assets and Liabilities**

(000s, except %)	2012	2011	Change
Other assets			
Derivative assets	\$ 45,388	\$ 72,424	(37.3%)
Retained interest on securitization	9,172	-	-
Accrued interest receivable and prepaid assets	85,233	79,650	7.0%
Capital assets	6,578	5,372	22.4%
Intangible assets	66,343	63,917	3.8%
Goodwill	15,752	15,752	-
	<b>\$ 228,466</b>	<b>\$ 237,115</b>	<b>(3.6%)</b>
Other liabilities			
Derivative liabilities	\$ 2,386	\$ 3,458	(31.0%)
Income taxes payable	21,912	17,628	24.3%
Other liabilities	148,590	136,025	9.2%
Deferred tax liabilities	35,800	40,040	(10.6%)
	<b>\$ 208,688</b>	<b>\$ 197,151</b>	<b>5.9%</b>

The decline in other assets was driven by a decline in derivative assets. Derivative assets and liabilities are discussed in the Derivatives and Hedging section of this MD&A. The growth in intangible assets reflects the continued development of new software. The increased investment is offset partially by amortization of the Company's core banking system, which was substantially completed during the fourth quarter of 2011. Further information on the Company's intangible assets can be found in Note 9 to the consolidated financial statements included in this report.

Retained interest relates to the Company's multi-unit residential securitization activities that qualify for off-balance sheet accounting and represents the Company's rights to expected future cash flows.

The increase in other liabilities resulted primarily from an increase in accrued interest payable on deposits, reflecting the increase in deposits outstanding.

### 2013 Outlook for Other Assets and Liabilities

Other assets and liabilities are expected to grow in line with growth in total loans and general business growth.

## Shareholders' Equity

**Table 18: Shareholders' Equity**

(000s, except %)	2012	2011	Change
Shareholders' equity at the beginning of the year	\$ 774,785	\$ 628,585	23.3%
Net income	221,983	190,080	16.8%
Other comprehensive income (loss)	5,446	(15,097)	(136.1%)
Amounts related to stock-based compensation	7,439	6,223	19.5%
Repurchase of shares	(8,117)	(7,946)	2.2%
Dividends	(33,323)	(27,060)	23.1%
Shareholders' equity at the end of the year	<b>\$ 968,213</b>	<b>\$ 774,785</b>	<b>25.0%</b>

The increase in total shareholders' equity was largely internally generated from net income during the year. Also contributing to the increase were amounts related to stock-based compensation and the decrease in accumulated other comprehensive loss, primarily reflecting increases in the fair value of available for sale securities. These increases were partially offset by amounts related to the repurchase of the Company's common shares and dividends. Details related to stock-based compensation and the repurchase of shares are provided in Note 14 to the consolidated financial statements included in this report.

At December 31, 2012, the book value per common share was \$27.96, compared to \$22.38 at December 31, 2011.

Strong earnings contributed to continuing robust returns on shareholders' equity. Return on equity when combined with dividends of \$0.90 per common share in fiscal 2012 (\$0.76 per common share in 2011) confirms the Company's continued commitment to total shareholder return.

# Management's Discussion and Analysis

## Contingencies and Contractual Obligations

During 2011, the Company became aware of alleged irregularities regarding three of its loans with a total principal amount of \$4.6 million. These loans were advanced to two residential condominium corporations. The registered security documents associated with these loans provide the Company with secured priority claims against the condominium corporations, the condominium structures and the underlying residential units. The borrowers are disputing the validity of the Company's security in the Ontario Court. It is not currently possible to reasonably determine the outcome of this matter or to estimate the amount of loss, if any. A specific provision has not been recorded for these loans but these loans are classified as non-performing residential loans.

In the normal course of its activities, the Company enters into various types of contractual agreements. The main obligations result from the acceptance of deposits from retail investors to finance lending activities. The Company ensures that sufficient cash resources are available to meet these contractual obligations when they become due.

In addition to the obligations related to deposits, securitization liabilities and senior debt previously discussed, the following table presents a summary of the Company's other contractual obligations as at December 31, 2012.

**Table 19: Contractual Obligations**

(000s)	2013	2014	2015	2016	2017	Thereafter	Total
Premises and equipment	\$ 4,562	\$ 4,084	\$ 5,451	\$ 2,875	\$ 2,875	\$ 15,811	\$ 35,658

The Company also has outstanding commitments for future advances on mortgages and unutilized and available credit on its credit card products. Refer to the Off-balance Sheet Arrangements section of this report and Note 18 to the consolidated financial statements for a description of those commitments.

## Derivatives and Hedging

From time to time, the Company enters into derivative transactions primarily in order to hedge interest rate exposure resulting from outstanding loan commitments and requirements to replace assets in the CMB program, as well as interest rate risk on fixed-rate debt, such as CMB liabilities and subordinated debt. Where appropriate, the Company will apply hedge accounting to minimize volatility in reported earnings from interest rate changes.

### Cash Flow Hedging

The Company uses Government of Canada bond forwards and interest rate swaps to hedge the impact of movements in interest rates between the time that mortgage commitments are made and the time that those mortgages are funded and/or securitized. Hedges are structured such that the fair value movements of the hedge instruments offset, within a reasonable range, the changes in the fair value of the pool of fixed-rate mortgages due to interest rate fluctuations between commitment and funding. The term of these hedges is generally 60 to 150 days. These hedge instruments are settled or unwound at the time of funding or securitization of the underlying mortgages. The Company applies cash flow hedge accounting to the Government of Canada bond forwards and certain interest rate swaps. The intent of hedge accounting is to recognize the effective matching of the gain or loss on the Government of Canada bond forwards and interest rate swaps with the recognition of the related interest expense on the resulting funding.

The following table summarizes the activities related to cash flow hedges included in the Company's financial statements:

**Table 20: Cash Flow Hedging**

(000s)	2012	2011
Notional amount outstanding at year end	\$ -	\$ -
Fair value losses recorded in OCI	\$ (370)	\$ (7,386)
Amounts reclassified from OCI to net interest income	(1,462)	(618)
Fair value losses recorded in non-interest income (ineffectiveness)	-	(545)

The losses reflect a decline in bond yields over the period of the hedge and were deferred through accumulated other comprehensive income. These losses will be recognized in income over the term of the related MBS, as part of the interest expense on the hedged secured borrowing. These costs are generally offset by attractive interest rates on mortgage originations.



### ***Fair Value Hedging***

The Company is exposed to interest rate risk through participation in the CMB program due to reinvestment risk between the amortizing fixed-rate MBS and the bullet maturity fixed-rate CMB. Additionally, the Company is exposed to interest rate risk through its fixed-rate senior debt. To hedge these risks, the Company enters into interest rate swaps and applies fair value hedge accounting. The intent of fair value hedge accounting is to have the fair value changes in the interest rate swap offset, within a reasonable range, the changes in the fair value of the fixed-rate borrowing resulting from changes in the interest rate environment. Any unmatched fair value change is recorded in income as hedge ineffectiveness through net realized and unrealized gain or loss on derivatives. The following table summarizes the notional amount of derivatives outstanding, the change in the fair value of derivatives and the change in hedged fixed-rate liabilities:

**Table 21: Fair Value Hedging**

(000s)	2012	2011
Notional amount outstanding at year end	\$ 1,571,514	\$ 1,635,914
Fair value changes recorded on interest rate swaps	\$ (26,923)	\$ 53,561
Fair value changes of hedged fixed-rate liabilities for interest rate risk	30,393	(53,326)
Hedge ineffectiveness gain recorded in non-interest income	\$ 3,470	\$ 235

### ***Economic Hedge of Loans Held for Securitization and Sale***

The Company may enter into bond forwards to hedge interest rate risk on loans held for securitization and sale through NHA MBS securitization programs. The underlying loans are classified as held for trading for accounting purposes and held at fair value on the balance sheet. The loans are insured mortgages on multi-unit residential properties. The derivatives used to hedge these loans are not designated in hedge accounting relationships. The fair value changes of these derivatives are mostly offset by the fair value changes related to loans held for trading. The fair value changes reflect changes in interest rates. The net unrealized gain as at December 31, 2012 for fair value changes in both the outstanding derivatives and the loans held for trading was \$0.1 million. The Company did not enter into any of these transactions in 2011. The unrealized gains or losses on the derivatives is recorded in net realized and unrealized gain or losses on derivatives and fair value changes of loans held for sale are recorded in net realized and unrealized gains and losses on securities and mortgages on the consolidated statement of income. When these loans held for trading are securitized and sold, the mortgages are removed from the balance sheet and the net realized gain or loss on the derivatives and mortgages held for sale are reclassified to securitization income on the consolidated statement of income.

### ***Other Interest Rate Swaps***

The Company also has certain interest rate swaps that are not designated in hedge accounting relationships and, therefore, are adjusted to fair value without an offsetting hedged amount. These swaps are economic hedges of the Company's general interest rate risk.

**Table 22: Other Interest Rate Swaps**

(000s)	2012	2011
Notional amount outstanding at year end	\$ 100,000	\$ 118,100
Unrealized gains (losses) recorded in non-interest income	\$ 318	\$ (3,460)

Please see Note 19 of the consolidated financial statements for further information.

### ***Off-balance Sheet Arrangements***

The Company offers credit products to meet the financial needs of its customers and has outstanding commitments for future advances on mortgage loans which amounted to \$571.8 million at December 31, 2012 (\$612.4 million – December 31, 2011). Included within the outstanding commitments are unutilized non-residential loan advances of \$46.0 million at December 31, 2012 (\$80.7 million – December 31, 2011). Commitments for the loans remain open for various periods. As at December 31, 2012, unutilized credit card balances amounted to \$75.7 million (\$89.6 million – December 31, 2011). Outstanding commitments for future advances for the Equityline Visa portfolio were \$4.8 million at December 31, 2012 (\$10.5 million – December 31, 2011). These commitments are in the normal course of business and are considered through the Company's liquidity and capital management processes.

# Management's Discussion and Analysis

## OPERATING SEGMENT REVIEW

The following section summarizes results of the operating segments of the Company. The Company operates principally through two segments, mortgage lending and consumer lending. These operating segments are supported by other activities, including treasury and general corporate activities. For more detailed information, refer to Note 23 to the consolidated financial statements in this report.

Mortgage lending remains the Company's key segment, contributing 89.4% (81.7% in 2011) to the Company's net income in 2012, while consumer lending contributed 14.7% (15.8% in 2011) and the Other segment produced a loss in 2012, compared to generating income in 2011. The Other segment includes dividend income, which is tax exempt for the Company and, therefore, tax provisions in this segment are correspondingly reduced or reflect a recovery.

### Mortgage Lending

**Table 23: Mortgage Lending**

(000s, except %)	2012	2011	Change
Net interest income	\$ 328,087	\$ 273,738	19.9%
Provision for credit losses	(13,164)	(5,916)	122.5%
Fees and other income	27,465	19,457	41.2%
Securitization income	8,131	-	-
Derivative gains (losses)	944	(4,821)	(119.6%)
Non-interest expenses	(78,573)	(67,851)	15.8%
Income before income taxes	272,890	214,607	27.2%
Income taxes	(74,534)	(59,331)	25.6%
Net income	\$ 198,356	\$ 155,276	27.7%
Goodwill	\$ 2,324	\$ 2,324	-
Total assets	\$17,198,250	\$15,997,106	7.5%
<b>Additional financial information</b>			
Total segment revenue	\$ 796,860	\$ 695,684	
as a percentage of total revenue	89.8%	88.0%	
Net segment income	\$ 198,356	\$ 155,276	
as a percentage of total net income	89.4%	81.7%	
Efficiency ratio (TEB)	21.5%	23.5%	
Net interest margin (TEB)	2.0%	1.8%	

The principal line of business, the mortgage lending segment, continued its strong performance, contributing \$198.4 million in net income for the year, compared to \$155.3 million for 2011. Net interest income continues to grow on higher loan balances and net interest margin, reflecting continued strong demand for the Company's products through enhanced broker relationships, superior customer service and balanced real estate markets across most of the country. The Company's strategic shift in focus to higher-yielding traditional products has resulted in an improvement in net interest margin.

The increase in net interest income in 2012 reflects higher average mortgage loan balances and higher net interest margin. Average loan balances were \$2.03 billion higher for the twelve months ending December 31, 2012 compared to 2011.

The efficiency ratio improved over 2011 despite higher expenses, reflecting improving overall efficiency. The increase in expenses relate to higher costs associated with growth in mortgage loans under administration. There were accompanying increases in income tax associated with higher income. While the provision for credit losses for the mortgage lending segment increased on higher traditional mortgages, it remains within expected and acceptable ranges. Please see the Provision and Allowance for Credit Losses section of this MD&A for further discussion.

The Company's focus on customer service and broker relationships, as well as the breadth of mortgage product offerings, is leading to expanded market penetration. The Company continues to offer "one-stop" and "flexible lending solutions" strategies to brokers and customers, driving increased traditional mortgage originations.

## 2013 Outlook for Mortgage Lending

The Company's mortgage segment will continue to be the major contributor to the earnings of the Company in 2013, with additional growth in the Company's profitable uninsured loan products within the Company's risk tolerance.

## Consumer Lending

**Table 24: Consumer Lending**

(000s, except %)	2012	2011	Change
Net interest income	\$ 43,598	\$ 41,782	4.3%
Provision for credit losses	(1,556)	(1,603)	(2.9%)
Fees and other income	16,527	18,051	(8.4%)
Non-interest expenses	(14,056)	(16,255)	(13.5%)
Income before income taxes	44,513	41,975	6.0%
Income taxes	(11,821)	(11,872)	(0.4%)
Net income	\$ 32,692	\$ 30,103	8.6%
Goodwill	\$ 13,428	\$ 13,428	-
Total assets	\$ 769,098	\$ 614,626	25.1%

### Additional financial information

Total segment revenue	\$ 70,013	\$ 67,987
as a percentage of total revenue	7.9%	8.6%
Net segment income	\$ 32,692	\$ 30,103
as a percentage of total net income	14.7%	15.8%
Efficiency ratio (TEB)	23.4%	27.2%
Net interest margin (TEB)	6.3%	7.4%

**Table 25: Consumer Lending Products**

(000s, except %)	2012		2011		% Change	
	Number of Accounts	Amount Outstanding	Number of Accounts	Amount Outstanding	Number of Accounts	Amount Outstanding
Visa	26,840	\$ 327,517	26,560	\$ 386,912	1.05%	(15.35%)
Water heaters	201,124	241,896	145,311	145,847	38.41%	65.86%
Other retail lending	6,743	30,080	7,194	27,434	(6.27%)	9.64%

Consumer lending, which includes Visa, retail lending and payment card services, continues to generate positive returns for the Company. Net interest income for 2012 increased by 4.3% compared to 2011, primarily due to an increase in outstanding receivables in the retail credit portfolio, which was partially offset by lower outstanding receivables in the Visa product line. The decrease in net interest margin is primarily attributed to a reduction in the proportion of Visa accounts in the portfolio and reduced yield on the Equityline Visa portfolio as the Company began to issue lower rate cards to high-quality borrowers. Additionally, the continued growth of water heater loans throughout 2012, which tend to have lower average yields, reduced average yield.

Fees and other income decreased during 2012 due to slower growth in the Visa portfolio relative to 2011.

Expenses have decreased as the Company continues to effectively manage its expenditures, reflected in an improving efficiency ratio year over year. In order to ensure that the Company is able to support future growth initiatives, the Company continues to invest in infrastructure.

In 2012, 3,484 Equityline Visa accounts with \$80.1 million in authorized credit limits were issued compared to 7,697 accounts with \$203.7 million in authorized credit limits issued in 2011, reflecting the Company's caution in new issues while reviewing new underwriting guidelines. The Equityline Visa accounts are fully secured by residential real estate. Equityline Visa represents 96.9% of the Visa portfolio. In 2012, the Company launched a new unsecured Preferred Visa program to qualified existing customers with strong credit history.

## Management's Discussion and Analysis

The largest component of retail lending, representing 88.9% of the portfolio, is water heater loans. There were 116,297 new water heater accounts added during 2012, an increase of 149.1% compared to 2011. Water heater receivables increased by \$96.0 million during the year to \$241.9 million, an increase of 65.9% compared to 2011.

Included in the operating results of the consumer lending segment are the operations of PSiGate. The Company expects PSiGate to continue to contribute revenue growth for the consumer lending segment. For 2012, PSiGate contributed \$2.0 million to the net income of the consumer lending segment, compared to \$1.9 million in 2011.

### 2013 Outlook for Consumer Lending

The consumer lending portfolio will contribute favourably to the Company's profitability in 2013. The Company anticipates continued growth in the water heater line of business and other large-ticket retail lending. Equityline Visa accounts are expected to increase modestly in 2013, while the new Preferred Visa program is anticipated to contribute modestly to the portfolio.

### Other

**Table 26: Other**

(000s, except %)	2012	2011	Change
Net interest income	\$ 9,787	\$ 18,432	(46.9%)
Fees and other income	2	489	(99.6%)
Net gain on securities and other	2,833	1,706	66.1%
Non-interest expenses	(30,106)	(20,896)	44.1%
Income before income taxes	(17,484)	(269)	6,399.6%
Income tax recovery	8,419	4,970	69.4%
Net (loss) income	\$ (9,065)	\$ 4,701	(292.8%)
Total assets	\$ 832,731	\$ 1,084,739	(23.2%)

### Additional financial information

Total segment revenue	\$ 20,812	\$ 26,603
as a percentage of total revenue	2.3%	3.4%
Net interest margin (TEB)	1.5%	2.2%

The Other segment includes the operating results from the Company's securities portfolio and corporate activities. There was a loss of \$9.1 million for the year compared to a net income of \$4.7 million in 2011. The decrease in income for the segment is due to lower net interest income and an increase in expenses. Net interest income is down primarily due to a smaller securities portfolio and lower interest yields in the liquidity portfolio, while expenses are up due to increased staffing in the corporate compliance, internal audit and risk management functions. Included in gains and losses on securities are realized net gains on sale of securities of \$1.8 million compared to \$7.1 million in 2011 and unrealized losses for impairment of available for sale securities of \$1.8 million compared to \$3.0 million in 2011. Additionally, there were unrealized gains on derivatives of \$0.3 million compared to \$3.6 million in unrealized losses last year. Please see the Derivatives and Hedging section of this MD&A for further discussion.

The tax amounts allocated to this segment include the benefit of non-taxable dividends from Canadian companies.

### 2013 Outlook for Other

The Other segment primarily generates its income from the Company's securities portfolio and bears much of the cost of the Company's control and corporate functions. Income from this source is highly correlated with the movement in interest rates and performance of the Canadian capital markets. Control function costs tend to increase as the portfolio of loans grows and the Company enters into more complex transactions.

## SUMMARY OF QUARTERLY RESULTS

**Table 27: Summary of Quarterly Results**

(000s, except per share and %)	2012				2011			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Net interest income (TEB <sup>1</sup> )	\$ 101,151	\$ 100,617	\$ 95,109	\$ 89,626	\$ 90,197	\$ 89,478	\$ 83,121	\$ 78,232
Less: TEB adjustment	1,243	1,126	1,255	1,407	1,785	1,866	1,799	1,626
Net interest income per financial statements	99,908	99,491	93,854	88,219	88,412	87,612	81,322	76,606
Non-interest income	14,537	13,449	12,426	15,490	9,658	5,661	12,454	7,109
Non-interest expense	31,620	32,065	29,882	29,168	27,107	26,036	26,643	25,216
Total revenues	227,649	226,603	218,751	214,682	208,400	198,694	198,568	184,613
Net income	58,965	57,254	53,230	52,534	50,280	48,417	48,206	43,178
Return on common shareholders' equity	25.0%	25.6%	25.1%	26.2%	26.7%	27.0%	28.2%	26.7%
Return on average total assets	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%	1.1%
Earnings per common share								
Basic	\$ 1.70	\$ 1.65	\$ 1.54	\$ 1.52	\$ 1.45	\$ 1.40	\$ 1.39	\$ 1.24
Diluted	\$ 1.70	\$ 1.65	\$ 1.54	\$ 1.52	\$ 1.45	\$ 1.39	\$ 1.38	\$ 1.24
Book value per common share	\$ 27.96	\$ 26.53	\$ 25.05	\$ 23.83	\$ 22.38	\$ 21.10	\$ 20.24	\$ 19.14
Efficiency ratio (TEB <sup>1</sup> )	27.3%	28.1%	27.8%	27.7%	27.1%	27.4%	27.9%	29.5%
Efficiency ratio	27.6%	28.4%	28.1%	28.1%	27.6%	27.9%	28.4%	30.1%
Tier 1 capital ratio <sup>2</sup>	17.01%	16.97%	17.09%	17.49%	17.29%	17.67%	18.37%	18.98%
Total capital ratio <sup>2</sup>	20.68%	20.78%	21.09%	21.62%	20.46%	21.05%	22.06%	20.27%
Net non-performing loans as a % of gross loans	0.33%	0.28%	0.31%	0.28%	0.25%	0.32%	0.23%	0.29%
Annualized provision as a % of gross loans	0.09%	0.10%	0.05%	0.11%	0.07%	0.06%	0.03%	0.03%

<sup>1</sup> TEB – Taxable Equivalent Basis: see definition under the Non-GAAP Measures and Glossary section.

<sup>2</sup> These figures relate to the Company's operating subsidiary, Home Trust Company.

The Company's key financial measures for each of the last eight quarters are summarized in the previous table. These highlights illustrate the Company's profitability and return on equity, as well as efficiency measures and capital ratios. The quarterly results are modestly affected by seasonal factors, with first quarter mortgage advances typically impacted by winter weather conditions, first quarter arrears impacted by the holiday season and the fourth quarter normally producing increased credit card activity over the holiday period.

The Company continues to achieve positive financial results driven by revenue growth in mortgage lending, and continued low efficiency ratios. Tier 1 and Total capital ratios through 2011 and 2012 reflect the Company's prudent capital management strategies and the proactive approach to maintaining a strong capital base.

Return on equity has remained at or above 25% for the last eight quarters.

# Management's Discussion and Analysis

## FOURTH QUARTER 2012 PERFORMANCE

The Company continued its strong performance in the fourth quarter of 2012. Key results for the fourth quarter of 2012 are as follows:

- > Net income of \$59.0 million was 17.3% higher than the \$50.3 million net income recorded in the fourth quarter of 2011. Net income in the fourth quarter of 2012 increased 3.0% over net income in the third quarter of 2012.
- > Basic and diluted earnings per share were \$1.70 for the fourth quarter. This represents an increase of 17.2% over the \$1.45 basic and diluted earnings per share in the fourth quarter of 2011 and an increase of 3.0% over \$1.65 recorded in the third quarter of 2012.
- > Return on equity was 25.0% in the quarter compared to 26.7% in the comparable quarter of 2011 and 25.6% in the third quarter of 2012.
- > During the fourth quarter of 2012, the Company completed the sale of residual interests in NHA MBS loan securitizations related to \$662.2 million in existing on-balance sheet mortgages, leading to off-balance sheet accounting for the mortgages and a gain on sale of \$4.8 million. As of the date of this MD&A, the regulatory treatment for these transactions has not been confirmed. For purposes of the calculation of the ACM, the Company has included these off-balance sheet mortgages in the determination of regulatory balance sheet assets. While the ultimate regulatory treatment will impact the Company's volume of sales of residual interests in securitization transactions, the Company expects to continue sales when the economic returns are favourable.
- > The securitization gains were partly offset by \$3.6 million in charges recorded in derivative gains and losses. These charges relate to the reversal of gains on derivatives recorded on adoption of IFRS which are charged to income as the related CMB bonds mature. See the Non-interest Income section of this MD&A report for a discussion of the derivative gains and losses.
- > Net interest income rose to \$99.9 million in the fourth quarter representing an increase of 13.0% over the \$88.4 million recorded in the fourth quarter of 2011. Net interest income increased marginally over the \$99.5 million recorded in the third quarter of 2012. The growth in total net interest income quarter over quarter was reduced by the sale of the residual interests in securitization transactions discussed above, as the interest income associated with such securitized mortgages is no longer reflected in interest income. Net interest income on non-securitized assets of \$85.1 million in the fourth quarter was up 3.8% from \$81.9 million in the third quarter and 34.6% from the \$63.2 million reported in the fourth quarter of 2011.
- > Net interest margin (TEB) was 2.13% in the fourth quarter compared to 2.06% in the fourth quarter of 2011 and 2.14% in the third quarter of 2012. Total net interest margin is influenced by the mix of the loan portfolio between securitized and non-securitized mortgages and the net interest margin on each of these portfolios. Beginning in 2011 and continuing through 2012 the weighting of lower yielding securitized mortgages in the total portfolio declined, generally leading to higher total net interest margins. The net interest margin on the non-securitized portfolio has also generally improved over that period, with some fluctuations quarter to quarter. Fourth quarter net interest margin for non-securitized mortgages was 3.11%, a decline from 3.17% in the third quarter. This was due to a change in the mix of the non-securitized portfolio and the spreads achieved in the quarter. The securitized net interest margin was 0.79% in the fourth quarter compared to 0.89% in the third quarter, which reflects the maturity of higher yielding CMB mortgages during the quarter and lower yielding replacement assets in the program.
- > The credit performance of the loans portfolio remained strong in the fourth quarter. Net non-performing loans ended 2012 at 0.33% of the total loans portfolio compared to 0.25% at the end of 2011 and 0.28% at the end of the third quarter of 2012 with the increase reflecting the relatively higher proportion of uninsured mortgages in the total portfolio. The provision for credit losses for the fourth quarter was 0.09% of gross loans on an annualized basis and 0.09% for the year compared to 0.07% in the comparable quarter of 2011 and 0.10% in the third quarter of 2012. This reflects a year-over-year increase in the proportion of uninsured mortgages. The 2012 results are within the Company's objective of the provision being 0.05% to 0.15% of gross loans. Net write-offs were \$3.3 million for the quarter or 0.08% of gross loans, compared to \$4.8 million or 0.12% in the comparable quarter of 2011 and \$3.1 million or 0.07% million last quarter.
- > Home Trust's Tier 1 and Total capital ratios remained very strong at 17.01% and 20.68%, respectively, at December 31, 2012 and well above Company and regulatory minimum targets. Home Trust's ACM was 13.98 at December 31, 2012 compared to 14.44 at December 31, 2011 and 14.07 at September 30, 2012.
- > Total loans increased by \$0.81 billion in 2012 to \$16.90 billion, representing growth of 5.1% over the \$16.09 billion at the end of 2011 and decreased by 2.2% or \$0.39 billion from the \$17.29 billion at the end of the third quarter of 2012. Total loans under administration (which includes all loans carried on the balance sheet plus off-balance sheet securitized loans) increased by \$1.70 billion in 2012 to \$17.79 billion, representing growth of 10.5% over the \$16.09 billion at the end of 2011 and 1.9% or \$0.33 billion from the \$17.46 billion at the end of the third quarter of 2012. Loan growth was below the Company's 2012 objective of 13% to 18% while profitability was within targets due to a relatively larger focus on the Company's traditional mortgages portfolio.

- > The total value of mortgages originated in the fourth quarter of 2012 was \$1.47 billion, compared to \$1.25 billion in the fourth quarter of 2011. Total originations were \$1.68 billion in the third quarter of 2012. The year-over-year increase in originations reflects increased focus on and demand for the Company's traditional mortgage products. Compared to the third quarter, a decline in originations reflects normal and expected seasonal factors. The Company has generally observed increased credit quality on new originations.
- > The Company originated \$1.16 billion of traditional mortgages in the fourth quarter, compared to \$0.95 billion in the comparative period of 2011 and \$1.26 billion in the third quarter of 2012.
- > Accelerator (insured) mortgage originations were \$174.2 million in the fourth quarter of 2012, compared to \$188.5 million in the comparable period of 2011 and \$236.7 million in the third quarter of 2012.
- > Multi-unit residential originations were \$57.2 million for the fourth quarter of 2012, compared to \$6.5 million in the same period of 2011 and \$114.3 million in the third quarter of 2012. A significant portion of the multi-unit residential mortgages originated in 2012 are insured and securitized through programs that qualify for off-balance sheet accounting. The Company sold \$64.6 million through these programs in the fourth quarter and recognized \$0.8 million in gains. The Company did not participate in this program in 2011.
- > Non-residential mortgage advances were \$52.4 million in the fourth quarter of 2012, compared to \$41.5 million in the comparable period of 2011 and \$46.6 million in the third quarter of 2012. The Company continues to maintain a cautious approach to increases in this portfolio.
- > Store and apartment advances were \$24.8 million for the quarter, compared to \$35.5 million in the same period of 2011 and \$18.2 million in the third quarter of 2012.

#### **Fourth Quarter Segment Review**

##### ***Mortgage Lending***

The mortgage lending segment continued its strong performance in the fourth quarter, with net income of \$53.7 million, up 25.6% over the \$42.7 million in net income earned in the comparable quarter of 2011 and up 0.6% from the \$53.3 million earned in the third quarter of 2012. Net interest income continues to grow on higher loan balances and strong net interest margins, reflecting continued strong demand for the Company's products through enhanced broker relationships, superior customer service and stable real estate markets in most regions across the country.

##### ***Consumer Lending***

Consumer lending continues to generate attractive returns for the Company, with net income for the fourth quarter of 2012 of \$8.4 million, up 10.3% from the \$7.6 million earned in the same quarter of 2011 and up 2.6% from the \$8.1 million earned in the third quarter of 2012.

The average net interest margin earned on the Visa portfolio was 8.4% during the fourth quarter, compared to 8.2% in the same quarter of 2011 and 8.3% in the third quarter of 2012. The average net interest margin earned in the consumer lending portfolio was 6.5% during the quarter, compared to 7.3% in the comparable quarter of 2011 and 6.5% in the third quarter of 2012.

During the quarter, 716 Equityline Visa accounts with \$13.6 million in authorized credit limits were issued, compared to 1,814 accounts with \$44.2 million in authorized credit limits issued in the comparable quarter of 2011 and 550 accounts with \$11.1 million in authorized credit limits in the third quarter of 2012.

The Company's consumer lending portfolio also includes the results from its retail lending operations. The largest component of retail lending, representing 88.9% of the retail credit portfolio, is water heater loans. There were 14,998 new water heater accounts added during the quarter, a decrease of 5.2% over the 15,817 added in the third quarter of 2012. Total retail lending receivables increased by \$49.9 million during the quarter to reach \$272.0 million at the end of 2012.

Consumer lending also includes the results of PSiGate which contributed \$0.4 million to net income for the quarter, \$0.5 million in the comparable quarter of 2011 and \$0.4 million in the third quarter of 2012.

##### ***Other***

The Other segment includes the operating results from the Company's treasury portfolio and corporate activities. Net interest income declined from the prior year, reflecting lower yields on liquidity assets and lower average balances of liquid assets as the Company reduced its securitization activity in 2011. Securitization activity generally requires higher balances of liquid assets to support the accumulation of assets and subsequent exchange of cash.

# Management's Discussion and Analysis

## FOURTH QUARTER FINANCIAL INFORMATION

Table 28: Fourth Quarter Review of Financial Performance

	For the three months ended				Change
	December 31 2012	September 30 2012	December 31 2011	December 31, 2012- September 30, 2012	December 31, 2012- December 31, 2011
(000s, except per share amounts and %)					
<b>Net Interest Income Non-Securitized Assets</b>					
Interest from loans	\$ 144,310	\$ 138,271	\$ 111,065	4.4%	29.9%
Dividends from securities	3,502	3,172	4,559	10.4%	(23.2%)
Other interest	949	1,093	1,241	(13.2%)	(23.5%)
	<b>148,761</b>	142,536	116,865	4.4%	27.3%
Interest on deposits	61,873	58,962	51,989	4.9%	19.0%
Interest on senior debt	1,825	1,648	1,673	10.7%	9.1%
Net interest income non-securitized assets	<b>85,063</b>	81,926	63,203	3.8%	34.6%
<b>Net Interest Income Securitized</b>					
<b>Loans and Assets</b>					
Interest income from securitized					
loans and assets	64,351	70,618	81,876	(8.9%)	(21.4%)
Interest expense on securitization liabilities	49,506	53,053	56,667	(6.7%)	(12.6%)
Net interest income securitized					
loans and assets	14,845	17,565	25,209	(15.5%)	(41.1%)
<b>Total Net Interest Income</b>	<b>99,908</b>	99,491	88,412	0.4%	13.0%
Provision for credit losses	3,685	4,239	2,979	(13.1%)	23.7%
	<b>96,223</b>	95,252	85,433	1.0%	12.6%
<b>Non-Interest Income</b>					
Fees and other income	11,059	11,281	11,294	(2.0%)	(2.1%)
Securitization income	5,659	1,204	-	370.0%	-
Net realized and unrealized losses					
on securities and mortgages	(883)	(1,172)	(1,306)	(24.7%)	(32.4%)
Net realized and unrealized (loss) gain					
on derivatives	(1,298)	2,136	(330)	(160.8%)	293.3%
	<b>14,537</b>	13,449	9,658	8.1%	50.5%
	<b>110,760</b>	108,701	95,091	1.9%	16.5%
<b>Non-Interest Expenses</b>					
Salaries and benefits	14,991	15,465	13,184	(3.1%)	13.7%
Premises	2,562	2,296	2,007	11.6%	27.7%
Other operating expenses	14,067	14,304	11,916	(1.7%)	18.1%
	<b>31,620</b>	32,065	27,107	(1.4%)	16.6%
<b>Income Before Income Taxes</b>	<b>79,140</b>	76,636	67,984	3.3%	16.4%
Income taxes					
Current	22,649	19,904	15,909	13.8%	42.4%
Deferred	(2,474)	(522)	1,795	373.9%	(237.8%)
	<b>20,175</b>	19,382	17,704	4.1%	14.0%
<b>NET INCOME</b>	<b>\$ 58,965</b>	\$ 57,254	\$ 50,280	3.0%	17.3%
<b>NET INCOME PER COMMON SHARE</b>					
Basic	\$ 1.70	\$ 1.65	\$ 1.45	3.0%	17.2%
Diluted	\$ 1.70	\$ 1.65	\$ 1.45	3.0%	17.2%
<b>AVERAGE NUMBER OF COMMON SHARES OUTSTANDING</b>					
Basic	34,655	34,697	34,668	(0.1%)	(0.0%)
Diluted	34,779	34,803	34,782	(0.1%)	(0.0%)
Total number of outstanding common shares	<b>34,630</b>	34,668	34,625	(0.1%)	0.0%
Book value per common share	\$ 27.96	\$ 26.53	\$ 22.38	5.4%	24.9%



**Table 29: Fourth Quarter Review of Comprehensive Income**

(000s, except %)	For the three months ended			Change	
	December 31 2012	September 30 2012	December 31 2011	December 31, 2012- September 30, 2012	December 31, 2012- December 31, 2011
<b>NET INCOME</b>	<b>\$ 58,965</b>	\$ 57,254	\$ 50,280	3.0%	17.3%
<b>OTHER COMPREHENSIVE INCOME</b>					
<b>Available for Sale Securities</b>					
Net unrealized gains on securities available for sale	<b>1,471</b>	1,667	700	(11.8%)	110.1%
Net losses reclassified to net income	<b>457</b>	1,141	1,174	(59.9%)	(61.1%)
	<b>1,928</b>	2,808	1,874	(31.3%)	2.9%
Income tax expense	<b>509</b>	742	505	(31.4%)	0.8%
	<b>1,419</b>	2,066	1,369	(31.3%)	3.7%
<b>Cash Flow Hedges</b>					
Net unrealized losses on cash flow hedges	-	-	(639)	-	-
Net losses reclassified to net income	<b>376</b>	376	338	-	11.2%
	<b>376</b>	376	(301)	-	(224.9%)
Income tax expense (recovery)	<b>99</b>	99	(36)	-	(375.0%)
	<b>277</b>	277	(265)	-	(204.5%)
Total other comprehensive income	<b>\$ 1,696</b>	\$ 2,343	\$ 1,104	(27.6%)	53.6%
<b>COMPREHENSIVE INCOME</b>	<b>\$ 60,661</b>	\$ 59,597	\$ 51,384	1.8%	18.1%

# Management's Discussion and Analysis

**Table 30: Fourth Quarter Review of Financial Position**

	As at		
(000s, except for %)	December 31 2012	September 30 2012	Change
<b>ASSETS</b>			
<b>Cash Resources and Restricted Cash</b>	<b>\$ 439,287</b>	\$ 543,825	(19.2%)
<b>Securities</b>			
Available for sale	414,344	401,830	3.1%
Pledged securities	843,547	784,098	7.6%
	<b>1,257,891</b>	1,185,928	6.1%
<b>Loans Held for Sale</b>	<b>21,921</b>	36,405	(39.8%)
<b>Loans</b>			
Residential mortgages	8,843,923	8,456,791	4.6%
Securitized residential mortgages	6,450,682	7,238,946	(10.9%)
Non-residential mortgages	988,416	993,174	(0.5%)
Personal and credit card loans	599,493	567,079	5.7%
	<b>16,882,514</b>	17,255,990	(2.2%)
Collective allowance for credit losses	(30,000)	(29,800)	0.7%
	<b>16,852,514</b>	17,226,190	(2.2%)
<b>Other</b>			
Derivative assets	45,388	57,651	(21.3%)
Other assets	94,405	102,741	(8.1%)
Capital assets	6,578	7,165	(8.2%)
Intangible assets	66,343	66,342	0.0%
Goodwill	15,752	15,752	-
	<b>228,466</b>	249,651	(8.5%)
	<b>\$ 18,800,079</b>	\$ 19,241,999	(2.3%)
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Liabilities</b>			
<b>Deposits</b>			
Deposits payable on demand	\$ 105,923	\$ 49,835	112.5%
Deposits payable on a fixed date	10,030,676	9,820,856	2.1%
	<b>10,136,599</b>	9,870,691	2.7%
<b>Senior Debt</b>	<b>150,684</b>	153,724	(2.0%)
<b>Securitization Liabilities</b>			
Mortgage-backed security liabilities	1,301,693	1,923,017	(32.3%)
Canada Mortgage Bond liabilities	6,034,202	6,155,475	(2.0%)
	<b>7,335,895</b>	8,078,492	(9.2%)
<b>Other</b>			
Derivative liabilities	2,386	3,767	(36.7%)
Income taxes payable	21,912	8,689	152.2%
Other liabilities	148,590	168,743	(11.9%)
Deferred tax liabilities	35,800	38,275	(6.5%)
	<b>208,688</b>	219,474	(4.9%)
	<b>17,831,866</b>	18,322,381	(2.7%)
<b>Shareholders' Equity</b>			
Capital stock	61,903	61,873	0.0%
Contributed surplus	6,224	5,847	6.4%
Retained earnings	903,831	857,339	5.4%
Accumulated other comprehensive loss	(3,745)	(5,441)	(31.2%)
	<b>968,213</b>	919,618	5.3%
	<b>\$ 18,800,079</b>	\$ 19,241,999	(2.3%)

**Table 31: Fourth Quarter Net Interest Margin**

	For the three months ended		
	December 31 2012	September 30 2012	December 31 2011
Net interest margin non-securitized interest earning assets (TEB)	3.11%	3.17%	3.03%
Net interest margin non-securitized interest earning assets (non-TEB)	3.07%	3.13%	2.95%
Net interest margin securitized assets	0.79%	0.89%	1.16%
Total net interest margin (TEB)	2.13%	2.14%	2.06%
Total net interest margin (non-TEB)	2.11%	2.11%	2.02%
Spread of non-securitized loans over deposits only	3.13%	3.16%	3.16%

**Table 32: Fourth Quarter Net Interest Income**

	For the three months ended					
	December 31, 2012			September 30, 2012		
(000s, except %)	Average Balance <sup>1</sup>	Income/ Expense	Average Rate <sup>1</sup>	Average Balance <sup>1</sup>	Income/ Expense	Average Rate <sup>1</sup>
<b>Assets</b>						
Cash resources and securities	\$ 817,669	\$ 4,451	2.18%	\$ 731,533	\$ 4,265	2.33%
Traditional single-family residential mortgages	8,017,732	109,208	5.45%	7,386,369	102,660	5.56%
Accelerator single-family residential mortgages	582,728	4,470	3.07%	646,033	5,219	3.23%
Multi-unit residential mortgages	107,658	1,274	4.73%	141,761	1,187	3.35%
Non-residential mortgages	981,483	15,789	6.43%	1,017,194	15,685	6.17%
Personal and credit card loans	578,116	13,569	9.39%	567,186	13,520	9.53%
Total non-securitized loans	10,267,717	144,310	5.62%	9,758,543	138,271	5.67%
Taxable equivalent adjustment	-	1,243	-	-	1,126	-
Total on non-securitized interest earning assets	11,085,386	150,004	5.41%	10,490,076	143,662	5.48%
Securitized loans and pledged assets	7,627,113	64,351	3.37%	8,073,588	70,618	3.50%
Other assets	294,020	-	-	249,064	-	-
<b>Total Assets</b>	<b>\$19,006,519</b>	<b>\$ 214,355</b>	<b>4.51%</b>	<b>\$18,812,728</b>	<b>\$ 214,280</b>	<b>4.56%</b>
<b>Liabilities and Shareholders' Equity</b>						
Deposits	\$ 9,944,774	\$ 61,873	2.49%	\$ 9,400,930	\$ 58,962	2.51%
Securitization liabilities	7,661,311	49,506	2.58%	8,123,804	53,053	2.61%
Other liabilities and shareholders' equity	1,400,434	1,825	0.52%	1,287,994	1,648	0.51%
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$19,006,519</b>	<b>\$ 113,204</b>	<b>2.38%</b>	<b>\$18,812,728</b>	<b>\$ 113,663</b>	<b>2.42%</b>
<b>Net Interest Income (TEB)</b>		<b>\$ 101,151</b>			<b>\$ 100,617</b>	
<b>Tax Equivalent Adjustment</b>		<b>(1,243)</b>			<b>(1,126)</b>	
<b>Net Interest Income per Financial Statements</b>		<b>\$ 99,908</b>			<b>\$ 99,491</b>	

<sup>1</sup> The average rate is an average calculated with reference to opening and closing monthly asset and liability balances.

# Management's Discussion and Analysis

For the three months ended December 31, 2011

(000s, except %)	Average Balance <sup>1</sup>	Income/Expense	Average Rate <sup>1</sup>
<b>Assets</b>			
Cash resources and securities	\$ 987,740	\$ 5,800	2.35%
Traditional single-family residential mortgages	5,513,181	77,933	5.65%
Accelerator single-family residential mortgages	436,066	3,304	3.03%
Multi-unit residential mortgages	112,288	1,562	5.56%
Non-residential mortgages	957,859	14,998	6.26%
Personal and credit card loans	555,359	13,268	9.56%
Total non-securitized loans	7,574,753	111,065	5.87%
Taxable equivalent adjustment	-	1,785	-
Total on non-securitized interest earning assets	8,562,493	118,650	5.54%
Securitized loans and pledged assets	8,703,077	81,876	3.76%
Other assets	254,958	-	-
<b>Total Assets</b>	<b>\$17,520,528</b>	<b>\$ 200,526</b>	<b>4.58%</b>
<b>Liabilities and Shareholders' Equity</b>			
Deposits	\$ 7,662,457	\$ 51,989	2.71%
Securitization liabilities	8,725,546	56,667	2.60%
Other liabilities and shareholders' equity	1,132,525	1,673	0.59%
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$17,520,528</b>	<b>\$ 110,329</b>	<b>2.52%</b>
<b>Net Interest Income (TEB)</b>		<b>\$ 90,197</b>	
<b>Tax Equivalent Adjustment</b>		<b>(1,785)</b>	
<b>Net Interest Income per Financial Statements</b>		<b>\$ 88,412</b>	

<sup>1</sup> The average rate is an average calculated with reference to opening and closing monthly asset and liability balances.

**Table 33: Fourth Quarter Mortgage Production**

(000s)	For the three months ended		
	December 31 2012	September 30 2012	December 31 2011
Traditional single family residential mortgages	\$ 1,164,037	\$ 1,257,379	\$ 948,848
Accelerator single family residential mortgages	174,214	236,673	188,484
Multi-unit residential mortgages	57,245	114,279	6,522
Non-residential mortgages	52,417	46,624	41,508
Store and apartment mortgages	24,835	18,175	35,544
Warehouse commercial mortgages	-	6,000	27,000
Total mortgage advances	\$ 1,472,748	\$ 1,679,130	\$ 1,247,906

**Table 34: Provision for Credit Losses**

(000s, except %)	For the three months ended		
	December 31 2012	September 30 2012	December 31 2011
Collective provision	\$ 200	\$ 300	\$ 50
Individual provision	3,485	3,939	2,929
Total provision	\$ 3,685	\$ 4,239	\$ 2,979
Provision as % of gross loans	0.09%	0.10%	0.07%
Net write-offs	\$ 3,294	\$ 3,075	\$ 4,843
Net write-offs as % of gross loans	0.08%	0.07%	0.12%

**Table 35: Net Non-performing Loans and Allowances**

	December 31 2012	September 30 2012	December 31 2011
(000s, except %)			
Net non-performing loans	\$ 56,308	\$ 48,817	\$ 40,297
Gross loans (excluding allowances)	16,885,233	17,258,569	16,091,162
Net non-performing loans as % of gross loans	0.33%	0.28%	0.25%
Collective allowance	\$ 30,000	\$ 29,800	\$ 29,440
Individual allowance	3,638	3,447	1,859
Total allowance	\$ 33,638	\$ 33,247	\$ 31,299

**Table 36: Loans Allowance****For the three months ended December 31, 2012**

(000s)	Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
Individual allowances				
Allowance on loan principal				
Balance at the beginning of the period	\$ 1,660	\$ -	\$ 919	\$ 2,579
Provision for credit losses	3,413	-	21	3,434
Write-offs	(2,848)	-	(794)	(3,642)
Recoveries	156	-	192	348
	2,381	-	338	2,719
Allowance on accrued interest receivable				
Balance at the beginning of the period	868	-	-	868
Provision for credit losses	51	-	-	51
	919	-	-	919
Total individual allowance	3,300	-	338	3,638
Collective allowance				
Balance at the beginning of the period	16,659	9,300	3,841	29,800
Provision for credit losses	200	-	-	200
	16,859	9,300	3,841	30,000
Total allowance	\$ 20,159	\$ 9,300	\$ 4,179	\$ 33,638
Total provision	\$ 3,664	\$ -	\$ 21	\$ 3,685

**For the three months ended September 30, 2012**

(000s)	Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
Individual allowances				
Allowance on loan principal				
Balance at the beginning of the period	\$ 1,179	\$ -	\$ 663	\$ 1,842
Provision for credit losses	3,216	-	596	3,812
Write-offs	(2,898)	-	(464)	(3,362)
Recoveries	163	-	124	287
	1,660	-	919	2,579
Allowance on accrued interest receivable				
Balance at the beginning of the period	741	-	-	741
Provision for credit losses	127	-	-	127
	868	-	-	868
Total individual allowance	2,528	-	919	3,447
Collective allowance				
Balance at the beginning of the period	16,359	9,300	3,841	29,500
Provision for credit losses	300	-	-	300
	16,659	9,300	3,841	29,800
Total allowance	\$ 19,187	\$ 9,300	\$ 4,760	\$ 33,247
Total provision	\$ 3,643	\$ -	\$ 596	\$ 4,239

# Management's Discussion and Analysis

**Table 36: Loans Allowance (continued)**

For the three months ended December 31, 2011

(000s)	Residential Mortgages	Non- Residential Mortgages	Personal and Credit Card Loans	Total
<b>Individual allowances</b>				
<b>Allowance on loan principal</b>				
Balance at the beginning of the period	\$ 1,312	\$ 33	\$ 1,854	\$ 3,199
Provision for credit losses	2,108	45	1,005	3,158
Write-offs	(2,874)	-	(2,223)	(5,097)
Recoveries	196	-	58	254
	742	78	694	1,514
<b>Allowance on accrued interest receivable</b>				
Balance at the beginning of the period	574	-	-	574
Provision for credit losses	(229)	-	-	(229)
	345	-	-	345
<b>Total individual allowance</b>	<b>1,087</b>	<b>78</b>	<b>694</b>	<b>1,859</b>
<b>Collective allowance</b>				
Balance at the beginning of the period	16,919	8,334	4,137	29,390
Provision for credit losses	(620)	966	(296)	50
	16,299	9,300	3,841	29,440
<b>Total allowance</b>	<b>\$ 17,386</b>	<b>\$ 9,378</b>	<b>\$ 4,535</b>	<b>\$ 31,299</b>
<b>Total provision</b>	<b>\$ 1,259</b>	<b>\$ 1,011</b>	<b>\$ 709</b>	<b>\$ 2,979</b>

**Table 37: Earnings by Business Segment**

For the three months ended December 31, 2012

(000s)	Mortgage Lending	Consumer Lending	Other	Total
Net interest income	\$ 86,650	\$ 11,002	\$ 2,256	\$ 99,908
Provision for credit losses	(3,664)	(21)	-	(3,685)
Fees and other income	7,318	3,739	2	11,059
Securitization income	5,659	-	-	5,659
Net (loss) gain on securities and other	(2,557)	-	376	(2,181)
Non-interest expenses	(20,203)	(3,350)	(8,067)	(31,620)
Income before income taxes	73,203	11,370	(5,433)	79,140
Income taxes	(19,532)	(3,018)	2,375	(20,175)
Net income (loss)	\$ 53,671	\$ 8,352	\$ (3,058)	\$ 58,965
Goodwill	\$ 2,324	\$ 13,428	\$ -	\$ 15,752
<b>Total assets</b>	<b>\$17,198,250</b>	<b>\$ 769,098</b>	<b>\$ 832,731</b>	<b>\$18,800,079</b>

For the three months ended September 30, 2012

(000s)	Mortgage Lending	Consumer Lending	Other	Total
Net interest income	\$ 86,523	\$ 10,874	\$ 2,094	\$ 99,491
Provision for credit losses	(3,644)	(595)	-	(4,239)
Fees and other income	7,128	4,087	66	11,281
Securitization income	1,204	-	-	1,204
Net gain (loss) on securities and other	1,447	-	(483)	964
Non-interest expenses	(20,200)	(3,277)	(8,588)	(32,065)
Income before income taxes	72,458	11,089	(6,911)	76,636
Income taxes	(19,110)	(2,951)	2,679	(19,382)
Net income (loss)	\$ 53,348	\$ 8,138	\$ (4,232)	\$ 57,254
Goodwill	\$ 2,324	\$ 13,428	\$ -	\$ 15,752
Total assets	\$17,623,833	\$ 717,386	\$ 900,780	\$19,241,999

For the three months ended December 31, 2011

(000s)	Mortgage Lending	Consumer Lending	Other	Total
Net interest income	\$ 74,164	\$ 10,639	\$ 3,609	\$ 88,412
Provision for credit losses	(1,975)	(1,004)	-	(2,979)
Fees and other income	6,829	4,343	122	11,294
Net loss on securities and other	(1,095)	-	(541)	(1,636)
Non-interest expenses	(18,824)	(3,417)	(4,866)	(27,107)
Income before income taxes	59,099	10,561	(1,676)	67,984
Income taxes	(16,370)	(2,987)	1,653	(17,704)
Net income (loss)	\$ 42,729	\$ 7,574	\$ (23)	\$ 50,280
Goodwill	\$ 2,324	\$ 13,428	\$ -	\$ 15,752
Total assets	\$15,997,106	\$ 614,626	\$ 1,084,739	\$17,696,471

## CAPITAL MANAGEMENT

Capital is a key factor in assessing the safety and soundness of a financial institution. A strong capital position assists the Company in promoting confidence among depositors, creditors, regulators and shareholders. The Company's Capital Management Policy governs the quantity and quality of capital held. The objective of the policy is to ensure that regulatory and risk-based capital requirements are met while also providing a sufficient return to investors. Senior management reviews compliance with the policy on at least a monthly basis while the Risk and Capital Committee and the Board of Directors review compliance with the policy on a quarterly basis.

### Capital Management Framework

Two capital standards are addressed in the Company's policy: the ACM and the risk-based capital ratios. Management reviews these ratios on an ongoing basis and the Board of Directors reviews both ratios quarterly.

Capital adequacy for Canadian banks and trust companies is governed by the requirements of OSFI. These requirements are consistent with the published framework to measure the adequacy of capital for international banks, issued by the Bank for International Settlements (BIS), referred to as Basel II. Under these standards, there are two components of capital. Tier 1 consists primarily of shareholders' equity and non-cumulative preferred shares. Tier 2 consists primarily of subordinated debentures, cumulative preferred shares, and the collective allowance. As Home Trust, a wholly owned subsidiary of the Company, is regulated under the Trust and Loan Companies Act (Canada), its ability to accept deposits is limited primarily by its permitted ACM. This is defined as the ratio of total regulatory assets to total regulatory capital of Home Trust.

## Management's Discussion and Analysis

The table below shows the components of capital, the risk-based capital ratios and the ACM.

**Table 38: Basel II Regulatory Capital (Based only on the subsidiary, Home Trust Company)**

(000s, except % and multiples)	2012	2011
Tier 1 capital		
Capital stock	\$ 23,497	\$ 23,497
Contributed surplus	951	951
Retained earnings	909,728	717,223
Accumulated other comprehensive loss <sup>1</sup>	-	(4,229)
IFRS transition adjustment	-	49,188
<b>Total</b>	<b>934,176</b>	<b>786,630</b>
Tier 2 capital		
Collective allowance for credit losses <sup>2</sup>	30,000	29,440
Accumulated other comprehensive income <sup>3</sup>	337	-
Subordinated debentures	171,000	115,000
<b>Total</b>	<b>201,337</b>	<b>144,440</b>
<b>Total regulatory capital</b>	<b>\$ 1,135,513</b>	<b>\$ 931,070</b>
Risk-weighted assets for		
Credit risk	\$ 4,870,575	\$ 4,068,823
Operational risk	620,938	480,873
<b>Total risk-weighted assets</b>	<b>\$ 5,491,513</b>	<b>\$ 4,549,696</b>
Regulated capital to risk-weighted assets		
Tier 1 capital	17.01%	17.29%
Tier 2 capital	3.67%	3.17%
<b>Total regulatory capital ratio</b>	<b>20.68%</b>	<b>20.46%</b>
<b>Assets to regulatory capital multiple</b>	<b>13.98</b>	<b>14.44</b>

<sup>1</sup> Accumulated other comprehensive loss relates to unrealized losses on certain available for sale equity securities, net of tax, which decrease Tier 1 capital.

<sup>2</sup> The Company is allowed to include its collective allowance for credit losses up to a prescribed percentage of risk-weighted assets in Tier 2 capital. At December 31, 2012, the Company's collective allowance represented 0.55% of risk-weighted assets.

<sup>3</sup> Accumulated other comprehensive income relates to unrealized gains on certain available for sale equity securities, net of tax, which increase Tier 2 capital.

**Table 39: Risk-Weighted Assets (RWA) (Based only on the subsidiary, Home Trust Company)**

(000s, except %)	Balance Sheet Amounts	Risk Weighting	2012 Risk-weighted Amount
Cash and claims on or guaranteed by Canadian and provincial governments (including insured mortgages)	\$ 8,122,266	0%	\$ -
Claims on banks and municipal governments and interest rate contracts	577,581	20%	115,516
Conventional mortgages on owner-occupied residences	8,162,363	35%	2,856,827
Visa secured and consumer loans	377,738	75%	283,304
Commercial mortgages, equities and other assets	1,607,386	100%	1,607,386
Non-performing commercial loans	5,028	150%	7,542
Total assets subject to risk rating	18,852,362	-	4,870,575
Collective allowance	(30,000)	-	-
Total assets	18,822,362		4,870,575
Off-balance sheet items			
Loan commitments	647,513	0%	-
Total credit risk	19,469,875		4,870,575
Operational risk	-		620,938
<b>Total</b>	<b>\$19,469,875</b>		<b>\$ 5,491,513</b>



	2011		
(000s, except %)	Balance Sheet Amounts	Risk Weighting	Risk-weighted Amount
Cash and claims on or guaranteed by Canadian and provincial governments (including insured mortgages)	\$ 9,285,116	0%	\$ -
Claims on banks and municipal governments and interest rate contracts	672,727	20%	134,545
Conventional mortgages on owner-occupied residences	5,757,457	35%	2,015,110
Visa secured and consumer loans	330,516	75%	247,887
Commercial mortgages, equities and other assets	1,669,860	100%	1,669,860
Non-performing commercial loans	947	150%	1,421
Total assets subject to risk rating	17,716,623	-	4,068,823
Collective allowance	(29,440)	-	-
Total assets	17,687,183		4,068,823
Off-balance sheet items			
Loan commitments	287,199	0%	-
Total credit risk	17,974,382		4,068,823
Operational risk	-		480,873
<b>Total</b>	<b>\$17,974,382</b>		<b>\$ 4,549,696</b>

Home Trust's Tier 1 and Total capital ratios continue to significantly exceed OSFI's well-capitalized targets of 7.0% for Tier 1 and 10.0% for Total capital, as well as Home Trust's internal capital targets.

Risk-weighted assets are determined by applying the OSFI prescribed rules to on-balance sheet and off-balance sheet exposures. For the purposes of calculating credit risk-weighted assets, the Company follows the Standardized Approach, and for operational risk, the Company follows the Basic Indicator Approach. The Company's securitization activities are not subject to the Basel II securitization framework as they are all within the NHA MBS program and do not involve tranching of credit risk.

Over the year, risk-weighted assets increased by \$941.8 million due to growth in conventional mortgages. The operational risk factor in the calculation also increased as the Company's gross income, on which the calculation is based, increased.

Home Trust elected to apply OSFI's IFRS transitional relief to the IFRS opening retained earnings adjustment. Home Trust was permitted to amortize the effect of the transition adjustment on regulatory capital over the eight quarters ending December 31, 2012. The amount added to regulatory capital was reduced to zero by the end of 2012.

### Basel III

In December 2010, the Basel Committee for Banking Supervision (BCBS) released *Basel III: A global regulatory framework for more resilient banks and banking systems* with the objective of promoting financial stability and sustainable economic growth. The Basel III capital rules aim to raise the quality, consistency and transparency of the capital base across banks, strengthen the risk coverage of the capital framework, limit the build-up of excessive leverage and reduce procyclicality in the banking sector. The Basel III capital rules will be phased in over the period from 2013 to 2019. The BCBS also released non-viability contingent capital requirements in January 2011 to ensure loss absorbency of regulatory capital instruments at the point of non-viability.

In the fourth quarter of 2012, OSFI released the final guidance on the Canadian application of Basel III capital ratios. The Basel III capital rules will be phased in, beginning in the first quarter of 2013. The Company has completed an analysis of the Basel III capital requirements and has identified the following components as applicable:

- > *Common Equity Tier 1 Capital (CET 1)*. Basel III includes a number of phased-in deductions from Common Equity Tier 1 capital. OSFI requires that prescribed target minimum capital ratios be met on an "all-in" basis without transitional rules. The ACM is permitted to be calculated on a transitional basis. Deductions from CET 1 capital include unconsolidated investments in financial institutions in excess of a prescribed portion of the Company's capital, intangible assets (including software), and portions of AOCI. In anticipation of Basel III, the Company divested itself of its holdings of investments in financial institutions above the threshold. Consequently, the principal deduction from CET 1 capital is the intangible assets.
- > *Non-viability Contingent Capital (NVCC)*. Basel III requires all Tier 1 and Tier 2 capital instruments, other than common shares, to contain provisions that require a full and permanent conversion into common shares of the institution upon a trigger event, generally described as a condition of non-viability, as determined by OSFI. As permitted by the guidelines, in early 2013 Home Trust will amend the terms of all of its subordinated debt, which debt is all issued to the Company, to comply with the requirements for inclusion in Tier 2 capital.
- > *Capital Conservation Buffer*. A capital conservation buffer of 2.5% of risk-weighted assets will be required. This is phased in as a minimum "all-in" CET 1 ratio of 7.0% in the first quarter of 2013 with "all-in" targets of 8.5% for total Tier 1 and 10.5% for Total capital by the first quarter of 2014.

# Management's Discussion and Analysis

**Table 40: Basel III All-in Capital Ratios and ACM (Based only on the subsidiary, Home Trust Company)**

Basel III Ratio	Minimum Basel III	Capital Conservation Buffer	OSFI Targets <sup>1</sup>	Home Trust Proforma
Common Equity Tier 1	4.50%	2.50%	7.00%	<b>16.09%</b>
Tier 1 capital	6.00%	2.50%	8.50%	<b>16.11%</b>
Total capital	8.00%	2.50%	10.50%	<b>19.82%</b>
<b>Assets to regulatory capital multiple</b>				<b>14.12</b>

<sup>1</sup> OSFI targets are required by the first quarter of 2013 for the Common Equity Tier 1 capital ratio and by the first quarter of 2014 for Tier 1 and Total capital ratios.

The Company's analysis suggests that it will be able to meet OSFI's requirements without adjustments to its capital structure.

## Capital Management Activity

To further enhance Home Trust's regulatory capital position and support growth objectives, the Company issued \$150.0 million in long-term senior debt in the second quarter of 2011. Of the net proceeds, \$100.0 million was provided to Home Trust as subordinated debt in 2011. In the first quarter of 2012, an additional \$50.0 million was provided to Home Trust, and in the second quarter of 2012, an additional \$6.0 million was provided utilizing excess cash of the Company.

On September 12, 2012 the Company filed a new Normal Course Issuer Bid through the Toronto Stock Exchange, which allows it to purchase over a 12-month period up to 10% of the public float outstanding on September 12, 2012. The Company believes that, from time to time, the market price of its common shares does not fully reflect the value of its business and the repurchase of shares may represent an appropriate and desirable business decision.

During 2012, the Company repurchased 163,500 common shares (2011 – 156,300 common shares) for \$8.1 million, thereby reducing retained earnings by \$7.8 million and share capital by \$0.3 million (2011 – \$7.7 million and \$0.2 million, respectively).

## Internal Capital Adequacy Assessment Process (ICAAP)

Under the Company's capital and risk management policies, and OSFI's guidelines, periodically, but no less than annually, the Company is required to assess the adequacy of current and projected capital resources under expected and stressed conditions. This involves evaluating the Company's strategy, financial plan and risk appetite; assessing the effectiveness of its risk and capital management practices (including Board and senior management oversight); subjecting the Company's plans to a range of stress tests; and drawing conclusions about its capital adequacy (including a rigorous review and challenge). Based on the Company's ICAAP, management has concluded that Home Trust is adequately capitalized.

## Credit Ratings

The following table presents the credit ratings for the Company and its subsidiary Home Trust. These investment-grade credit ratings would allow the Company to obtain institutional debt financing should the need arise for additional capital.

**Table 41: Credit Rating**

	Home Capital Group Inc.			Home Trust Company		
	DBRS	Standard & Poor's	Fitch Rating	DBRS	Standard & Poor's	Fitch Rating
Long-term rating	BBB	BBB-	BBB	BBB (high)	BBB	BBB
Short-term rating	R2 (middle)	A-3	F2	R2 (high)	A-2	F2
Outlook	Stable	Stable	Negative	Stable	Stable	Negative

Early in 2012, Standard & Poor's and Fitch revised their outlook for Canadian financial institutions generally, and reduced the outlook for the Company to negative. In December 2012, Standard & Poor's further revised its ratings of a number of the Canadian financial institutions and reduced its ratings of the Company by one notch and revised its outlook back to stable. These ratings reductions are related to a view on the relative strength of the Canadian financial system, which continues to be very highly rated, but has increased in overall risk in the view of these rating agencies. The overall level of consumer debt has also influenced these ratings. The rating changes do not impact the current operations of the Company.

## Share Information

**Table 42: Share Information**

(000s)	2012		2011	
	Number of Shares	Amount	Number of Shares	Amount
Common shares issued and outstanding <sup>1</sup>	<b>34,630</b>	<b>\$ 61,903</b>	34,625	\$ 55,104
Employee stock options outstanding <sup>2</sup>	<b>783</b>	<b>n/a</b>	929	n/a
Employee stock options exercisable <sup>3</sup>	<b>557</b>	<b>19,647</b>	594	20,432

<sup>1</sup> No shares were issued, other than through employee stock options exercised.

<sup>2</sup> Please see Note 14(D). Amount for employee stock options is not applicable.

<sup>3</sup> For employee stock options exercisable, the amount refers to proceeds payable to the Company upon exercise.

### 2013 Outlook for Capital Management

The Company remains committed to maintaining its financial strength, strong capital ratios under Basel III and a growing capital base throughout 2013 and beyond. The inclusion of mortgages securitized after March 31, 2010 in the ACM makes this measure the Company's primary capital constraint. The Company will continue to proactively monitor and assess its ACM on an ongoing basis.

## RISK MANAGEMENT

The shaded areas of this MD&A represent a discussion of risk management policies and procedures relating to credit, market and liquidity risks that are required under IFRS 7 *Financial Instruments: Disclosures* which permits these specific disclosures to be included in the MD&A. Therefore, the shaded areas presented in this Risk Management section form an integral part of the audited consolidated financial statements for the year ended December 31, 2012.

Risk management is an essential component of the Company's strategy, contributing directly to the Company's profitability and consistently high return on equity. The Company continues to invest significantly in risk management practices.

The Company's business strategies and operations expose the Company to a wide range of risks that could adversely affect its operations, financial condition, or financial performance, and which may influence an investor to buy, hold, or sell the Company's shares. When evaluating risks, the Company makes decisions about which risks it accepts, which risks it mitigates, offsets or hedges, and which risks it will avoid. These decisions are guided by the Company's risk appetite framework.

# Management's Discussion and Analysis

## Risk Appetite

The Company has adopted a risk appetite framework that sets out the amount and types of risk the Company will take in pursuit of its business objectives and strategies. The Company's risk appetite framework, which was updated in the fourth quarter of 2012, provides the structure to link the objectives of the Company's key stakeholders with the level of risk the Company can, and is willing to, take. The risk appetite framework comprises five major components.

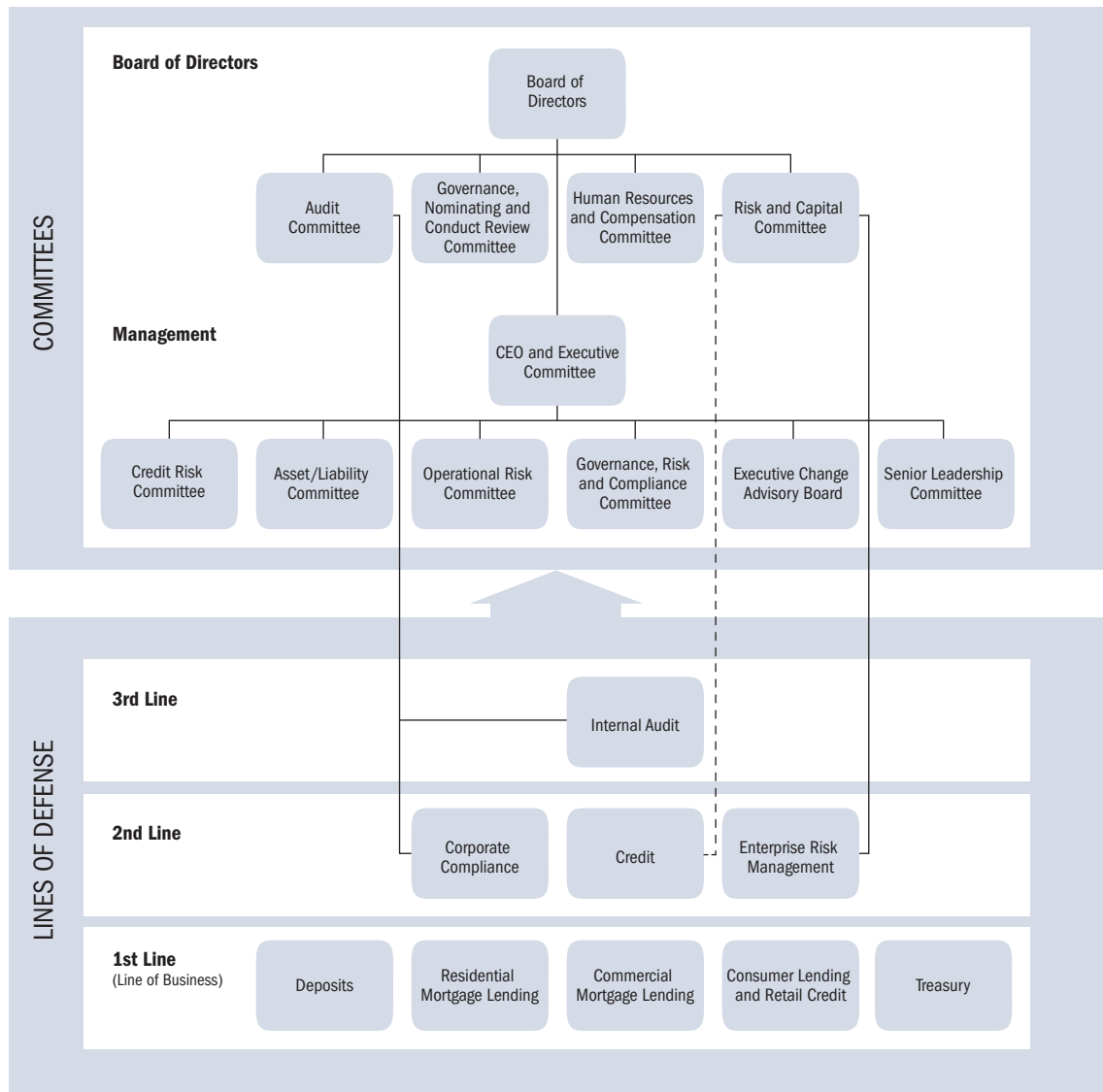
1. Clear articulation of the Company's overall mission and objectives, given key stakeholder concerns. The level of risk inherent in these objectives drives the level of risk the Company may accept.
2. Identification of the Company's risk capacity by identifying the supply of capital capable of supporting risk and absorbing loss. Risk capacity is limited by other factors including regulatory constraints.
3. Identification of the risks inherent in the corporate strategy supporting the mission and the governing objectives of the Company and establishment of a risk-taking philosophy that sets out the key principles that guide how the Company may take and mitigate risk.
4. Documentation of the amount and types of risk the Company may take given its mission, risk capacity, strategy and risk-taking philosophy. The Company explicitly articulates its Balance Sheet risk appetite (how much of the Company's capital it will put at risk), Earnings Volatility risk appetite, Portfolio Composition risk appetite (the types of risk the Company will take) and Non-financial risk appetite (expressions of risk appetite that are difficult to quantify). Among others, the Company has established risk appetite statements addressing:
  - > maximum capital at risk and minimum capital ratios;
  - > maximum leverage or assets to capital multiple;
  - > maximum amount of top-level individual risk types; and
  - > reputational risk.
5. Establishment of risk limits as an expression of the Company's risk appetite for individual risks or factors that contribute to risk levels.

## Risk Governance

The Company's strategies and management of risk are supported by an overall enterprise risk management (ERM) framework including policies, guidelines, and procedures for each major category of risk to which it is exposed (strategic, credit, market, funding and liquidity, operational, legislative and regulatory, and reputational). The Company defines ERM as an ongoing process involving its Board of Directors (the "Board"), management and other personnel in the identification, measurement, assessment and management of risks that may positively or negatively impact the organization as a whole. ERM is applied in strategy-setting across the enterprise and is designed to provide reasonable assurance that the Company's objectives can be realized given its stated risk appetite. The goal of ERM is to help maximize, within the Company's risk appetite, the benefit to the enterprise, shareholders and other stakeholders from a portfolio of risks that the Company is willing to accept.

Supporting the Company's ERM structure is a risk culture and a governance framework, including Board and senior management oversight and an increasingly robust set of risk policies and guidelines reflective of the Company's risk appetite, that set boundaries on acceptable business strategies, exposures and activities. The Company's governance structure is supported by three lines of defense. Authority is delegated by the Board of Directors through the Chief Executive Officer to business units that are responsible for managing the risks they take in the pursuit of their business objectives. The ERM group, along with the Credit group and the Corporate Compliance group, represents the second line of defense, and provides policy guidance to business units and helps ensure that all risks are identified, monitored, measured, assessed and reported to senior management and the Board. Internal Audit, the third line of defense, provides objective and independent reviews of the risk management process, its controls, and the effectiveness of governance, risk management and controls.

The governance structure as depicted in the following figure ensures that there is a framework in place for risk oversight and accountability across the organization. Risk owners are responsible for developing and executing strategies for controlling risk.



## Management's Discussion and Analysis

The Board is accountable for establishing the overall vision, mission, objectives and strategies of the Company and setting the Company's risk appetite and risk-bearing capacity. It challenges management's proposals and plans to ensure that the forecasted results and risk assessments are reasonable and in line with the Company's capabilities, objectives and risk appetite. These risk management responsibilities are primarily carried out through the Risk and Capital Committee of the Board. In this oversight role the Committee is designed to ensure that all significant risks to the Company, regardless of sources, are proactively identified and effectively managed. This is accomplished by reviewing and approving, on at least an annual basis, all key risk policies; monitoring, on at least a quarterly basis, the Company's actual exposures versus Board-approved risk appetite and limits; and providing direction to management where deemed necessary. It further ensures that the ERM function is independent of the business activities it oversees and that an appropriate, independent monitoring and reporting framework is in place and operating effectively, so as to deliver accurate, timely and meaningful risk information for its review and evaluation.

The Executive Committee (EC), chaired by the Chief Executive Officer, is responsible for recommending corporate strategy to the Board and for overseeing its execution. A critical component of this mandate is recommending to the Risk and Capital Committee of the Board a risk appetite that aligns with the objectives and strategy of the Company. The EC is accountable for establishing an appropriate "risk aware" culture and proactively monitoring actual exposures and business activities in comparison to risk appetite. The EC reviews and validates the Company's portfolio of key risk exposures through comprehensive risk reporting as well as by an ongoing risk identification and assessment process. Through this process, significant risks are identified in light of current business, market, and economic conditions, ensuring that the risks the Company manages and monitors are not static but evolving in context with the greatest likelihood of impact on the Company at any given point in time.

The most significant risks to the Company, described as principal risks and as reflected in the following diagram, are subject to more specific review, monitoring and assessment under the mandates of supporting risk committees. These committees (Credit Risk, Asset/Liability, Operational Risk, and Governance, Risk and Compliance) recommend policies and guidelines for approval as proposed by the lines of business, with concurrence from the ERM group, and proactively monitor and assess the specific risks under their mandates compared to the approved risk appetite. In addition to the Executive Committee and the supporting risk committees, the Company's risk governance is supported by:

- > The Chief Risk Officer and the ERM group. The ERM group is mandated to work with the executive team and the Board of Directors of the Company to support sustainable business performance through the independent identification, measurement, assessment and monitoring of all significant risks to the Company, regardless of source. Working closely with the Risk and Capital Committee, the ERM group recommends the Company's overall risk appetite and limits. It develops policies to address significant risks and recommends Board and/or management approval. ERM independently maintains a current view of the Company's risk profile by monitoring actual exposure and practice against approved risk appetite, limits, policies and guidelines.
- > The Chief Compliance Officer (CCO) and Chief Anti-Money Laundering Officer (CAMLO) and the Corporate Compliance group. The CCO/Corporate Compliance group is mandated to establish and maintain an independent enterprise-wide Compliance Framework (a set of controls and oversight processes) designed to mitigate the Company's Legislative and Regulatory Risk. The CCO/Corporate Compliance group is mandated to promote a sound compliance culture; report to the Company's Senior Management and the Board about compliance with the Company's legislative and regulatory requirements; follow up with Senior Management on breaches; and make recommendations related to the Compliance Framework activities. The CCO and CAMLO are responsible for expressing an independent opinion to the Audit Committee on the status, adequacy and effectiveness of the Company's state of compliance on a periodic basis.
- > The Senior Vice President, Internal Audit, and the Internal Audit department. Internal Audit is mandated to independently assess and report to the Audit Committee, the Board of Directors and management on the effectiveness of governance, risk management and internal control processes.

In order to integrate the Company's risk and control processes, management has formed the Governance, Risk and Compliance Committee to review and align the management structure, resources, processes and controls to match the size, complexity, scope, and risk profile of the organization. This committee makes recommendations to the Executive Committee to improve, operate and sustain all aspects of governance, risk and compliance.

### Stress Testing

In addition to the day-to-day risk management practices, a key component of the ERM framework is stress testing and scenario analysis. Management conducts regular stress testing, including annual stress testing through its internal capital adequacy assessment process and ad hoc stress testing to evaluate a range of extreme but plausible scenarios. Stress tests are conducted to determine the potential impact of these events, the effectiveness of management's contingency plans to deal with these unlikely but possible events, and management's ability to mitigate the potential risk. A common set of scenarios is developed to assess the impact on the Company's financial results, capital position, and operational capabilities to respond to the event. In particular, management has evaluated a range of economic scenarios, including a real estate-driven recession. Management analyzes the outcomes from stress testing and, where applicable, takes proactive measures to mitigate potential risks to the business.

### Principal Risks

The Company has identified seven principal risks that are material to the business: strategic, credit, market, funding and liquidity, operational, legislative and regulatory, and reputational risk. In addition to these principal risks, The Company employs a risk register to outline risk sub-categories and provide more detailed linkages to the specific risks inherent to, or taken by, the business. These risks are identified, measured, assessed, and monitored on an ongoing basis, with regular reporting to both management and the Board of Directors. Where appropriate, principal and sub-category risks are mitigated through various actions to reduce the inherent risk to acceptable residual levels, as defined by the Company's risk appetite. Strategic and reputational risks are considered overarching risks, as substantial outcomes from other principal risks could pose significant second order impact to the Company's reputation or ability execute strategic objectives.



### Strategic Risk

Strategic and business risk is the risk of loss due to changes in the external business environment, the failure of management to adjust its strategies and business activities for external events or business results, or the inability of the business to change its cost levels in response to those changes. Strategic and business risk is managed by the Executive Committee. On a regular basis, the Executive Committee reviews the current environment, the business results and the actions of the Company's competitors and adjusts business plans accordingly. The Board approves the Company's strategies at least annually and reviews results against those strategies at least quarterly.

# Management's Discussion and Analysis

## Credit Risk

Credit risk is the risk of the loss of principal and/or interest from the failure of debtors and/or counterparties to honour their financial or contractual obligations to the Company, for any reason. The Company's overall exposure to credit risk is governed by credit specific risk appetite limits and Credit Risk Policies as approved by the Board. The Credit Risk Committee establishes, implements and monitors credit risk related policies and guidelines enterprise-wide, taking into account business objectives, risk appetite, planned financial performance and risk profile. Credit risk limits are established for all types of credit exposures and include geographic, product, property and security type limits over all classes of exposure. The Company's risk management policy limits the total aggregate exposure to any entity or connection. The lines of business are responsible for managing the Company's credit risks in accordance with approved policies, and assessing overall credit conditions and exposures on an ongoing basis.

The Credit Risk Committee, the ERM group, and the Risk and Capital Committee of the Board oversee the credit portfolio through ongoing reviews of credit risk management policies, lending practices, portfolio composition and risk profile, the adequacy of loan loss reserves and credit-risk based capital.

At a transactional level, loans are independently approved by credit staff commensurate with their experience and expertise to extend credit within the bounds of the Company's credit risk policies. A foundation of the Company's approach to credit is a high level of due diligence on each individual transaction with oversight from a management team with strong industry experience. All transactions are subject to detailed reviews of the underlying security, an assessment of the applicant's ability to service the loan, and the application of a standard risk rating or credit score. Enhanced due diligence is conducted on transactions deemed to be higher credit risks based on pre-defined parameters. Transactions in excess of individual authority are approved by the Credit Risk Transactional Sub-Committee of the Credit Risk Committee and ultimately by the Risk and Capital Committee of the Board as required.

As part of credit risk management of the loan portfolio, senior management and the ERM group monitor various characteristics including the characteristics in the following table.

**Table 43: Credit Risk Portfolio Monitors**

	2012	2011
<i>(000s, except % and number of credit cards issued)</i>		
<b>Total loans balance (net of individual allowances)</b>	<b>\$ 16,882,514</b>	\$ 16,089,648
<b>Mortgage Portfolio<sup>1</sup></b>		
Total mortgage portfolio balance (net of individual allowance)	<b>\$ 16,283,021</b>	\$ 15,529,455
Residential mortgages as a percentage of total mortgages	<b>93.9%</b>	93.9%
Non-residential mortgages as a percentage of total mortgages	<b>6.1%</b>	6.1%
Percentage of insured residential mortgages	<b>50.6%</b>	61.0%
Percentage of mortgages current	<b>97.6%</b>	97.3%
Percentage of mortgages over 90 days past due	<b>0.4%</b>	0.4%
Percentage of insured residential mortgage originations	<b>19.3%</b>	26.1%
Loan to value of residential mortgages (current uninsured) <sup>2</sup>	<b>65.5%</b>	70.0%
<b>Credit Card Portfolio</b>		
Total credit card portfolio balance	<b>\$ 327,517</b>	\$ 386,912
Percentage of Equityline Visa credit cards	<b>96.9%</b>	97.8%
Percentage of secured credit cards	<b>3.0%</b>	2.2%
Percentage of credit cards current	<b>96.6%</b>	96.8%
Percentage of credit cards over 90 days past due	<b>1.1%</b>	1.4%
Loan to value of Equityline Visa (current) <sup>2</sup>	<b>69.9%</b>	71.3%
Visa card security deposits	<b>\$ 14,345</b>	\$ 13,219
Total authorized limits of credit cards	<b>\$ 403,110</b>	\$ 476,576
Total number of credit cards issued	<b>26,840</b>	26,560
Average balance authorized	<b>\$ 15</b>	\$ 18

<sup>1</sup> Residential mortgages include \$2.09 billion (2011 - \$2.19 billion) of multi-unit residential mortgages on properties with over four units and builders' inventory.

<sup>2</sup> Loan to value is calculated as the current balance outstanding to the appraised value at origination.



Credit risk mitigation is a key component of the Company's approach to credit risk management. The composition of the mortgage portfolio is well within the policy limits.

The Company mitigates credit risk on residential mortgages through collateral in the form of real property. At December 31, 2012, the current average loan to value ratio of the total portfolio, which includes both insured and uninsured mortgages, was 69.2% compared to 70.0% last year. These loan to value ratios reflect current outstanding mortgage amounts and were calculated under the assumption that, unless the collateral related to a specific mortgage was reappraised, the value of the collateral on each mortgage would remain at the original appraised amount.

Due to the level of activity and price appreciation in the high-rise condominium market in certain cities, the Company continues to closely monitor market conditions and the performance of this portfolio. High-rise condominiums represent approximately 7% of the residential portfolio and of these 46.6% are insured. The average current loan to value ratio of the portfolio is 64.9% compared to 69.2% for the entire residential portfolio. The credit performance of the portfolio remains strong with 97.6% of the portfolio current and 0.95% over 90 days in arrears.

The level of non-residential mortgages was relatively stable over the last twelve months. As a proportion of the total portfolio, the Company anticipates that the non-residential portfolio will remain relatively stable or exhibit modest growth in the foreseeable future. The Company slowly began increasing its exposure to non-residential mortgage lending in 2010 through early 2012 in proportion with growth in the overall asset portfolio. The proportion of residential to non-residential portfolios is well within the policy limits approved by the Board's Risk and Capital Committee and the Board of Directors.

Senior management and ERM closely monitor the credit performance of the mortgage loans portfolio. The portfolio continues to perform well, with arrears that are well within expected levels.

Personal and credit card loans were \$599.5 million or 3.5% of the total loan portfolio at December 31, 2012 compared to \$560.2 million or 3.5% at December 31, 2011. The gross credit card receivable balance was 54.6% of the personal and credit card loan portfolio, virtually all of which is secured by either cash deposits or residential property. Within the secured credit card portfolio, Equityline Visa credit cards represent the principal driver of receivable balances. Equityline Visa credit cards are secured by collateral residential mortgages, and this portfolio segment amounted to \$317.2 million, or 96.9% of the total credit card receivable balance at the end of 2012, compared to 97.8% at the end of 2011. Cash deposits for secured credit card accounts are included in the Company's deposit liabilities. Additionally, the Equityline Visa portfolio had a loan to value ratio of 69.9% at the end of 2012, compared to 71.3% at the end of 2011.

Retail credit is secured by charges on financed assets, principally improvements to residential property or fixtures, such as water heaters. Water heater loans are guaranteed by the gas supplier, a highly rated credit risk.

Senior management and ERM closely monitor the credit performance of the credit card portfolio. The portfolio continues to perform well, with arrears that are well within expected levels. At December 31, 2012, \$3.6 million or 1.1% of the credit card portfolio was over 90 days in arrears, compared to \$5.5 million or 1.4% at December 31, 2011. During the year, the Company launched its Preferred Visa card program, which offers unsecured Visa cards with relatively low authorized limits to the Company's mortgage customers with good credit performance. The Preferred Visa portfolio represents 0.04% of outstanding Visa balances at December 31, 2012.

Refer to Note 5(A) of the consolidated financial statements for a breakdown of the overall loan portfolio by geographic region. While the Company's overall strategy is to increase the geographic diversification of the loan portfolio, this has been tempered by credit conditions in some regional markets.

***Additional Information: Residential Loans and Equityline Visa (Home Equity Line of Credit)***

The tables below provide additional information on the composition of the Company's residential mortgage portfolio by province and insured status, as well as amortization periods and loan to value by province. Residential mortgages in these tables exclude multi-unit residential mortgages on properties with over four units and builders' inventory, which are included in residential mortgages in the calculations in the previous table and on the balance sheet.

All mortgages originated by the Company after July 2012 have amortization periods of 30 years or less.

For 2012 the Company's loan to value ratio for newly originated uninsured residential mortgages averaged 69.8%, with ratios varying depending on risk assessments related to specific markets. New Equityline Visa loans are restricted at 65% loan to value, and averaged 64.2% over the year.

# Management's Discussion and Analysis

**Table 44: Residential Loans by Province<sup>1</sup>**

As at December 31, 2012							
(000s, except %)	Insured Residential Mortgages <sup>2</sup>	Percentage of Total for Province	Uninsured Residential Mortgages	Percentage of Total for Province	Equityline Visa	Percentage of Total for Province	Total
British Columbia	\$ 472,791	55.7%	\$ 368,598	43.4%	\$ 7,821	0.9%	\$ 849,210
Alberta	409,836	58.3%	269,973	38.4%	23,539	3.3%	703,348
Ontario	3,935,164	35.2%	6,963,718	62.3%	281,545	2.5%	11,180,427
Quebec	303,979	57.1%	226,970	42.6%	1,531	0.3%	532,480
Atlantic provinces	120,197	52.1%	108,313	46.9%	2,214	1.0%	230,724
Other	13,815	51.4%	12,480	46.4%	586	2.2%	26,881
	<b>\$ 5,255,782</b>	<b>38.9%</b>	<b>\$ 7,950,052</b>	<b>58.8%</b>	<b>\$ 317,236</b>	<b>2.3%</b>	<b>\$13,523,070</b>

<sup>1</sup> Residential mortgages in this table are defined by OSFI and exclude multi-unit residential mortgages on properties with over four units and builders' inventory.

<sup>2</sup> Insured mortgages include mortgages insured by CMHC or other approved insurers at origination and mortgages that are portfolio insured post origination.

**Table 45: Insured and Uninsured Residential Mortgages by Amortization Period at Origination**

As at December 31, 2012							
(000s, except %)	Less than 20 Years	20 to 24 Years	25 to 29 Years	30 to 35 Years	Greater than 35 Years	Total	
Balance outstanding	\$ 83,969	\$ 147,862	\$ 1,884,491	\$ 8,809,584	\$ 2,279,928	\$13,205,834	
Percentage of total	0.6%	1.1%	14.3%	66.7%	17.3%	100.0%	

**Table 46: Average Loan to Value (LTV) Ratios for Uninsured Loans Originated During the Year**

2012					
(000s, except %)	Uninsured Residential Mortgages		Equityline Visa		
	Amount	LTV	Amount	LTV	
British Columbia	\$ 179,427	61.1%	\$ 921	55.7%	
Alberta	95,779	66.0%	826	54.0%	
Ontario	3,785,063	70.7%	73,955	64.7%	
Quebec	131,364	63.8%	585	55.7%	
Atlantic provinces	54,150	63.0%	412	49.6%	
Other	11,057	73.5%	100	56.1%	
<b>Total</b>	<b>\$ 4,256,840</b>	<b>69.8%</b>	<b>\$ 76,799</b>	<b>64.2%</b>	

**Table 47: Non-performing Loans**

(000s, except %)	2012		2011		Change	
	Gross	Net <sup>1</sup>	Gross	Net <sup>1</sup>	Gross	Net <sup>1</sup>
Residential mortgages	\$ 54,696	\$ 52,315	\$ 36,845	\$ 36,103	48.4%	44.9%
Non-residential mortgages	501	501	822	744	(39.1%)	(32.7%)
Personal and credit card loans	3,830	3,492	4,144	3,450	(7.6%)	1.2%
Non-performing loans	<b>\$ 59,027</b>	<b>\$ 56,308</b>	\$ 41,811	\$ 40,297	41.2%	39.7%
<b>Total gross loans</b>	<b>\$16,885,233</b>		\$16,091,162		4.9%	
Net non-performing loans						
as a % of gross loans		0.33%		0.25%		
Total allowance for credit losses	\$ 33,638		\$ 31,299			
Total allowance as a % of gross loans		0.20%		0.19%		
Total allowance as a % of gross non-performing loans		56.99%		74.86%		

<sup>1</sup> Non-performing loans are net of individual allowances as shown in Table 48, Allocation of Allowance for Credit Losses.

Net non-performing loans remain within expected and acceptable ranges. As part of the Company's ongoing business strategy, experienced employees, in conjunction with ERM, undertake reviews of all non-performing loans greater than 90 days to analyze patterns and drivers and then modify, where appropriate, the Company's lending guidelines. This analytical approach and attention to emerging trends have resulted in continued low write-offs relative to the gross loans portfolio. Write-offs, net of recoveries, totalled \$12.4 million or 0.07% of gross loans in 2012, compared to \$10.7 million or 0.07% of gross loans in 2011. The Company continually monitors arrears and write-offs and deals effectively with non-performing loans.

**Table 48: Allocation of Allowance for Credit Losses**

(000s)	2012 Opening Balance	Write-offs Net of Recoveries	Provision for Credit Losses	2012 Ending Balance
<b>Individual allowances</b>				
Residential mortgages	\$ 1,087	\$ (10,468)	\$ 12,681	\$ 3,300
Non-residential mortgages	78	-	(78)	-
Personal and credit card loans	694	(1,913)	1,557	338
	<b>1,859</b>	<b>(12,381)</b>	<b>14,160</b>	<b>3,638</b>
<b>Collective allowance</b>				
Residential mortgages	16,299	-	560	16,859
Non-residential mortgages	9,300	-	-	9,300
Personal and credit card loans	3,841	-	-	3,841
	<b>29,440</b>	<b>-</b>	<b>560</b>	<b>30,000</b>
<b>Total allowance for credit losses</b>	<b>\$ 31,299</b>	<b>\$ (12,381)</b>	<b>\$ 14,720</b>	<b>\$ 33,638</b>
<hr/>				
(000s)	2011 Opening Balance	Write-offs Net of Recoveries	Provision for Credit Losses	2011 Ending Balance
<b>Individual allowances</b>				
Residential mortgages	\$ 2,160	\$ (7,263)	\$ 6,190	\$ 1,087
Non-residential mortgages	-	-	78	78
Personal and credit card loans	3,140	(3,410)	964	694
	<b>5,300</b>	<b>(10,673)</b>	<b>7,232</b>	<b>1,859</b>
<b>Collective allowance</b>				
Residential mortgages	16,299	-	-	16,299
Non-residential mortgages	9,357	-	(57)	9,300
Personal and credit card loans	3,497	-	344	3,841
	<b>29,153</b>	<b>-</b>	<b>287</b>	<b>29,440</b>
<b>Total allowance for credit losses</b>	<b>\$ 34,453</b>	<b>\$ (10,673)</b>	<b>\$ 7,519</b>	<b>\$ 31,299</b>

The allowance for credit losses has been established to cover incurred losses and identified credit events in the loans portfolio.

Individual allowances represent the amount on identified non-performing loans required to reduce the carrying value of those loans to their estimated realizable amount. The balance will fluctuate from time to time and is driven by the performance of individual loans and the realizable value of the underlying security.

The collective allowance for credit losses is established for incurred losses inherent in the portfolio that are not presently identifiable on a loan-by-loan basis and reflects the relative risk of the various loan portfolios that the Company manages. The Company maintains a collective allowance that, in management's judgement, is sufficient to absorb probable incurred losses in its loans portfolio. At December 31, 2012 the Company held a collective allowance of \$30.0 million, marginally higher than the \$29.4 million held at December 31, 2011. The Company monitors the adequacy of the collective allowance on a monthly basis. The Company has security in the form of real property or cash deposits against loans, representing virtually the entire total loans portfolio. The Company's evaluation of the adequacy of the collective allowance takes into account asset quality, borrowers' creditworthiness, property location, past loss experience, current and forecasted probability of default and exposure at default based on product, risk ratings and credit scores, and current economic conditions. The Company periodically reviews the methods utilized in assessing the collective allowance, giving due consideration to changes in economic conditions, interest rates and local housing market conditions. The principal factors currently impacting the Company's assessment of the adequacy of the collective allowance are the improving employment environment in the Company's markets, the increased weighting of uninsured loans and the reduced loan to value ratio of the uninsured loan portfolios. For the most part, these considerations tend to offset each other, and the collective allowance has been increased marginally and continues to exceed two years of current year write-offs.

# Management's Discussion and Analysis

## 2013 Outlook for Credit Risk

Please refer to the 2013 Outlook for Provision and Allowance for Credit Losses section included in the Financial Performance Review section of this MD&A.

## Market Risk

For the Company, Market Risk consists primarily of Structural Interest Rate Risk and Investment Risk. A summary of these risks is as follows:

### Structural Interest Rate Risk

Structural interest rate risk is the risk of lost earnings or capital due to sudden changes in interest rates. The objective of interest rate risk management is to ensure that the Company is able to realize stable and predictable earnings over specific time periods despite interest rate fluctuations. The Company has adopted an approach to the management of its asset and liability positions to prevent interest rate fluctuations from materially impacting future earnings, and typically matches liabilities to assets in terms of maturity and interest rate repricing through its actions in the deposit market in priority to accessing off-balance sheet solutions.

The Company's market risk management framework includes interest rate risk policies, guidelines and procedures that are approved by the Asset/Liability Committee (ALCO) and the Risk and Capital Committee of the Board of Directors. The ALCO is responsible for defining and monitoring the Company's structural interest rate risk and reviewing significant maturity and/or duration mismatches, as well as developing strategies that allow the Company to operate within its overall risk appetite. In addition, the ALCO oversees stress testing of structural interest rate risk using a number of interest rate scenarios. The Treasury group is responsible for managing the Company's interest rate gaps in accordance with approved policies and assesses the impact of market events on the Company's net interest income and economic value of shareholders' equity. The ERM group recommends prudential policies and guidelines, and provides independent enterprise-wide oversight to all interest rate risk.

From time to time, the Company enters into interest rate derivative transactions in order to hedge its structural interest rate risk. The use of derivative products has been approved by the Board of Directors; however, permitted usage is governed by specific policies. Derivatives are only permitted in circumstances in which the Company is hedging asset-liability mismatches, or loan commitments, or as a result of hedging requirements under the terms of its participation in the CMB program. Moreover, the policy expressly articulates that use of derivatives is not permitted for transactions that are undertaken to potentially create trading profits through speculation on interest rate movements.

The interest rate sensitivity position as at December 31, 2012 is presented under Note 21 in the consolidated financial statements. The table in Note 21 represents positions at a point in time, and the gap represents the difference between assets and liabilities in each maturity category. This note summarizes assets and liabilities in terms of their contractual amounts. Over the lifetime of certain assets, some contractual obligations such as residential mortgages will be terminated prior to their stated maturity at the election of the borrower, by way of prepayments. Similarly, some contractual off-balance sheet mortgage commitments may be made but may not materialize. In measuring its interest rate risk exposure, the Company makes assumptions about these factors.

To assist in matching assets and liabilities, the Company utilizes two interest rate risk sensitivity metrics that measure the relationship between changes in interest rates and the resulting estimated impact on both the Company's future net interest income and economic value of shareholders' equity. The Company measures these metrics over a number of different yield curve scenarios.

The following table provides measurements of interest rate sensitivity and the potential after-tax impact of an immediate and sustained 100 basis-point increase and decrease in interest rates on net interest income and on the economic value of shareholders' equity.

As illustrated in the following table, an increase in interest rates will have a positive impact on net interest income after tax and the economic value of shareholder's equity in a 100 basis-point movement in rates without management action. A positive gap exists when interest-sensitive assets exceed interest-sensitive liabilities in specific maturity or repricing periods. As these gaps widen the fluctuation in the sensitivity becomes more pronounced and, for this reason, the Company's ALCO manages this to within authorized limits.

**Table 49: Impact of Interest Rate Shifts**

(000s)	Increase in interest rates		Decrease in interest rates	
	<b>December 31 2012</b>	December 31 2011	<b>December 31 2012</b>	December 31 2011
<b>100 basis point shift</b>				
Impact on net interest income, after tax (for the next 12 months)	\$ 12,614	\$ 8,142	\$ (12,614)	\$ (8,142)
Impact on net present value of shareholders' equity	<b>9,746</b>	4,175	<b>(11,447)</b>	(5,914)

**Investment Risk**

Investment risk is the risk of loss due to impairment in the fair value of investments.

The Company's investment risk management framework includes investment policies that are approved by the ALCO and the Risk and Capital Committee of the Board of Directors. The ALCO is responsible for defining and monitoring the Company's investment portfolio and identifying investments that may be at risk of impairment. The Treasury group is responsible for managing the Company's investment portfolio in accordance with approved policies and assesses the impact of market events on potential implications to its total value. ERM recommends prudential policies and guidelines, and provides independent enterprise-wide oversight of all investment risk, including valuations.

**Funding and Liquidity Risk**

This is the risk that the Company is unable to generate or obtain cash or equivalents in a timely manner and at a reasonable cost to meet its commitments (both on- and off-balance sheet) as they become due. This risk will arise from fluctuations in the Company's cash flows associated with lending, securitization, deposit-taking, investing and other business activities.

The Company's liquidity risk management framework includes funding and liquidity policies, guidelines and procedures that are approved by the ALCO and the Risk and Capital Committee of the Board of Directors. The mandate of the ALCO includes establishing and recommending to the Board an enterprise-wide liquidity risk appetite. In addition, the ALCO reviews the composition and term structure of assets and liabilities, reviews funding and liquidity policies and strategies and regularly monitors compliance with those policies. The ALCO also oversees the stress testing of funding and liquidity risk and the testing of the Company's Contingency Funding Plan. The Treasury group is responsible for managing the Company's funding and liquidity positions in accordance with approved policies and assesses the impact of market events on liquidity requirements on an ongoing basis. ERM recommends liquidity policies and guidelines, and provides independent enterprise-wide oversight of all funding and liquidity risk.

The Company's funding and liquidity policies are designed to ensure that cash balances and the inventory of other liquid assets are sufficient to meet all cash outflows both in ordinary market conditions and during periods of extreme market stress. The Company's policies address several key elements, such as the minimum levels of liquid assets to be held at all times; the composition of types of liquid assets to be maintained; daily monitoring of the liquidity position by Treasury, senior management, and the ERM group; monthly reporting to the ALCO; and quarterly reporting to the Risk and Capital Committee of the Board of Directors.

The Company uses a Net Cumulative Cash Flow (NCCF) liquidity horizon as its main liquidity metric. Using maturity gap analysis, the Company projects a time horizon when its NCCF turns negative, after taking into account the market value of its stock of liquid assets. The Company's liquidity horizon is calculated daily and is based upon contractual and behavioural cash flows. Forecasts are made using normal market conditions and a number of stressed liquidity scenarios, including ability to fund, loan growth, liquidity portfolio valuation, loan arrears and write-downs. In addition, the Company regularly monitors a number of other structural funding and liquidity ratios in its overall funding and liquidity risk management framework.

The Company holds liquid assets in the form of cash, bank deposits, securities issued or guaranteed by the Government of Canada, securities issued by provincial governments, and highly rated short-term money market securities and corporate bonds and debentures. At December 31, 2012, eligible liquid assets amounted to \$771.8 million, compared to \$808.2 million at December 31, 2011.

# Management's Discussion and Analysis

The Company's main sources of funding come from retail deposits and securitization. Retail deposits are primarily sourced through the deposit broker network. The majority of these deposits are received through channels that are controlled by several of the major Canadian banks. The broker network provides the Company access to a very large volume of potential deposits, which are sourced almost entirely from individual investors or small businesses, with no reliance on wholesale funding markets. The bulk of deposits raised are fixed-term Guaranteed Investment Certificates (GICs) that are not subject to early redemption. The Company has contractual agreements with over 240 independent brokers, including most major national investment dealers. The Company continues to add new brokers in order to diversify its sources of funds.

In 2012, Home Trust launched a high interest savings account offered only through financial advisors and investment and mutual fund dealers and commenced an advertising campaign aimed at building its direct deposits channel.

The Company is an approved NHA MBS issuer and an approved seller into the CMB program, which are securitization initiatives sponsored by CMHC. Securitization funding provides the Company with long-term matched funding at very attractive interest rates. Traditionally, the Company has used securitization markets to fund its Accelerator mortgages and insured multi-unit residential mortgages and, to a lesser extent, its traditional mortgages that qualified for bulk portfolio insurance. On-balance sheet Accelerator mortgages and multi-unit residential mortgages classified as held for sale are generally held for securitization and are funded with deposits until securitized. When mortgages are securitized, the Company receives principal and interest payments on its underlying mortgage loans before the required payments are passed-through to MBS investors. However, as a part of its servicing obligations, the Company must pass-through any payments that are not collected due to arrears on a timely basis. In the case of defaults, the Company would make required payments to investors and place the mortgage/property through the insurance claims process to recoup any losses. This may result in cash flow timing mismatches that may marginally increase funding and liquidity risk.

## Upcoming Basel Liquidity Requirements

In December 2010 the Basel Committee on Banking Supervisions published its international framework for liquidity measurements, standards and monitoring. The standard includes new liquidity measures, the details of which are not yet finalized. Based on the information provided to date the Company's conclusions about these requirements are as follows:

- > *Liquidity Coverage Ratio (LCR)* – effective January 1, 2015. The LCR establishes a common measure of liquidity risk and requires institutions to maintain sufficient liquid assets to cover a minimum of 30 days of cash flow requirements in a stress situation. As at December 31, 2012, the Company had sufficient liquid assets to meet the minimum LCR as currently described.
- > *Net Stable Funding Ratio (NSFR)* – effective January 1, 2018. The NSFR establishes a second common measure of liquidity based on longer term assets to longer term liabilities. As at December 31, 2012, the Company had sufficient long-term funding to meet the minimum NSFR as currently described.

## 2013 Outlook for Funding and Liquidity Risk

The Company will continue to source deposits from the public through investment dealers and deposit brokers while seeking to expand this network through agreements with additional brokers that meet the Company's selection criteria and through additional products that meet the requirements for CDIC coverage. The Company anticipates that the overall size of available deposits in this channel will continue to increase in the medium to long term. However, it is also anticipated that competition amongst issuers may increase, possibly resulting in increased funding costs. The Company will place a renewed emphasis on growing its direct channel and will continue to emphasize growth of its newly launched high interest savings account and by enhancing its direct channel sales and service capabilities. The rate of growth in the deposit portfolio is expected to mirror the growth of the Company's non-insured loan portfolio, while securitization will continue to support insured mortgages. Ensuring a reliable and sufficient source of deposits to fund operations and liquidity reserves will remain a key objective for the Company.

## Operational Risk

Operational risk, which is inherent in all business activities, is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal risk, but excludes strategic and reputational risk. The impact of operational risk may include financial loss, loss of competitive position, or regulatory enforcement actions, among others. It is an integral and unavoidable part of the Company's business as it is inherent in every business and support activity, product and service. While operational risk cannot be eliminated, the Company has taken proactive steps to mitigate this risk. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls. The Company strengthened its operational risk framework during 2012, with the addition of staff and methodologies. Key elements of the Company's operational risk framework include:

### ***Governance***

The Company maintains a system of comprehensive policies and an internal control framework designed to provide a sound and well-controlled operational environment. Operational risk policies are approved by the Risk and Capital Committee of the Board. A three line of defense model is used to manage operational risk, as described under Risk Governance. Oversight over the Company's operational risk exposures is also provided by the Operational Risk Committee.

### ***Risk Identification and Assessment***

In 2012, the risk control self-assessment program was enhanced to proactively identify the Company's exposure to key operational risks and to assess the effectiveness of mitigating controls. Risk assessments are also performed on significant new initiatives (e.g., products, services and systems) by business and support areas and other internal subject matter experts to ensure that associated risks are identified, assessed and approved and that the Company's control infrastructure can support the initiative prior to implementation.

### ***Risk Measurement***

The Company has adopted the Basic Indicator Approach for operational risk under Basel II. In addition, scenario analysis and stress testing are used to assess the possible impact of extreme but plausible operational risk loss events. Scenario analysis and stressing testing provide a forward-looking basis for managing exposures beyond the Company's risk appetite.

### ***Risk Monitoring and Reporting***

The Company monitors key risk indicators to gain assurance that it remains within its stated risk appetite and to identify early warning signals of changes in the risk environment, control effectiveness and potential risk issues before they crystallize and result in financial loss or other negative impact.

Operational losses, including near misses, are collected, analyzed and reported in order to reduce the likelihood of future recurrences and to strengthen risk management practices. The Company also proactively analyzes operational events in the industry and external environment to understand its exposure, if any, to similar events and takes steps to prevent such occurrences.

Operational risk issues and action plans across the Company are centrally captured, classified, monitored and reported upon.

Reporting and monitoring form an integral part of the Company's operational risk management processes, which are designed to ensure that risks and issues are identified, escalated and managed on a timely basis. Regular reporting is in place with respect to the Company's current and emerging operational risks, key risk indicators, operational loss events, external event analyses, issues management, new initiative risk assessment, crisis management preparedness and third-party risk management.

### ***Business Continuity and Crisis Management***

The Company is implementing an all-hazards-based business continuity and crisis management strategy to ensure minimal impact to the Company's clients and operations in the event of a disruption or other adverse event.

### ***Corporate Insurance***

The Company maintains insurance coverage through a financial institution bond policy, which is reviewed at least annually for changes to coverage and the Company's operations.

### ***Legislative and Regulatory Risk***

Legislative and Regulatory Risk refers to the risk of non-compliance with an applicable legislative or regulatory requirement (law, regulation, guideline, an undertaking to a regulatory authority or provision, section, subsection, order, term or condition). This includes requirements that have been identified by the Governance, Risk and Compliance Committee and Senior Management that require the Company to do certain things, including conducting its affairs in a particular manner, and where non-compliance could have an impact on the Company's reputation and/or safety and soundness.

While all business units of the Company (as the first line of defense) are responsible for ensuring that Legislative and Regulatory Risk is mitigated, the independent oversight of Legislative and Regulatory Risk is principally managed by the CCO, CAMLO and the Corporate Compliance group as part of the Company's Compliance Framework.

# Management's Discussion and Analysis

## **Reputational Risk**

Reputational risk is the risk that shareholders or the public will, with or without basis, judge the Company's operations or practices negatively, potentially resulting in a decline in its value, brand, liquidity, or customer base.

The Company views reputational risk as an exposure to earnings and/or capital from the consequence or failure to adequately manage any risk, regardless of the source, rather than a specific risk. Failure to effectively manage these risks can result in reduced market capitalization, loss of client loyalty, and the inability to achieve the Company's strategic objectives.

The most effective way for the Company to safeguard its public reputation is through the successful management of the underlying risks in the business. The Company aims to achieve this through the adoption of its ERM framework.

## **Risk Factors That May Affect Future Results**

In addition to the risks described in this Risk Management section, there are numerous other risk factors, in particular macroeconomic and industry factors beyond the Company's control, which could cause the Company's results to differ significantly from the Company's plans, objectives and estimates. All forward-looking statements, including those in this MD&A, are subject to inherent risks and uncertainties, general and specific, which may cause the Company's actual results to differ materially from the expectations expressed in the forward-looking statements. Some of these external factors are discussed below.

### ***Monetary and Fiscal Policy***

The Company's earnings are affected by the monetary policy of the Bank of Canada and the fiscal policy of the federal government of Canada and other governments in Canada and abroad. Changes in the supply of money, government spending and the general level of interest rates can affect the Company's profitability. A change in the level of interest rates affects the interest spread between the Company's deposits and loans and, as a result, impacts the Company's net interest income. Changes in monetary and fiscal policy and in the financial markets are beyond the Company's control and are difficult to predict or anticipate.

### ***Level of Competition***

The Company's performance is impacted by the level of competition in the markets in which it operates. The Company currently operates in a highly competitive industry. Customer retention can be influenced by many factors, such as the pricing of products or services, changes in customer service levels, changes in products or services offered, and general trends in consumer demand.

### ***Changes in Legislation and Regulations***

Changes in legislation and regulations, including interpretation or implementation, could affect the Company by limiting the scale and scope of its products and services. Also, the Company's failure to comply with its legislative and regulatory requirements could result in sanctions and financial penalties that could adversely impact the Company's earnings and damage its reputation and ability to operate as a regulated entity.

### ***Information Systems and Technology***

The Company is highly dependent upon its information technology systems. The Company uses third-party software and software that it has developed or modified for its main operations and relies on third parties for credit card processing, Internet connections and access to external networks. Should the Company experience any major disruptions in operations or connections of software, Internet or telecommunications for voice or data, this would impair its ability to provide service to clients. The longer and more severe the disruption, the more the Company's ability to conduct business would be impaired.

### ***Accounting Policies and Estimates Used by the Company***

The accounting policies and estimates the Company utilizes determine how the Company reports its financial condition and results of operations, and they may require management to make estimates or rely on assumptions about matters that are inherently uncertain. Such estimates and assumptions may require revisions, and changes to them may materially adversely affect the Company's results of operations and financial condition. More discussion is included in the Accounting Standards and Policies section and within the notes to the consolidated financial statements.

### ***Ability to Attract and Retain Employees and Executives***

The Company's future performance depends to a large extent on its ability to attract and retain key personnel. There is strong competition for the best people in the financial services sector. There is no assurance that the Company will be able to continue to attract and retain key personnel, although this remains a fundamental corporate priority.



## ACCOUNTING STANDARDS AND POLICIES

The significant accounting policies are outlined in Note 2 to the consolidated financial statements included in this report. These policies are critical as they refer to material amounts and require management to make estimates.

Critical accounting estimates that require management to make significant judgements, some of which are inherently uncertain, are outlined in Note 2 to the consolidated financial statements included in this report. These estimates are critical as they involve material amounts and require management to make determinations that, by their very nature, include uncertainties. The preparation of consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions, mainly concerning the valuation of items, which affect the amounts reported. Actual results could differ from those estimates. Key areas where management has made estimates and applied judgement include allowance for credit losses, fair values and impairment of financial instruments, goodwill and intangible assets, income taxes, fair value of stock options and useful lives of capital assets and intangible assets. In addition, the Company's management has applied judgement in the application of its accounting policy with respect to derecognition of the loans and other assets used in current securitization programs. Most loans and other assets are not derecognized, based on management's judgement that the Company has not transferred substantially all of the risks and rewards of ownership of the loans and other assets. Certain loans are recognized only to the extent of the Company's continuing involvement, based on management's judgement that it cannot be determined whether substantially all the risks and rewards of ownership have been transferred while control has been retained as defined by IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). Certain loans where residual interests in securitized transactions are sold are derecognized based on management's judgement that substantially all the risks and rewards of ownership have been transferred. Further information can be found under Notes 4, 5, 6, 8, 9, 10, 14, 16, 19 and 22 to the consolidated financial statements.

## ACCOUNTING DEVELOPMENTS

The following new IFRS pronouncements have been issued but are not yet effective and may have a future impact on the Company:

### ***IAS 1 Presentation of Financial Statements***

Beginning with the 2013 annual financial statements, the Company will be required to adopt amendments to IAS 1 *Presentation of Financial Statements*, which may result in changes in the way OCI is presented in the consolidated statement of income. However, it is not expected to result in material changes to the overall presentation of the Company's consolidated financial statements.

### ***IFRS 9 Financial Instruments***

As of January 1, 2015, the Company will be required to adopt IFRS 9, *Financial Instruments* (IFRS 9), which is the first phase of the International Accounting Standards Board's (IASB) project to replace IAS 39, *Financial Instruments: Recognition and Measurement*. IFRS 9 will provide new requirements for the way in which an entity should classify and measure financial assets and liabilities that are in the scope of IAS 39. The standard requires all financial assets to be classified on the basis of the entity's business model for managing such financial assets and the contractual cash flow characteristics of the financial assets. In September 2012, the IASB issued a review draft of the standard on general hedge accounting with a final standard expected to be issued during the first quarter of 2013. The general hedge accounting standard is intended to provide better links between an entity's risk management activities, the rationale for hedging and the impact of hedging on the financial statements. The standard will potentially simplify the Company's hedge accounting strategies. The impairment phase of the IASB's financial instruments project is currently under development. Management is currently evaluating the potential impact that the adoption of IFRS 9 will have on the Company's consolidated financial statements.

### ***IFRS 10 Consolidated Financial Statements***

As of January 1, 2013, the Company will be required to adopt IFRS 10 *Consolidated Financial Statements* (IFRS 10). Under IFRS 10, consolidated financial statements will include all controlled entities under a single control model. Management does not anticipate any material changes to the financial position or operating results upon adoption of IFRS 10.

### ***IFRS 13 Fair Value Measurement***

As of January 1, 2013, the Company will be required to adopt IFRS 13 *Fair Value Measurement* (IFRS 13). IFRS 13 establishes a single source of guidance for fair value measurements when fair value is required or permitted by IFRS and provides for enhanced disclosures when fair value is applied. The adoption of IFRS 13 is not expected to be material to the results of operations or financial position of the Company.

# Management's Discussion and Analysis

## CONTROLS OVER FINANCIAL REPORTING

### Disclosure Controls and Internal Control over Financial Reporting

Management is responsible for establishing the integrity and fairness of financial information presented in the consolidated financial statements prepared in accordance with Canadian generally accepted accounting principles. As such, management has established disclosure controls and procedures and internal controls over financial reporting to ensure that the Company's consolidated financial statements and Management's Discussion and Analysis present fairly, in all material respects, the financial position of the Company and the results of its operations.

### Disclosure Controls and Procedures

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the Chief Executive Officer and Chief Financial Officer, on a timely basis so that appropriate decisions can be made regarding public disclosure.

An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures was conducted as of December 31, 2012. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures, as defined by National Instrument 52-109 Certificate of Disclosure in Issuers' Annual and Interim Filing, were effective as of December 31, 2012.

### Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The Company's internal control over financial reporting includes policies and procedures that:

- > Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- > Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and receipts and expenditures are being made in accordance with authorizations of management and the Board of Directors of the Company; and
- > Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Due to inherent limitations, internal controls over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. As a result, the Company's management acknowledges that its internal control over financial reporting will not prevent or detect all misstatements due to error or fraud. Furthermore, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of a change in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

The Company has used the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework and COBIT, an IT governance framework, to evaluate the design of the Company's internal controls over financial reporting.

An evaluation of the design and operating effectiveness of internal controls over financial reporting was conducted as of December 31, 2012. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's internal controls over financial reporting were operating effectively as of December 31, 2012.

### Changes in Internal Control over Financial Reporting

During the year, management identified and subsequently implemented certain changes to accounting processes and procedures. The material changes in processes and procedures relate to accounting for the sale of residual interests (interest only strips) related to certain securitizations.

As a result of these changes to accounting process and procedures, management revised existing internal controls and designed and implemented new internal controls over financial reporting to provide reasonable assurance that the risk of material misstatements in the Company's financial reporting has been mitigated.

There were no other changes that have affected or could reasonably be expected to materially affect internal control over financial reporting.

### Comparative Consolidated Financial Statements

The comparative audited consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2012 audited consolidated financial statements.

## NON-GAAP MEASURES AND GLOSSARY

### Non-GAAP Measures

The Company uses a number of financial measures to assess its performance. Some of these measures are not calculated in accordance with GAAP, are not defined by GAAP, and do not have standardized meanings that would ensure consistency and comparability between companies using these measures. The non-GAAP measures used in this MD&A are defined as follows:

#### *Return on Shareholders' Equity*

Return on equity is a profitability measure that presents the net income available to common shareholders as a percentage of the capital deployed to earn the income. The Company calculates its return on shareholders' equity using average common shareholders' equity, including all components of shareholders' equity.

#### *Return on Assets*

Return on assets is a profitability measure that presents the annualized net income as a percentage of the average total assets for the period deployed to earn the income.

#### *Efficiency or Productivity Ratio*

Management uses the efficiency ratio as a measure of the Company's efficiency in generating revenue. This ratio represents non-interest expenses as a percentage of total revenue, net of interest expense. The Company also looks at the same ratio on a taxable equivalent basis and will include this adjustment in arriving at the efficiency ratio, on a taxable equivalent basis. A lower ratio indicates better efficiency.

#### *Tier 1 and Total Capital Ratios*

The capital ratios provided in this MD&A are those of the Company's wholly owned subsidiary Home Trust Company. The calculations are in accordance with guidelines issued by OSFI. Refer to Note 14(l) to the consolidated financial statements included in this report.

#### *Assets to Capital Multiple*

The multiple reflects total assets, including specified off-balance sheet items net of other specified deductions, divided by regulatory Total capital.

#### *Taxable Equivalent Basis (TEB)*

Most banks and trust companies analyze and discuss their financial results on a taxable equivalent basis (TEB) to provide uniform measurement and comparison of net interest income. Net interest income (as presented in the consolidated statements of income) includes tax-exempt income principally from preferred and common equity securities. The adjustment to TEB used in this MD&A increases income and the provision for income taxes to what they would have been had the income from tax-exempt securities been taxed at the statutory tax rate. TEB adjustments of \$5.0 million for 2012 (\$7.2 million in 2011) increased interest income as used in the calculation of net interest margin. TEB does not have a standard meaning prescribed by GAAP and therefore may not be comparable to similar measures used by other companies. Net interest margin is discussed on a TEB throughout this MD&A. See Table 5 for the calculation of net interest income on a tax equivalent basis.

#### *Net Interest Margin (TEB)*

Net interest margin is calculated by taking net interest income, on a taxable equivalent basis, divided by the average total assets generating the interest income.

#### *Net Interest Margin (Non-TEB)*

Net interest margin is calculated by taking net interest income divided by the average total assets generating the interest income.

# Management's Discussion and Analysis

## Glossary of Financial Terms

**Assets or Loans under Administration** refer to assets or loans administered by a financial institution that are beneficially owned by clients and therefore not reported on the balance sheet of the administering financial institution, plus all assets or loans beneficially owned by the Company and carried on the balance sheets.

**Average Earning Assets** represents the monthly average balance of deposits with other banks and loans and securities over a relevant period.

**Basis Point** is one-hundredth of a percentage point.

**Canada Deposit Insurance Corporation (CDIC)** is a Canadian federal Crown corporation created to protect deposits made with member financial institutions in case of their failure.

**Collective Allowance** (previously referred to as the General Allowance) is established for incurred losses inherent in the portfolio that are not presently identifiable on a loan-by-loan basis and reflects the relative risk of the various loan portfolios that the Company manages. The Company's evaluation of the adequacy of the collective allowance takes into account asset quality, borrowers' creditworthiness, property location, past loss experience, current and forecasted probability of default and exposure at default based on product, risk ratings and credit scores, and current economic conditions. The Company periodically reviews the methods utilized in assessing the collective allowance, giving due consideration to changes in economic conditions, interest rates and local housing market conditions.

**Derivatives** used by the Company are contracts whose value is "derived" from movements in interest rates. Derivatives allow for the transfer, modification or reduction of current or expected risks from changes in rates.

**Forwards** used by the Company are contractual agreements to either buy or sell a specified amount of an interest-rate-sensitive financial instrument or security at a specific price and date in the future. Forwards are customized contracts transacted in the over-the-counter market.

**Hedging** is a risk management technique used by the Company to neutralize, manage or offset interest rate, equity, or credit exposures arising from normal banking activities.

**Impaired or Non-performing Loans** are loans for which there is no longer reasonable assurance of the timely collection of principal or interest.

**Individual Allowances** (previously referred to as Specific Allowances) reduce the carrying value of individual credit assets to the amount expected to be recovered if there is evidence of deterioration in credit quality.

**Insured Loans** are loans insured against default by CMHC or another approved insurer. The Company's insured lending includes single family homes and multi-residential properties.

**Net Interest Income** is comprised of earnings on assets, such as loans and securities, including interest and dividend income, less interest expense paid on liabilities, such as deposits.

**Notional Amount** refers to the principal used to calculate interest and other payments under derivative contracts. The principal does not change hands under the terms of a derivative contract.

**Office of the Superintendent of Financial Institutions Canada (OSFI)** is the government agency responsible for regulating banks, insurance companies, trust companies, loan companies and pension plans in Canada.

**Provision for Credit Losses** is a charge to income that represents an amount deemed adequate by management to fully provide for impairment in a portfolio of loans and other credit instruments, given the composition of the portfolio, the probability that default has occurred, the economic environment and the allowance for credit losses already established.

**Securitization** is the practice of selling pools of contractual debts, such as residential or commercial mortgages, to third parties.

**Swaps** are contractual agreements between two parties to exchange a series of cash flows. The only type of swap agreements used by the Company are interest rate swaps where counterparties generally exchange fixed-rate and floating-rate interest payments based on a notional value in a single currency.

**Tier 1 Capital** is primarily comprised of regulatory common equity and certain qualifying instruments.

**Tier 2 Capital** is primarily comprised of subordinated debentures and a portion of the collective allowance for credit losses.

**Total Capital** includes Tier 1 and Tier 2 capital, net of certain deductions.

# Consolidated Financial Statements

## CONSOLIDATED FINANCIAL STATEMENTS

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## Management's Responsibility for Financial Information

The consolidated financial statements of Home Capital Group Inc. were prepared by management, which is responsible for the integrity and fairness of the financial information presented. The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles for publicly accountable enterprises, which are International Financial Reporting Standards as issued by the International Accounting Standards Board, including the accounting requirements specified by the Office of the Superintendent of Financial Institutions Canada that apply to its subsidiary Home Trust Company. The financial statements reflect amounts which must, of necessity, be based on the best estimates and judgement of management with appropriate consideration as to materiality. The financial information presented elsewhere in this report is consistent with that in the financial statements.

Management is responsible for ensuring the fairness and integrity of the financial information. It is also responsible for the implementation of the supporting accounting systems. In discharging its responsibilities, management maintains the necessary internal control system designed to provide assurance that the transactions are properly authorized, assets are safeguarded and proper accounting records are held. The controls include quality standards in hiring and training of employees, written policies, authorized limits for managers, procedure manuals, a corporate code of business conduct and ethics and appropriate management information systems.

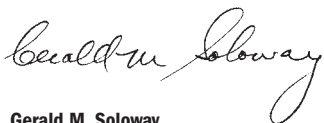
The internal control systems are further supported by a compliance function, which ensures that the Company and its employees comply with all regulatory requirements, as well as by an enterprise risk function that ensures proper risk control, related documentation and the measurement of the financial impact of risks. In addition, the internal audit function periodically assesses various aspects of the Company's operations and makes recommendations to management for, among other things, improvements to the control systems.

Every year, the Office of the Superintendent of Financial Institutions Canada makes such examinations and inquiries as deemed necessary to satisfy itself that Home Trust Company is in a sound financial position and that it complies with the provisions of the Trust and Loan Companies Act (Canada).

Ernst & Young LLP, independent auditors, appointed by the shareholders, perform an annual audit of the Company's consolidated financial statements, and their report follows.

The internal auditors, the chief compliance officer, the external auditors and the Office of the Superintendent of Financial Institutions Canada meet periodically with the Audit Committee, with management either present or absent, to discuss all aspects of their duties and matters arising therefrom.

The Board of Directors is responsible for reviewing and approving the financial statements and Management's Discussion and Analysis of results of operations and financial condition appearing in the Annual Report. It oversees the manner in which management discharges its responsibilities for the presentation and preparation of financial statements, maintenance of appropriate internal controls, risk management as well as assessment of significant transactions and related party transactions through its Audit Committee. The Audit Committee is composed solely of Directors who are not Officers or employees of the Company.



**Gerald M. Soloway**  
Chief Executive Officer  
Toronto, Canada  
February 13, 2013



**Robert Blowes, CPA, C.A.**  
Chief Financial Officer

# Independent Auditors' Report

To the Shareholders of **Home Capital Group Inc.**

We have audited the accompanying consolidated financial statements of Home Capital Group Inc., which comprise the consolidated balance sheets as at December 31, 2012 and 2011, and the consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years ended December 31, 2012 and 2011, and a summary of significant accounting policies and other explanatory information.

## **Management's responsibility for the consolidated financial statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

## **Auditors' responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

## **Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Home Capital Group Inc. as at December 31, 2012 and 2011, and its financial performance and its cash flows for the years ended December 31, 2012 and 2011 in accordance with International Financial Reporting Standards.

*Ernst + Young LLP*

Toronto, Canada  
February 13, 2013

Chartered Accountants  
Licensed Public Accountants

# Consolidated Balance Sheets

	December 31 2012	December 31 2011
As at		
thousands of Canadian dollars		
<b>ASSETS</b>		
<b>Cash Resources and Restricted Cash</b> (note 4(A))	<b>\$ 439,287</b>	\$ 665,806
<b>Securities</b> (notes 4(B) and (C))		
Available for sale	<b>414,344</b>	391,754
Pledged securities (notes 4(B) and 6(C))	<b>843,547</b>	341,588
	<b>1,257,891</b>	733,342
<b>Loans Held for Sale</b>	<b>21,921</b>	-
Loans (note 5)		
Residential mortgages	<b>8,843,923</b>	6,339,883
Securitized residential mortgages (note 6)	<b>6,450,682</b>	8,243,350
Non-residential mortgages	<b>988,416</b>	946,222
Personal and credit card loans	<b>599,493</b>	560,193
	<b>16,882,514</b>	16,089,648
Collective allowance for credit losses (note 5(E))	<b>(30,000)</b>	(29,440)
	<b>16,852,514</b>	16,060,208
<b>Other</b>		
Derivative assets (note 19)	<b>45,388</b>	72,424
Other assets (note 7)	<b>94,405</b>	79,650
Capital assets (note 8)	<b>6,578</b>	5,372
Intangible assets (note 9)	<b>66,343</b>	63,917
Goodwill (note 10)	<b>15,752</b>	15,752
	<b>228,466</b>	237,115
	<b>\$18,800,079</b>	\$17,696,471
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
<b>Deposits</b> (note 11)		
Deposits payable on demand	<b>\$ 105,923</b>	\$ 75,965
Deposits payable on a fixed date	<b>10,030,676</b>	7,846,159
	<b>10,136,599</b>	7,922,124
<b>Senior Debt</b> (note 12)	<b>150,684</b>	153,336
<b>Securitization Liabilities</b> (notes 6(D) and (E))		
Mortgage-backed security liabilities	<b>1,301,693</b>	2,417,801
Canada Mortgage Bond liabilities	<b>6,034,202</b>	6,231,274
	<b>7,335,895</b>	8,649,075
<b>Other</b>		
Derivative liabilities (note 19)	<b>2,386</b>	3,458
Income taxes payable	<b>21,912</b>	17,628
Other liabilities (note 13)	<b>148,590</b>	136,025
Deferred tax liabilities (note 16(C))	<b>35,800</b>	40,040
	<b>208,688</b>	197,151
	<b>17,831,866</b>	16,921,686
<b>Shareholders' Equity</b>		
Capital stock (note 14)	<b>61,903</b>	55,104
Contributed surplus	<b>6,224</b>	5,873
Retained earnings	<b>903,831</b>	722,999
Accumulated other comprehensive loss (note 15)	<b>(3,745)</b>	(9,191)
	<b>968,213</b>	774,785
	<b>\$18,800,079</b>	\$17,696,471

## Commitments and Contingencies (note 18)

The accompanying notes are an integral part of these consolidated financial statements.

On behalf of the Board:



**Gerald M. Soloway**  
Chief Executive Officer



**Robert A. Mitchell**  
Chair of Audit Committee



# Consolidated Statements of Income

	For the year ended	
	December 31 2012	December 31 2011
thousands of Canadian dollars, except per share amounts		
<b>Net Interest Income Non-Securitized Assets</b>		
Interest from loans	\$ 525,722	\$ 400,997
Dividends from securities	14,171	18,417
Other interest	4,019	5,487
	<b>543,912</b>	424,901
Interest on deposits	230,006	192,357
Interest on senior debt	6,831	4,364
Net interest income non-securitized assets	<b>307,075</b>	228,180
<b>Net Interest Income Securitized Loans and Assets</b>		
Interest income from securitized loans and assets	287,871	330,491
Interest expense on securitization liabilities	213,474	224,719
Net interest income securitized loans and assets	<b>74,397</b>	105,772
<b>Total Net Interest Income</b>	<b>381,472</b>	333,952
Provision for credit losses (note 5(E))	14,720	7,519
	<b>366,752</b>	326,433
<b>Non-interest Income</b>		
Fees and other income	43,994	37,997
Securitization income (note 6(B))	8,131	-
Net realized and unrealized (losses) gains on securities and mortgages	(71)	4,088
Net realized and unrealized gain (loss) on derivatives (note 19)	3,848	(7,203)
	<b>55,902</b>	34,882
	<b>422,654</b>	361,315
<b>Non-interest Expenses</b>		
Salaries and benefits	58,956	52,523
Premises	8,833	7,776
Other operating expenses	54,946	44,703
	<b>122,735</b>	105,002
<b>Income Before Income Taxes</b>	<b>299,919</b>	256,313
Income taxes (note 16(A))		
Current	82,176	66,270
Deferred	(4,240)	(37)
	<b>77,936</b>	66,233
<b>NET INCOME</b>	<b>\$ 221,983</b>	\$ 190,080
<b>NET INCOME PER COMMON SHARE</b> (note 14(H))		
Basic	\$ 6.40	\$ 5.48
Diluted	\$ 6.38	\$ 5.46
<b>AVERAGE NUMBER OF COMMON SHARES OUTSTANDING</b> (note 14(H))		
Basic	34,692	34,677
Diluted	34,820	34,787
Total number of outstanding common shares (note 14(B))	<b>34,630</b>	34,625
Book value per common share	<b>\$ 27.96</b>	\$ 22.38

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statements of Comprehensive Income

	For the year ended	
thousands of Canadian dollars	December 31 2012	December 31 2011
<b>NET INCOME</b>	<b>\$ 221,983</b>	<b>\$ 190,080</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>		
<b>Available for Sale Securities</b> (note 4(C))		
Net unrealized gains (losses) on securities available for sale	6,462	(8,602)
Net gains reclassified to net income	(114)	(4,815)
	<b>6,348</b>	(13,417)
Income tax expense (recovery)	1,775	(3,370)
	<b>4,573</b>	(10,047)
<b>Cash Flow Hedges</b> (note 19)		
Net unrealized losses on cash flow hedges	(370)	(7,386)
Net losses reclassified to net income	1,462	618
	<b>1,092</b>	(6,768)
Income tax expense (recovery)	219	(1,718)
	<b>873</b>	(5,050)
Total other comprehensive income (loss)	<b>5,446</b>	(15,097)
<b>COMPREHENSIVE INCOME</b>	<b>\$ 227,429</b>	<b>\$ 174,983</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Consolidated Statements of Changes in Shareholders' Equity

thousands of Canadian dollars, except per share amounts	Capital Stock	Contributed Surplus	Retained Earnings	Net Unrealized (Losses) Gains on Securities Available for Sale, After Tax	Net Unrealized Losses on Cash Flow Hedges, After Tax	Total Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
Balance at December 31, 2011	\$ 55,104	\$ 5,873	\$ 722,999	\$ (4,141)	\$ (5,050)	\$ (9,191)	\$ 774,785
Comprehensive income	-	-	221,983	4,573	873	5,446	227,429
Stock options settled (note 14(B))	7,088	(1,408)	-	-	-	-	5,680
Amortization of fair value of employee stock options (note 14(D))	-	1,759	-	-	-	-	1,759
Repurchase of shares (note 14(C))	(289)	-	(7,828)	-	-	-	(8,117)
Dividends paid (\$0.90 per share)	-	-	(33,323)	-	-	-	(33,323)
<b>Balance at December 31, 2012</b>	<b>\$ 61,903</b>	<b>\$ 6,224</b>	<b>\$ 903,831</b>	<b>\$ 432</b>	<b>\$ (4,177)</b>	<b>\$ (3,745)</b>	<b>\$ 968,213</b>
Balance at December 31, 2010	\$ 50,427	\$ 4,571	\$ 567,681	\$ 5,906	\$ -	\$ 5,906	\$ 628,585
Comprehensive income	-	-	190,080	(10,047)	(5,050)	(15,097)	174,983
Stock options settled (note 14(B))	4,921	(1,098)	-	-	-	-	3,823
Amortization of fair value of employee stock options (note 14(D))	-	2,400	-	-	-	-	2,400
Repurchase of shares (note 14(C))	(244)	-	(7,702)	-	-	-	(7,946)
Dividends paid (\$0.76 per share)	-	-	(27,060)	-	-	-	(27,060)
Balance at December 31, 2011	\$ 55,104	\$ 5,873	\$ 722,999	\$ (4,141)	\$ (5,050)	\$ (9,191)	\$ 774,785

The accompanying notes are an integral part of these consolidated financial statements.

# Consolidated Statements of Cash Flows

	For the year ended	
	December 31 2012	December 31 2011
thousands of Canadian dollars		
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income for the year	\$ 221,983	\$ 190,080
Adjustments to determine cash flows relating to operating activities:		
Deferred income taxes	(4,240)	(37)
Amortization of capital assets	3,118	3,052
Amortization of intangible assets	6,715	679
Amortization of net premium (discount) on securities	2,460	(49)
Amortization of securitization and senior debt transaction costs	13,396	14,153
Provision for credit losses	14,720	7,519
Change in accrued interest payable	13,519	4,993
Change in accrued interest receivable	(5,449)	(6,686)
Net realized and unrealized losses (gains) on securities and mortgages	71	(4,088)
Realized gain on securitization	(8,131)	-
Settlement of derivatives	(370)	(7,385)
(Gain) loss on derivatives	(3,848)	7,203
Net increase in mortgages	(1,687,717)	(1,897,308)
Net increase in personal and credit card loans	(40,858)	(107,817)
Net increase in deposits	2,214,475	1,326,145
Activity in securitization liabilities		
Proceeds from sale of mortgage-backed securities	242,009	-
Proceeds from securitization of mortgage-backed security liabilities	641,696	1,233,754
Settlement and repayment of securitization liabilities	(1,278,521)	(753,085)
Amortization of fair value of employee stock options	1,759	2,400
Changes in taxes payable and other	(6,732)	23,293
Cash flows provided by operating activities	340,055	36,816
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Repurchase of shares	(8,117)	(7,946)
Exercise of employee stock options	5,680	3,823
Issuance of senior debt	-	149,052
Dividends paid to shareholders	(31,244)	(26,371)
Cash flows (used in) provided by financing activities	(33,681)	118,558
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in securities		
Purchases	(4,291,902)	(1,641,985)
Proceeds from sales	381,049	389,978
Proceeds from maturities	3,391,425	935,824
Purchases of capital assets	(4,324)	(3,530)
Purchases of intangible assets	(9,141)	(16,679)
Cash flows used in investing activities	(532,893)	(336,392)
Net decrease in cash resources and restricted cash during the year	(226,519)	(181,018)
Cash resources and restricted cash at beginning of the year	665,806	846,824
<b>Cash Resources and Restricted Cash at End of the Year</b> (note 4(A))	<b>\$ 439,287</b>	<b>\$ 665,806</b>
<b>Supplementary Disclosure of Cash Flow Information</b>		
Dividends received on investments	\$ 12,626	\$ 17,318
Interest received	518,537	725,476
Interest paid	223,318	416,764
Income taxes paid	87,184	36,636

The accompanying notes are an integral part of these consolidated financial statements.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## NOTE 1 CORPORATE INFORMATION

Home Capital Group Inc. (the Company) is a public corporation traded on the Toronto Stock Exchange. The Company is incorporated and domiciled in Canada with its registered and principal business offices located at 145 King Street West, Suite 2300, Toronto, Ontario. The Company operates primarily through its federally regulated subsidiary, Home Trust Company (Home Trust), which offers deposits, residential and non-residential mortgage lending, securitization of insured residential first mortgage products, consumer lending and credit card products. The Company's subsidiary, Payment Services Interactive Gateway Inc. (PSiGate), provides payment card services. Licensed to conduct business across Canada, Home Trust has branch offices in Ontario, Alberta, British Columbia, Nova Scotia, Quebec and Manitoba. The Company is the ultimate parent of the group.

These consolidated financial statements for the year ended December 31, 2012 were authorized for issuance by the Board of Directors (the Board) of the Company on February 13, 2013. The Board has the power to amend the consolidated financial statements after their issuance only in the case of discovery of an error.

Subsequent to the end of the year and before the date these consolidated financial statements were authorized for issuance, the Board declared a quarterly cash dividend of \$9.0 million or \$0.26 per common share payable on March 1, 2013 to shareholders of record at the close of business on February 25, 2013.

## NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) for publicly accountable enterprises which are International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

The accounting policies were consistently applied to all periods presented unless otherwise noted. The significant accounting policies used in the preparation of these consolidated financial statements are summarized below.

### Use of Judgement and Estimates

Management has exercised judgement in the process of applying the Company's accounting policies. In particular, the Company's management has applied judgement in the application of its accounting policy with respect to derecognition of the loans and other assets used in current securitization programs. Most loans and other assets are not derecognized, based on management's judgement that the Company has not transferred substantially all of the risks and rewards of ownership of the loans and other assets. Certain loans are recognized only to the extent of the Company's continuing involvement, based on management's judgement that it cannot be determined whether substantially all the risks and rewards of ownership have been transferred while control has been retained as defined by IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). Certain loans where residual interests in securitized transactions are sold are derecognized based on management's judgement that substantially all the risks and rewards of ownership have been transferred.

The preparation of consolidated financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the consolidated balance sheet date and the reported amounts of revenue and expenses during the reporting period. Key areas where management has made estimates include allowance for credit losses, fair values and impairment of financial instruments, goodwill and intangible assets, income taxes, fair value of stock options and useful lives of capital assets and intangible assets. Actual results could differ from those estimates.

### Principles of Consolidation

The consolidated financial statements include the assets, liabilities and results of operations of the Company and all of its subsidiaries, after the elimination of intercompany transactions and balances.

Subsidiaries are entities the Company controls. The Company has control when it has the power to govern the financial and operating policies of the entity. The subsidiaries included in the consolidated financial statements are Home Trust and PSiGate, both of which are wholly owned.

The Company consolidates special purpose entities (SPEs) if the substance of the relationship with the Company and the SPE's risks and rewards indicate that the Company has control over the SPE. The Company is the sole beneficiary of an SPE and accordingly, the SPE is consolidated and its assets are included in residential mortgages on the consolidated balance sheets.

### **Cash Resources and Restricted Cash**

For the purposes of the consolidated financial statements, cash and cash equivalents comprise balances with less than 90 days to maturity from the date of acquisition, including cash and deposits with regulated financial institutions, treasury bills and other eligible deposits. Cash and deposits are carried at amortized cost. Interest income is recognized in income using the effective interest rate method and, to the extent not received at year end, recorded as a receivable in other assets on the consolidated balance sheets.

### **Securities**

Securities are classified as either held for trading or available for sale, based on management's intentions. On the trade date, all securities are recognized at their fair value, which is normally the transaction price.

Held for trading securities are financial assets purchased for resale, generally within a short period of time and primarily held for liquidity purposes. Interest earned is included in other interest income. Held for trading securities are measured at fair value, using published bid prices, as at the consolidated balance sheet date. All realized and unrealized gains and losses are reported in income under non-interest income. Transaction costs are expensed as incurred. The Company has not elected under the fair value option to designate any financial asset or liability as held for trading.

Available for sale securities are financial assets purchased for longer-term investment that may be sold in response to or in anticipation of changes in market conditions. Dividends and interest earned are included in dividends from securities or other interest income. Available for sale securities are measured at their fair value, using published bid prices, as at the consolidated balance sheet date. Unrealized gains and losses, net of related taxes, are included in accumulated other comprehensive income (AOCI) until the security is sold or an impairment loss is recognized, at which time the cumulative gain or loss is transferred to net income. Transaction costs are capitalized.

At the end of each reporting period, the Company conducts a review to assess whether there is any objective evidence that an available for sale security is impaired. Objective evidence of impairment results from one or more events that occur after the initial recognition of the security and which event (or events) has an impact that can be reliably estimated on the estimated future cash flows of the security. Such objective evidence includes observable data that comes to the attention of the Company such as significant financial difficulty of the issuer of the security. In the case of equity securities, objective evidence of impairment includes a significant or prolonged decline in the fair value of the security below its cost. The determination of what is significant or prolonged is based on management's judgement. Generally, management considers a significant decline to be 20% or more and a prolonged decline to be 12 months or more.

When there is objective evidence of an impairment of an available for sale security, any cumulative loss that has been recognized in other comprehensive income (OCI) is reclassified from AOCI to net income. The amount of the cumulative loss reclassified is the difference between the acquisition cost (net of any principal repayment, amortization and cumulative losses recognized in net income) and current fair value. In the case of debt securities, subsequent increases in fair value that can be objectively related to an event occurring after the impairment loss was recognized result in a reversal of the impairment loss through net income. Impairment losses on equity securities are not subsequently reversed through net income.

### **Obligations Related to Securities Sold Under Repurchase Agreements**

The purchase and sale of securities under sale and repurchase agreements are accounted for as collateralized lending and borrowing transactions and are recorded at cost. The related interest income and interest expense are recorded on an accrual basis in the consolidated statement of income.

### **Loans Held for Securitization and Sale**

Loans for which the Company has the intention of securitizing and derecognizing from the consolidated balance sheet in the near term are classified as held for trading for accounting purposes and are carried at fair value. Unrealized gains and losses resulting from the change in fair value of these loans are reported in net realized and unrealized gains or losses on securities and mortgages. Interest income earned on these loans is included in interest from loans. The fair value of loans held for trading is determined by discounting the expected future cash flows of the loans at market rates for financial instruments with similar terms and credit risk.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## Loans

Loans are recorded at amortized cost using the effective interest rate method. Interest income is allocated over the expected term of the loan by applying the effective interest rate to the carrying amount of the loan. The effective interest rate is the rate that exactly discounts estimated future cash receipts over the expected life of the loan. Origination revenues and costs are applied to the carrying amount of the loan.

Loans are carried net of the individual allowance for credit losses and any unearned income.

Interest income is accrued as earned with the passage of time and continues to accrue when a loan is considered impaired (with an appropriate allowance for credit loss as discussed below).

A loan is recognized as being impaired (non-performing) when the Company is no longer reasonably assured of the timely collection of the full amount of principal and interest. As a matter of practice, a loan is deemed to be impaired at the earlier of the date it has been individually provided for or when it has been in arrears for 90 days. Residential mortgages (including securitized residential mortgages) guaranteed by the Government of Canada are not considered impaired until payment is contractually 365 days past due. As securitized residential mortgages are insured, credit losses are not anticipated on this portfolio. Secured and unsecured credit card balances that have a payment that is contractually 120 days in arrears are individually provided for, and those that have a payment that is 180 days in arrears are written off. Equityline Visa credit card balances are measured on a basis consistent with mortgage loans.

When loans are classified as impaired, the book value of such loans is adjusted to their estimated realizable value based on the fair value of any security underlying the loan, net of any costs of realization, by totally or partially writing off the loan and/or establishing an allowance for loan losses as described below.

An impaired loan is not returned to an unimpaired status unless all principal and interest payments are up to date, and management is reasonably assured as to the recoverability of the loan.

## Allowance for Credit Losses

An allowance for credit losses is maintained at an amount that, in management's opinion, is considered adequate to absorb all credit-related losses that have occurred in the portfolio whether or not detected at the period end, including accrued interest on impaired loans. Allowances are mainly related to loans but may also apply to other assets. The allowance consists of accumulated individual and collective allowances, each of which is reviewed at least quarterly. The collective allowance is deducted from the loans on the consolidated balance sheets.

### Individual Allowances

Individual allowances are determined on an item-by-item basis and reflect the associated estimate of credit loss. In the case of loans and Equityline Visa credit cards, the individual allowances are the amounts required to reduce the carrying value of an impaired asset, including accrued interest, to its estimated realizable amount. The fair value of the underlying security is used to estimate the realizable amount of the receivable. The allowance is the difference between the receivable's carrying value, including accrued interest, and its estimated realizable amount. For secured and unsecured credit card receivables, individual provisions are provided for arrears over 120 days.

### Collective Allowances

Collective allowances are established to absorb credit losses on the aggregate exposures in each of the Company's loan portfolios for which losses have been incurred but not yet individually identified. The collective allowance is based upon statistical analysis of past performance, level of allowance already in place and management's judgement. The collective allowance, based on the historical loss experience adjusted to reflect changes in the portfolios and credit policies, is applied to each pool of loans with common risk characteristics. This estimate includes consideration of economic and business conditions.

The amount of the provision for credit losses that is charged to the consolidated statements of income is the amount that is required to establish a balance in the allowance for credit losses account that the Company's management considers adequate to absorb all credit-related losses in its portfolio of balance sheet items after charging amounts written off during the year, net of any recoveries, to the allowance for credit losses account.

### **Securitized Loans and Securitization Liabilities**

The Company periodically transfers pools of mortgages to SPEs or trusts that, in turn, issue securities to investors. Mortgage loan securitization is part of the Company's liquidity funding strategy. The Company only transfers assets to Canada Mortgage and Housing Corporation (CMHC) sponsored entities.

Most transfers of pools of mortgages under the current programs do not result in derecognition of the mortgages from the Company's consolidated balance sheets. As such, these transactions result in the recognition of securitization liabilities when cash is received from the securitization entities. Such mortgages are reclassified to securitized residential mortgages on the consolidated balance sheets and continue to be accounted for as loans, as described above.

The securitization liabilities are recorded at amortized cost using the effective interest rate method. Interest expense is allocated over the expected term of the borrowing by applying the effective interest rate to the carrying amount of the liability. The effective interest rate is the rate that exactly discounts estimated future cash outflows over the expected life of the liability. Transaction costs and premiums or discounts are applied to the carrying amount of the liability. Also included in securitization liabilities on the consolidated balance sheets are amounts related to fair value hedge accounting that increase or decrease the carrying amount of the securitization liability. Please see Note 19 for more information.

In certain cases, the Company's remaining involvement is quite limited, but it has not transferred substantially all of its risks and rewards in the underlying loans but it has retained control, as defined by IAS 39. Such mortgages are securitized and sold and the Company retains interest-only strips and servicing responsibilities for the assets sold, with very little exposure to variable cash flows. The Company accounts for its continuing involvement as retained interests and servicing liabilities on the consolidated balance sheet. Gains or losses on these transactions are recognized as securitization income in non-interest income on the consolidated income statement and are dependent in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests, based on their relative fair value at the date of transfer and net of transaction costs. Retained interests are classified as available for sale assets and are stated at their fair value with unrealized gains and losses reported in AOCI. The fair value of the retained interests is estimated using discounted cash flow methodology. Retained interests are revalued quarterly to assess for impairment.

In certain circumstances, the Company sells its retained interest arising from securitization transactions. When this results in the Company transferring substantially all of the risks and rewards of ownership associated with the underlying mortgages, the mortgages are derecognized and a resulting gain or loss is recorded. These gains or losses are recognized as securitization income in non-interest income on the consolidated income statement and are dependent in part on the previous carrying amount of the financial assets involved in the transfer.

### **Derivatives Held for Risk Management Purposes**

The Company utilizes derivatives to manage interest rate risk. Derivatives are carried at fair value and are reported as assets if they have a positive fair value and as liabilities if they have a negative fair value. The Company applies hedge accounting to derivatives that meet the criteria for hedge accounting in IAS 39. The Company utilizes two types of hedge relationships for accounting purposes, fair value hedges and cash flow hedges. If derivative instruments do not meet all of the criteria for hedge accounting, the changes in fair value of such derivatives are recognized in net income.

In order to qualify for hedge accounting, a hedge relationship must be designated and formally documented in accordance with IAS 39. The Company's documentation, in accordance with the requirements, includes the specific risk management objective and strategy being applied, the specific financial asset or liability or cash flow being hedged and how hedge effectiveness is assessed. To qualify for hedge accounting, the Company has decided that there must be a correlation of between 80% and 125% in the changes in fair values or cash flows between the hedged and hedging items.

Hedge effectiveness is assessed at the inception of the hedge and on an ongoing basis, at least quarterly. Hedge ineffectiveness occurs when the changes in the fair value of the hedging item (derivative) differ significantly from the fair value changes in the hedged risk in the hedged item. Hedge ineffectiveness is recognized immediately in income.

### **Fair Value Hedges**

Fair value hedges generally use interest rate swap derivatives to hedge changes in the fair value of fixed-rate liabilities (securitization liabilities) attributable to interest rate risk. Changes in fair value of the hedged fixed-rate liabilities attributable to the interest rate risk being hedged are recorded as part of the carrying value of the hedged item and are recognized in net interest income. Changes in fair value of the hedging item (interest rate swap) are also recognized in net interest income. As such, any hedge ineffectiveness resulting from differences in the fair value changes is also recognized in non-interest income.

If the hedging instrument expires, or is settled or sold, or if the hedge no longer meets the criteria for hedge accounting under IAS 39, the hedge relationship is terminated and the basis adjustment on the fixed-rate liability is then amortized over the remaining term of the fixed-rate liability. If the hedged item is settled, the unamortized basis adjustment is recognized in income immediately.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## Cash Flow Hedges

Cash flow hedges generally use bond forwards or interest rate swaps to hedge changes in future cash flows attributable to interest rate fluctuations arising on highly probable forecasted issuances of fixed-rate secured borrowings.

The effective portion of the change in fair value of the derivative instrument is recognized in OCI until the forecasted cash flows being hedged are recognized in income in future accounting periods. When the forecasted cash flows are recognized in income, an appropriate amount of the fair value changes of the derivative instrument is reclassified from AOCI into income. Any hedge ineffectiveness is immediately recognized in non-interest income. If the forecasted issuance of fixed-rate debt is no longer expected to occur, the related cumulative gain (loss) in AOCI is immediately recognized in income.

## Capital Assets

Capital assets, which comprise office furniture and equipment, computer equipment and software and leasehold improvements, are recorded at cost and amortized over their estimated useful lives on a straight-line basis. The ranges of useful lives for each asset type are as follows:

Office furniture and equipment	5 to 10 years
Computer equipment and software	3 to 7 years

Leasehold improvements are amortized on a straight-line basis over the remaining term of the lease.

The Company assesses, at each reporting period date, whether there is an indication that a capital asset may be impaired. If any indication of impairment exists, the Company performs an impairment test to determine whether an impairment loss is required to be recognized. The impairment tests are performed in accordance with the steps discussed in the accounting policy note below entitled "Impairment of Capital Assets and Intangible Assets."

## Goodwill

Goodwill is initially measured as the excess of the price paid for the acquisition of a consolidated entity over the fair value of the net identifiable tangible and intangible assets acquired. Goodwill is allocated to the cash-generating units (CGUs) or groups of CGUs that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Each unit to which the goodwill has been allocated represents the lowest level within the Company at which the goodwill is monitored for internal management purposes and is not larger than an operating segment.

Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is evaluated for impairment annually or more often if events or circumstances indicate there may be impairment. Impairment is determined for goodwill by assessing whether the carrying amount of a CGU, including the allocated goodwill, exceeds its recoverable amount. The recoverable amount is determined as the greater of the estimated fair value, less the costs to sell or the value in use. Impairment losses recognized in respect of a CGU are first allocated to the carrying amount of goodwill, and any excess is allocated pro rata to the carrying amount of other assets in the CGU, on the basis of the carrying amount of each asset in the unit. Any goodwill impairment is charged to income in the period in which the impairment is identified. Impairment losses on goodwill are not subsequently reversed.

## Intangible Assets

An intangible asset is recognized only when its cost can be measured reliably and it is probable that the expected future economic benefits that are attributable to the asset will flow to the Company. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and any accumulated impairment losses.

The Company's intangible assets comprise software development costs. The Company's software development costs are considered to have finite useful lives and are amortized on a straight-line basis over their useful lives, generally not exceeding 10 years. The amortization period and the amortization method are reviewed at least at each financial year end. Changes in the expected useful life are accounted for by changing the amortization period, as appropriate, and treated as changes in accounting estimates. Amortization expense is included in other operating expenses in the consolidated statement of income.



The Company capitalized eligible development costs related to the development of its core banking system. Amortization of these costs over the appropriate useful life commenced when the development of the software module was substantially completed and the software became available for use in the manner intended by management. Eligible costs include external direct costs for materials and services, as well as payroll and payroll-related costs for employees directly associated with the project. Overhead costs, costs incurred during the research phase, costs to train staff to operate the asset and costs incurred after the software was substantially completed and available for use are expensed as incurred. The Company continues to capitalize eligible development costs related to additional software projects and will commence amortization of these costs when development of the asset is substantially complete and the asset becomes available for use in the manner intended by management.

The Company assesses, at each reporting period date, whether there is an indication that an intangible asset may be impaired. If any indication of impairment exists, the Company performs an impairment test to determine whether an impairment loss is required to be recognized. In relation to development costs for software that is not yet available for use, the Company performs an impairment test on an annual basis as well as when indications of impairment exist. Such annual impairment tests will continue until the software is available for use. The impairment tests are performed in accordance with the steps discussed in the accounting policy note below entitled "Impairment of Capital Assets and Intangible Assets."

### **Impairment of Capital Assets and Intangible Assets**

The Company assesses at each reporting date whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Company estimates the asset's recoverable amount. If it is not possible to determine the recoverable amount of the individual asset, the Company determines the recoverable amount of the CGU to which the asset belongs. The recoverable amount of an asset or a CGU is the higher of its fair value less costs to sell and its value in use, where value in use is the present value of the future cash flows expected to be derived from the asset or the CGU. Where the carrying amount of the asset or the CGU exceeds its recoverable amount, the asset is considered impaired and written down to its recoverable amount. The Company evaluates impairment losses for potential reversals when events or changes in circumstances warrant such consideration.

### **Deposits**

Deposits are financial liabilities that are measured at cost using the effective interest rate method. Deposit origination costs are included in deposits on the consolidated balance sheets as incurred and amortized to interest expense over the term of the deposit.

### **Senior Debt**

Senior debt is carried at amortized cost, including the principal amount received on issue, plus accrued interest and costs incurred on issue, less repayments of principal and interest, amortization of issue costs and any premium or discount to the face amount of the debt. Issue costs and premiums or discounts are amortized to income using the effective interest rate method. Also included in senior debt on the consolidated balance sheets are amounts related to fair value hedge accounting which increase or decrease the carrying amount of the senior debt. Please see Note 19 for more information.

### **Income Taxes**

The Company follows the asset and liability method of accounting for income taxes, whereby deferred tax assets and liabilities are recognized for the expected future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted or substantively enacted tax rates applicable to taxable income in the period in which those temporary differences are expected to be recovered or settled. Deferred tax assets are only recognized for deductible temporary differences, carry forward of unused tax credits and losses to the extent that it is probable that taxable profit will be available and the carry forward of unused tax credits and losses can be utilized.

### **Fee Income**

Fee income is accrued and recognized as income as the associated services are rendered.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## Stock-based Compensation Plans

The Company has stock-based compensation plans, which are described in Note 14.

The Company's Employee Stock Option Plan provides for the granting of stock options to certain employees of the Company. In some cases, stock appreciation rights are also granted in tandem with the stock option, providing the Company with, at its sole discretion, the alternative of settling the award in cash at an amount equal to the excess of the market price of the shares to which the option relates over the exercise price of the option. The Company accounts for stock options, including those with tandem stock appreciation rights, as equity-settled transactions where the fair value of options granted is charged to salary expense over the option vesting period, with the offsetting amount recognized in contributed surplus. For awards with graded vesting, the fair value of each tranche is recognized separately over its respective vesting period. For each reporting period, the Company reassesses its estimates of the number of awards that are expected to vest and recognizes the impact of any revision in the consolidated statements of income, with a corresponding adjustment to equity. The fair value of the options granted is determined using a Black-Scholes option pricing model.

The Company offers a deferred share unit (DSU) plan that is only open to non-employee Directors of the Company who annually elect to accept remuneration in the form of cash, cash and DSUs, or DSUs. The Company accounts for the DSUs as cash-settled transactions. Under the plan, the obligations for the DSUs are accrued quarterly based on the Directors' remuneration for the quarter. The obligations are periodically adjusted for fluctuations in the market price of the Company's common shares and allow for dividend equivalents. Changes in obligations under the plan are recorded as salaries and benefits in the consolidated statements of income, with a corresponding increase in other liabilities on the consolidated balance sheets.

## Employee Benefit Plans

Under both the Employee Share Purchase Plan and the Employee Retirement Savings Plan, the Company's contribution is expensed when paid (see Note 17).

## Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates prevailing at the consolidated balance sheet date. Revenues and expenses denominated in foreign currencies are translated at the average exchange rates prevailing during the period. Realized and unrealized gains and losses on foreign currency transactions are included in fees and other income in the consolidated statements of income.

## NOTE 3 FUTURE CHANGES IN ACCOUNTING POLICIES

The following accounting pronouncements issued by the IASB were not effective as at December 31, 2012 and therefore have not been applied in preparing these consolidated financial statements.

### IAS 1 Presentation of Financial Statements

In June 2011, the IASB issued amendments to IAS 1 *Presentation of Financial Statements* (IAS 1), which are effective for annual periods beginning on or after July 1, 2012, with earlier application permitted. The amendments may result in changes in the way OCI is presented in the consolidated statement of income. However, it is not expected to result in material changes to the overall presentation of the Company's consolidated financial statements.

### IFRS 9 Financial Instruments

In November 2009, the IASB issued, and subsequently revised in October 2010, IFRS 9 *Financial Instruments* (IFRS 9) as a first phase in its ongoing project to replace IAS 39. IFRS 9, which is to be applied retrospectively, is effective for annual periods beginning on or after January 1, 2015, with earlier application permitted. IFRS 9 provides new requirements as to how an entity should classify and measure financial assets and liabilities that are in the scope of IAS 39. The standard requires all financial assets to be classified on the basis of the entity's business model for managing such financial assets and the contractual cash flow characteristics of the financial assets. In September 2012, the IASB issued a review draft of the standard on general hedge accounting, with a final standard expected to be issued during the first quarter of 2013. The general hedge accounting standard is intended to provide better links between an entity's risk management activities, the rationale for hedging and the impact of hedging on the financial statements. The standard will potentially simplify the Company's hedge accounting strategies. The impairment phase of the IASB's financial instruments project is currently under development. Management is currently evaluating the potential impact that the adoption of IFRS 9 will have on the Company's consolidated financial statements.

### IFRS 10 Consolidated Financial Statements

In May 2011, the IASB issued IFRS 10 *Consolidated Financial Statements* (IFRS 10), which is effective for annual periods beginning on or after January 1, 2013, with earlier adoption permitted. IFRS 10 will replace portions of IAS 27 *Consolidated and Separate Financial Statements* (IAS 27) and interpretation SIC-12 *Consolidation – Special Purpose Entities*. Under IFRS 10, consolidated financial statements will include all controlled entities under a single control model. Management does not anticipate any material changes to the financial position or operating results upon adoption of IFRS 10.

### IFRS 13 Fair Value Measurement

In May 2011, the IASB issued IFRS 13 *Fair Value Measurement* (IFRS 13), which is effective for annual periods beginning on or after January 1, 2013, with earlier adoption permitted. IFRS 13 establishes a single source of guidance for fair value measurements when fair value is required or permitted by IFRS and provides for enhanced disclosures when fair value is applied. The adoption of IFRS 13 is not expected to be material to the results of operations or financial position of the Company.

## NOTE 4 CASH AND SECURITIES

### (A) Cash Resources and Restricted Cash

thousands of Canadian dollars	December 31 2012	December 31 2011
Deposits with regulated financial institutions	\$ 301,863	\$ 534,250
Treasury bills guaranteed by government	-	144
Cash resources unrestricted to Company use	301,863	534,394
Restricted cash – Canada Mortgage Bond program	100,387	92,963
Restricted cash – interest rate swaps	21,655	26,176
Restricted cash – other programs	15,382	12,273
	<b>\$ 439,287</b>	<b>\$ 665,806</b>

*Restricted cash – Canada Mortgage Bond program* represents deposits held as collateral by CMHC in connection with the Company's securitization activities. To participate in the National Housing Authority (NHA) mortgage-backed security (MBS) programs, the Company is required to maintain an amount of cash in a trust account to cover deposits of unscheduled principal prepayments (UPP) and property taxes collected on the securitized loans. The amount represents a percentage of UPP, which is based on the Company's average monthly UPP rate for the last year and calculated on the basis of the year-end principal balance. The Company is allowed to invest the above amount in eligible securities.

*Restricted cash – interest rate swaps* are deposits held by swap counterparties as collateral for the Company's interest rate swap transactions. The Company is required to provide collateral against its interest rate swap transactions as part of the agreements with the counterparties. The terms and conditions for these collaterals are governed by International Swaps and Derivatives Association (ISDA) agreements.

*Restricted cash – other programs* are reserve accounts held in trust for the water heater financing program and for PSiGate operations.

### (B) Securities at Fair Value by Type and Remaining Term to Maturity

thousands of Canadian dollars					December 31 2012	December 31 2011
	Within 1 Year	1 to 3 Years	3 to 5 Years	Over 5 Years	Total Fair Value	Total Fair Value
<b>Available for sale</b>						
Securities issued or guaranteed by						
Canada	\$ 5,047	\$ -	\$ -	\$ -	\$ 5,047	\$ 5,196
Corporations	99,785	-	-	-	99,785	8,060
Equity securities						
Common	8,836	-	-	-	8,836	8,851
Preferred	47,581	87,213	135,214	29,549	299,557	368,473
Mutual funds	1,119	-	-	-	1,119	1,174
<b>Pledged securities</b>						
Securities issued or guaranteed by						
Canada	407,639	180,430	255,478	-	843,547	341,588
	<b>\$ 570,007</b>	<b>\$ 267,643</b>	<b>\$ 390,692</b>	<b>\$ 29,549</b>	<b>\$ 1,257,891</b>	<b>\$ 733,342</b>

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## (C) Unrealized Gains and Losses on Available for Sale Securities

						As at December 31, 2012
thousands of Canadian dollars, except %	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Total Fair Value	Weighted- average Yield	
Securities issued or guaranteed by						
Canada	\$ 5,023	\$ 24	\$ -	\$ 5,047	1.5%	
Corporations	99,689	96	-	99,785	2.5%	
Equity securities						
Common	8,007	2,100	(1,271)	8,836	4.6%	
Preferred	300,040	4,163	(4,646)	299,557	4.7%	
Mutual funds	1,001	118	-	1,119	-	
	<b>\$ 413,760</b>	<b>\$ 6,501</b>	<b>\$ (5,917)</b>	<b>\$ 414,344</b>		

						As at December 31, 2011
thousands of Canadian dollars, except %	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Total Fair Value	Weighted- average Yield	
Securities issued or guaranteed by						
Canada	\$ 5,069	\$ 127	\$ -	\$ 5,196	2.5%	
Corporations	8,060	-	-	8,060	2.0%	
Equity securities						
Common	7,536	1,683	(368)	8,851	7.4%	
Preferred	375,853	2,591	(9,971)	368,473	5.0%	
Mutual funds	1,000	174	-	1,174	-	
	<b>\$ 397,518</b>	<b>\$ 4,575</b>	<b>\$ (10,339)</b>	<b>\$ 391,754</b>		

Net unrealized gains and losses are included in AOCI except for impairment losses which are transferred to net income. Please see Note 15 for more information.

The unrealized losses included above represent differences between the cost of a security and its current fair value. The Company regularly monitors its investments and market conditions for indications of impairment.

For the year ended December 31, 2012, the Company recognized \$1.8 million (2011 - \$3.0 million) of impairment losses on available for sale securities. These losses were transferred into net income. These unrealized losses are not included in the above table.

**NOTE 5 LOANS**
**(A) Loans by Geographic Region and Type (net of individual allowances for credit losses)**

As at December 31, 2012						
thousands of Canadian dollars, except %	Residential Mortgages <sup>1</sup>	Securitized Residential Mortgages <sup>1</sup>	Non- residential Mortgages <sup>2</sup>	Personal and Credit Card Loans	Total <sup>2</sup>	Percentage of Portfolio
British Columbia	\$ 426,595	\$ 679,771	\$ 3,521	\$ 10,079	\$ 1,119,966	6.6%
Alberta	362,221	540,352	25,953	25,849	954,375	5.7%
Ontario	7,601,916	4,310,994	860,703	557,471	13,331,084	78.9%
Quebec	303,872	580,207	61,691	1,532	947,302	5.6%
Atlantic provinces	132,034	149,821	28,059	3,377	313,291	1.9%
Other <sup>3</sup>	17,285	189,537	8,489	1,185	216,496	1.3%
	<b>\$ 8,843,923</b>	<b>\$ 6,450,682</b>	<b>\$ 988,416</b>	<b>\$ 599,493</b>	<b>\$16,882,514</b>	<b>100.0%</b>
As a % of portfolio	52.4%	38.2%	5.9%	3.5%	100.0%	

As at December 31, 2011						
thousands of Canadian dollars, except %	Residential Mortgages <sup>1</sup>	Securitized Residential Mortgages <sup>1</sup>	Non- residential Mortgages	Personal and Credit Card Loans	Total	Percentage of Portfolio
British Columbia	\$ 330,489	\$ 876,151	\$ 5,441	\$ 12,300	\$ 1,224,381	7.6%
Alberta	323,797	700,006	25,851	31,785	1,081,439	6.7%
Ontario	5,346,584	5,564,549	842,173	508,558	12,261,864	76.2%
Quebec	229,526	695,730	47,829	1,928	975,013	6.1%
Atlantic provinces	99,702	210,355	24,928	4,413	339,398	2.1%
Other <sup>3</sup>	9,785	196,559	-	1,209	207,553	1.3%
	<b>\$ 6,339,883</b>	<b>\$ 8,243,350</b>	<b>\$ 946,222</b>	<b>\$ 560,193</b>	<b>\$16,089,648</b>	<b>100.0%</b>
As a % of portfolio	39.4%	51.2%	5.9%	3.5%	100.0%	

<sup>1</sup> As at December 31, 2012, residential mortgages include \$154.3 million (2011 - \$182.7 million) and securitized mortgages include \$1.94 billion (2011 - \$2.01 billion) in multi-unit residential properties with over four units and builders inventory.

<sup>2</sup> Loans exclude mortgages held for sale.

<sup>3</sup> Other includes Manitoba, Saskatchewan, Nunavut and the Northwest Territories.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## (B) Past Due Loans That Are Not Impaired

A loan is recognized as being impaired (non-performing) when the Company is no longer reasonably assured of the timely collection of the full amount of principal and interest. As a matter of practice, a loan is deemed to be impaired at the earlier of the date it has been individually provided for or when it has been in arrears for 90 days. Residential mortgages (including securitized residential mortgages) guaranteed by the Government of Canada are not considered impaired until payment is contractually 365 days past due. As securitized residential mortgages are insured, credit losses are not anticipated on this portfolio. Secured and unsecured credit card balances that have a payment that is contractually 120 days in arrears are individually provided for, and those that have a payment that is contractually 180 days in arrears are written off. Equityline Visa credit card balances are measured on a basis consistent with mortgage loans.

As at December 31, 2012

thousands of Canadian dollars	Residential Mortgages	Securitized Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
1-30 days	\$ 213,669	\$ 38,243	\$ 9,247	\$ 3,958	\$ 265,117
31-60 days	49,935	6,581	544	1,779	58,839
61-90 days	6,100	453	-	1,986	8,539
Over 90 days	8,474 <sup>1</sup>	4,679 <sup>1</sup>	-	8	13,161
	<b>\$ 278,178</b>	<b>\$ 49,956</b>	<b>\$ 9,791</b>	<b>\$ 7,731</b>	<b>\$ 345,656</b>

As at December 31, 2011

thousands of Canadian dollars	Residential Mortgages	Securitized Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
1-30 days	\$ 208,340	\$ 72,359	\$ 6,237	\$ 4,809	\$ 291,745
31-60 days	43,809	10,169	264	1,018	55,260
61-90 days	11,707	324	284	1,343	13,658
Over 90 days	15,333 <sup>1</sup>	10,957 <sup>1</sup>	-	1,649	27,939
	<b>\$ 279,189</b>	<b>\$ 93,809</b>	<b>\$ 6,785</b>	<b>\$ 8,819</b>	<b>\$ 388,602</b>

<sup>1</sup> Insured residential mortgages are considered impaired when they are 365 days past due.

## (C) Impaired Loans and Individual Allowances for Credit Losses

Residential mortgages guaranteed by the Government of Canada are not considered impaired until payment is contractually 365 days past due. As securitized residential mortgages are all fully insured, credit losses are not anticipated.

As at December 31, 2012

thousands of Canadian dollars	Residential Mortgages	Securitized Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
Gross amount of impaired loans	\$ 54,696	\$ -	\$ 501	\$ 3,830	\$ 59,027
Individual allowances on principal	(2,381)	-	-	(338)	(2,719)
Net	<b>\$ 52,315</b>	<b>\$ -</b>	<b>\$ 501</b>	<b>\$ 3,492</b>	<b>\$ 56,308</b>

As at December 31, 2011

thousands of Canadian dollars	Residential Mortgages	Securitized Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
Gross amount of impaired loans	\$ 36,845	\$ -	\$ 822	\$ 4,144	\$ 41,811
Individual allowances on principal	(742)	-	(78)	(694)	(1,514)
Net	<b>\$ 36,103</b>	<b>\$ -</b>	<b>\$ 744</b>	<b>\$ 3,450</b>	<b>\$ 40,297</b>

Included in the gross amount of impaired loans are foreclosed loans with an estimated realizable value of \$1.7 million (2011 - \$3.7 million).

#### (D) Collateral

The fair value of collateral held against mortgages is based on appraisals at the time a loan is originated. Appraisals are only updated should circumstances warrant it or if a mortgage becomes impaired. At December 31, 2012, the total appraised value of the collateral held for past due mortgages that are not impaired, as determined when the mortgages were originated, was \$502.1 million (2011 - \$556.9 million). For impaired mortgages, the total appraised value of collateral at December 31, 2012 was \$153.9 million (2011 - \$132.0 million), which includes \$81.1 million related to the three loans associated with the alleged irregularities discussed in Note 18(D).

#### (E) Allowance for Credit Losses

	2012			
thousands of Canadian dollars	Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
Individual allowances				
Allowance on loan principal				
Balance at the beginning of the year	\$ 742	\$ 78	\$ 694	\$ 1,514
Provision for credit losses	12,107	(78)	1,557	13,586
Write-offs	(10,921)	-	(2,332)	(13,253)
Recoveries	453	-	419	872
	2,381	-	338	2,719
Allowance on accrued interest receivable				
Balance at the beginning of the year	345	-	-	345
Provision for credit losses	574	-	-	574
	919	-	-	919
Total individual allowance	3,300	-	338	3,638
Collective allowance				
Balance at the beginning of the year	16,299	9,300	3,841	29,440
Provision for credit losses	560	-	-	560
	16,859	9,300	3,841	30,000
Total allowance	\$ 20,159	\$ 9,300	\$ 4,179	\$ 33,638
Total provision	\$ 13,241	\$ (78)	\$ 1,557	\$ 14,720
				2011
thousands of Canadian dollars	Residential Mortgages	Non- residential Mortgages	Personal and Credit Card Loans	Total
Individual allowances				
Allowance on loan principal				
Balance at the beginning of the year	\$ 1,757	\$ -	\$ 3,140	\$ 4,897
Provision for credit losses	6,248	78	964	7,290
Write-offs	(7,754)	-	(3,574)	(11,328)
Recoveries	491	-	164	655
	742	78	694	1,514
Allowance on accrued interest receivable				
Balance at the beginning of the year	403	-	-	403
Provision for credit losses	(58)	-	-	(58)
	345	-	-	345
Total individual allowance	1,087	78	694	1,859
Collective allowance				
Balance at the beginning of the year	16,299	9,357	3,497	29,153
Provision for credit losses	-	(57)	344	287
	16,299	9,300	3,841	29,440
Total allowance	\$ 17,386	\$ 9,378	\$ 4,535	\$ 31,299
Total provision	\$ 6,190	\$ 21	\$ 1,308	\$ 7,519

There were no provisions, allowances or net write-offs on securitized residential mortgages.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## (F) Loans by Remaining Contractual Term to Maturity

					December 31 2012	December 31 2011
thousands of Canadian dollars	Within 1 Year	1 to 3 Years	3 to 5 Years	Over 5 Years	Total Book Value	Total Book Value
Residential mortgages	\$ 5,662,261	\$ 2,637,135	\$ 511,220	\$ 33,307	\$ 8,843,923	\$ 6,339,883
Securitized residential mortgages	1,253,374	3,446,116	1,085,018	666,174	6,450,682	8,243,350
Non-residential mortgages	580,828	314,583	92,166	839	988,416	946,222
Personal and credit card loans	342,757	30,778	118,134	107,824	599,493	560,193
	<b>7,839,220</b>	<b>6,428,612</b>	<b>1,806,538</b>	<b>808,144</b>	<b>16,882,514</b>	16,089,648
Collective allowance for credit losses	-	-	-	-	(30,000)	(29,440)
	<b>\$ 7,839,220</b>	<b>\$ 6,428,612</b>	<b>\$ 1,806,538</b>	<b>\$ 808,144</b>	<b>\$16,852,514</b>	\$16,060,208

## NOTE 6 SECURITIZATION ACTIVITY

### (A) Securitized Assets

The Company's wholly owned subsidiary, Home Trust, securitizes insured residential mortgage loans by participating in the NHA MBS program. Through the program, the Company issues securities backed by residential mortgage loans that are insured against borrowers' default. Once the mortgage loans are securitized, the Company assigns underlying mortgages and/or related securities to CMHC. As an issuer of the MBS, Home Trust is responsible for advancing all scheduled principal and MBS interest payments to CMHC, whether or not the amounts have been collected on the underlying transferred mortgages. Amounts advanced but not recovered will ultimately be recovered from the insurer.

The securitized activity includes the Company's participation in the Canada Mortgage Bond (CMB) program. Under the CMB program, CMHC guarantees the bonds of a special purpose trust, Canada Housing Trust (CHT). CHT uses the proceeds of its bond issuance to finance the purchase of NHA MBS issued by Home Trust. As the CMB is a bullet bond, the Company must provide eligible replacement assets to re-collateralize the CMB as the underlying mortgages amortize or are prepaid.

In many securitization activities, the Company retains certain prepayment and/or interest rate risks and rewards related to the transferred mortgages. Due to retention of these risks and rewards, transferred mortgages are not derecognized and the securitization proceeds are accounted for as secured borrowing transactions. There are no expected credit losses on the securitized mortgage assets as the mortgages are insured against default. Further, the investors and CMHC have no recourse to other assets of either the Company or Home Trust in the event of failure of debtors to pay when due. In other securitization activities, derecognition or continuing involvement accounting is applied. Please see Note 6(B).

The following table presents the gross carrying amounts of mortgages transferred during the year, which are recorded on the consolidated balance sheets as securitized residential mortgages or recorded off-balance sheet as loans under administration. The following table also presents the new securitization liabilities added during the year, which are secured by the mortgages and other pledged assets.

thousands of Canadian dollars	2012	2011
Mortgages assigned in new securitizations	\$ 646,785	\$ 1,242,219
Assets assigned as replacements of repaid amounts		
Through repurchase agreement	255,478	-
Mortgage assets	224,584	630,578
Non-Home Trust MBS and treasury bills	246,446	342,266
Gross carrying amount of mortgages and other assets assigned	<b>1,373,293</b>	2,215,063
Mortgages assigned and qualifying for off-balance sheet treatment	<b>233,892</b>	-
Proceeds received	<b>639,968</b>	1,233,962
New securitization liabilities	<b>\$ 258,899</b>	\$ 1,240,236



## (B) Securitization Income

During the year, the Company securitized and sold through the NHA MBS program insured multi-unit residential mortgages with zero prepayment privileges. These mortgages are recognized on the Company's consolidated balance sheet only to the extent of the Company's continuing involvement in the mortgages (continuing involvement accounting). The Company's continuing involvement is limited to its retained interest in the interest-only strip and its obligations for mortgage servicing. There is no prepayment or credit risk associated with the retained interest or the cost of servicing. The mortgages are effectively derecognized as a result of this transaction. The retained interest and servicing liability are recorded on the consolidated balance sheets in other assets and other liabilities, respectively.

During the year, the Company also sold residual interests in certain pools of mortgages securitized through the NHA MBS program. The sale resulted in the Company transferring substantially all of the risks and rewards of ownership associated with the underlying mortgages, and the mortgages were derecognized. The gain on this transaction is included in non-interest income under securitization income in the consolidated statements of income.

The following table provides quantitative information about these securitization and sales activities.

	<b>2012</b>		
	<b>Single Family Residential MBS</b>	<b>Multi-unit Residential MBS</b>	<b>Total MBS</b>
thousands of Canadian dollars			
Book value of underlying mortgages	\$ 662,153	\$ 233,892	\$ 896,045
Gains on sale of mortgages or residual interest	4,845	3,300	8,145
Retained interests recorded	-	9,691	9,691
Servicing liability recorded	-	1,786	1,786

## (C) Assets Pledged as Collateral

As a requirement of the NHA MBS program, the Company assigns to CMHC all of its interest in existing mortgage pools. If the Company fails to make timely payment under an NHA MBS security, CMHC may enforce the assignment of the mortgages included in all the mortgage pools as well as other assets backing the mortgage-backed securities issued.

The following table presents the principal value of the Company's on-balance sheet mortgage loans and other assets pledged as collateral. The mortgages are recorded as securitized residential mortgages, and assets pledged as CMB replacement assets are recorded as pledged securities. There were no transactions in 2011 that qualified for derecognition or continuing involvement accounting.

	<b>December 31 2012</b>	December 31 2011
thousands of Canadian dollars		
Principal value of mortgages pledged as collateral	\$ 6,418,171	\$ 8,196,167
MBS and treasury bills pledged as collateral	843,547	341,588

## (D) Securitization Liabilities

Securitization liabilities recorded on the consolidated balance sheets represent the funding received on securitization of insured mortgages and other assets assigned under the NHA MBS and the CMB programs when the transaction does not qualify for off-balance sheet treatment for the assets. Accrued interest on these liabilities is classified in other liabilities as accrued interest payable on securitization liabilities.

MBS securitization liabilities are repaid on a monthly basis as the principal payments are collected from securitized loans. CMB liabilities are bullet bond liabilities with fixed maturities. Any principal collected against securitized assets underlying CMB liabilities is used to purchase replacement assets. Interest accrued on securitization liabilities is recorded in other liabilities on the consolidated balance sheets and is based on the underlying MBS and CMB coupon.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## (E) Securitization Liabilities by Remaining Contractual Term to Maturity

	December 31 2012					December 31 2011
thousands of Canadian dollars, except %	Within 1 Year	1 to 3 Years	3 to 5 Years	Over 5 Years	Total Book Value	Total Book Value
Mortgage-backed security liabilities	\$ 469,790	\$ 576,304	\$ 255,599	\$ -	\$ 1,301,693	\$ 2,417,801
Effective yield	2.3%	2.1%	1.7%	-	2.1%	2.5%
Canada Mortgage Bond liabilities	\$ 912,419	\$ 3,122,970	\$ 1,272,600	\$ 726,213	\$ 6,034,202	\$ 6,231,274
Effective yield	3.3%	2.6%	1.9%	3.9%	2.7%	2.8%
	<b>\$ 1,382,209</b>	<b>\$ 3,699,274</b>	<b>\$ 1,528,199</b>	<b>\$ 726,213</b>	<b>\$ 7,335,895</b>	<b>\$ 8,649,075</b>

## NOTE 7 OTHER ASSETS

	December 31 2012	December 31 2011
thousands of Canadian dollars		
Accrued interest receivable	\$ 61,481	\$ 56,606
Prepaid CMB coupon	12,486	6,919
Retained interest on securitization	9,172	-
Other prepaid assets and deferred items	11,266	16,125
	<b>\$ 94,405</b>	<b>\$ 79,650</b>

## NOTE 8 CAPITAL ASSETS

	2012			
thousands of Canadian dollars	Computer Equipment and Software	Office Furniture and Equipment	Leasehold Improvements	Total
Cost				
Balance at the beginning of the year	\$ 16,502	\$ 6,906	\$ 3,739	\$ 27,147
Additions	2,350	693	1,281	4,324
Balance at the end of the year	18,852	7,599	5,020	31,471
Accumulated amortization				
Balance at the beginning of the year	13,376	5,323	3,076	21,775
Amortization expense	2,192	386	540	3,118
Balance at the end of the year	15,568	5,709	3,616	24,893
Carrying amount	\$ 3,284	\$ 1,890	\$ 1,404	\$ 6,578
				2011
thousands of Canadian dollars	Computer Equipment and Software	Office Furniture and Equipment	Leasehold Improvements	Total
Cost				
Balance at the beginning of the year	\$ 13,369	\$ 6,882	\$ 3,366	\$ 23,617
Additions	3,133	24	373	3,530
Balance at the end of the year	16,502	6,906	3,739	27,147
Accumulated amortization				
Balance at the beginning of the year	11,071	4,930	2,722	18,723
Amortization expense	2,305	393	354	3,052
Balance at the end of the year	13,376	5,323	3,076	21,775
Carrying amount	\$ 3,126	\$ 1,583	\$ 663	\$ 5,372

## NOTE 9 INTANGIBLE ASSETS

Intangible assets comprise internally developed software costs, which are principally costs related to the Company's core banking system. These costs are amortized over 10 years, commencing December 2011. The following table presents the net carrying amount of software costs for the core banking system and other software costs as at December 31, 2012, and 2011, along with the changes in net carrying amount for the years ended December 31, 2012 and 2011.

thousands of Canadian dollars	2012				2011			
	Core Banking System	Other Software Costs	Software Under Development	Total	Core Banking System	Other Software Costs	Software Under Development	Total
Cost								
Balance at the beginning of the year	\$ 62,193	\$ 3,494	\$ -	\$ 65,687	\$ 46,410	\$ 2,598	\$ -	\$ 49,008
Additions from internal development	287	2,903	5,951	9,141	15,783	896	-	16,679
Balance at the end of the year	62,480	6,397	5,951	74,828	62,193	3,494	-	65,687
Accumulated amortization								
Balance at the beginning of the year	330	1,440	-	1,770	-	1,091	-	1,091
Amortization expense	6,168	547	-	6,715	330	349	-	679
Balance at the end of the year	6,498	1,987	-	8,485	330	1,440	-	1,770
Carrying amount at the end of the year	\$ 55,982	\$ 4,410	\$ 5,951	\$ 66,343	\$ 61,863	\$ 2,054	\$ -	\$ 63,917

## NOTE 10 GOODWILL

The carrying amount of goodwill in relation to each of the Company's subsidiaries is as follows:

thousands of Canadian dollars	December 31 2012	December 31 2011
Home Trust	\$ 2,324	\$ 2,324
PSiGate	13,428	13,428
	\$ 15,752	\$ 15,752

There have been no additions, disposals or impairment losses of goodwill during the year.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, considering the business level at which goodwill is monitored for internal management purposes. The PSiGate goodwill is allocated to the PSiGate legal entity (the unit) and this unit is included in the consumer lending operating segment. Management has determined that the recoverable amount of the unit exceeds its carrying amount and that no impairment exists. The following information relates to the annual impairment test of the unit that was conducted during the fourth quarter of 2012.

The recoverable amount of the unit was determined on the basis of its fair value less costs to sell. The fair value of the unit was determined using a discounted cash flow methodology where estimated cash flows were projected to December 31, 2016 and assuming a terminal growth rate of 3.0% thereafter. A revenue growth rate of 8.1% was assumed over the period of projections, with a stable gross margin percentage. Operating expenses considered necessary to support the expected growth were included and increased over the period of projections at an expected inflationary rate. Planned capital expenditures, also necessary to support expected growth, were incorporated.

A discount rate of 15.5% was used, which comprised a risk-free rate, equity risk premium, size premium and company-specific risk premium. The risk-free rate, equity risk premium and size premium were based on data from external sources whereas the company-specific risk premium was based on factors considered by management to be specific to PSiGate.

The discounted cash flow methodology used is most sensitive to the discount rate and revenue growth rate used. In consideration of this sensitivity, management determined that either an increase in the discount rate from 15.5% to 21.3% or a decrease in annual revenue growth from 8.1% to a negative growth rate of 0.9% for each year of the projection, assuming unchanged values for the other assumptions, would have caused the recoverable amount to equal the carrying amount.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## NOTE 11 DEPOSITS BY REMAINING CONTRACTUAL TERM TO MATURITY

	December 31					December 31
	2012					2011
thousands of Canadian dollars, except %	Payable on Demand	Within 1 Year	1 to 3 Years	3 to 5 Years	Total	Total
Individuals	\$ 105,923	\$ 5,667,122	\$ 3,501,020	\$ 629,601	\$ 9,903,666	\$ 7,738,937
Businesses	-	138,897	79,982	14,054	232,933	183,187
	<b>\$ 105,923</b>	<b>\$ 5,806,019</b>	<b>\$ 3,581,002</b>	<b>\$ 643,655</b>	<b>\$10,136,599</b>	<b>\$ 7,922,124</b>
<b>Effective yield</b>	<b>1.7%</b>	<b>2.0%</b>	<b>2.5%</b>	<b>2.7%</b>	<b>2.2%</b>	<b>2.4%</b>

## NOTE 12 SENIOR DEBT

The Company issued \$150.0 million principal amount of 5.20% debentures on May 4, 2011. The debentures pay interest semi-annually on May 4 and November 4 in each year. The debentures mature on May 4, 2016 and are redeemable at the option of the Company upon 30 days written notice to the registered holder at a redemption price, equal to the greater of par and the price that would provide a yield to maturity equal to the Government of Canada bond rate plus 0.66%, plus accrued and unpaid interest to the date of redemption.

## NOTE 13 OTHER LIABILITIES

	December 31	December 31
	2012	2011
thousands of Canadian dollars		
Accrued interest payable on deposits	\$ 93,856	\$ 77,737
Accrued interest payable on securitization liabilities	19,595	22,195
Other, including accounts payable and accrued liabilities	35,139	36,093
	<b>\$ 148,590</b>	<b>\$ 136,025</b>

## NOTE 14 CAPITAL

### (A) Authorized

An unlimited number of common shares with no par value

An unlimited number of preferred shares, issuable in series, to be designated as senior preferred shares

An unlimited number of preferred shares, issuable in series, to be designated as junior preferred shares

### (B) Common Shares Issued and Outstanding

	2012		2011	
thousands	Number of Shares	Amount	Number of Shares	Amount
Outstanding at the beginning of the year	34,625	\$ 55,104	34,646	\$ 50,427
Options exercised	169	7,088	135	4,921
Repurchase of shares	(164)	(289)	(156)	(244)
<b>Outstanding at the end of the year</b>	<b>34,630</b>	<b>\$ 61,903</b>	<b>34,625</b>	<b>\$ 55,104</b>

### (C) Repurchase of Shares

During the year, 163,500 (2011 - 156,300) common shares were purchased for \$8.1 million (2011 - \$7.9 million). The purchase price of shares acquired through the Normal Course Issuer Bid is allocated between capital stock and retained earnings. The cost of the common shares was reduced by \$0.3 million in 2012 (2011 - \$0.2 million). The balance of the purchase price of \$7.8 million (2011 - \$7.7 million) was charged to retained earnings.

## (D) Stock Options

The details and changes in the issued and outstanding options are as follows:

	2012		2011	
number of shares in thousands	Number of Shares	Weighted-average Exercise Price	Number of Shares	Weighted-average Exercise Price
Outstanding at the beginning of the year	929	\$ 37.16	1,066	\$ 36.07
Granted	51	47.20	5	46.35
Exercised	(169)	33.56	(135)	28.33
Forfeited	(28)	33.74	(7)	47.92
Outstanding at the end of the year	783	\$ 38.71	929	\$ 37.16
Exercisable at the end of the year	557	\$ 35.29	594	\$ 34.40
Weighted-average market price per share at date of exercise		\$ 48.48		\$ 56.17
Weighted-average remaining contractual life in years		3.7		3.9

The Company's stock option plan was approved by the shareholders of the Company on December 31, 1986. The plan was amended in 2002, to conform to the Toronto Stock Exchange's Revised Policy on Listed Company Share Incentive Arrangements. As at December 31, 2012, the maximum number of options on common shares that may be issued was 4,585,198, representing approximately 13.2% of the aggregate number of common shares. The exercise price of the options is fixed by the Board at the time of issuance at the market price of such shares, subject to all applicable regulatory requirements. The exercise period of any option is limited to a period of seven years from the date of grant of the option. The period within which an option or portion thereof may be exercised by a participant is determined in each case by the Board. Stock options that are currently issued and outstanding vest at a rate of 25% per year over four years on the condition that set earnings per share targets are achieved for each year as established by the Board at the time of the grant.

During 2010, the Company approved an amendment to the employee stock option plan to provide stock appreciation rights that allow cash settlement of vested stock options, at the Company's discretion. No options were settled in cash during 2012 or 2011.

As at December 31, 2012, the exercise prices for stock options outstanding to acquire common shares ranged from \$16.27 to \$50.23 and are presented below along with the number of options exercisable and the respective expiry date.

Stock Options Outstanding	Stock Options Exercisable	Exercise Price per Share (Canadian Dollars)	Expiry Date
20,000	20,000	\$ 33.76 <sup>1</sup>	3/7/2014
175,000	175,000	41.29 <sup>1</sup>	12/7/2014
165,000	165,000	16.27 <sup>2</sup>	12/8/2015
15,000	11,250	31.87 <sup>3</sup>	5/5/2016
10,000	7,500	40.70 <sup>3</sup>	11/3/2016
22,500	16,875	41.06 <sup>3</sup>	12/2/2016
10,000	5,000	44.63 <sup>4</sup>	8/4/2017
314,000	156,125	47.97 <sup>4</sup>	12/1/2017
10,000	-	50.23 <sup>5</sup>	2/13/2019
1,000	-	49.55 <sup>5</sup>	3/7/2019
40,000	-	46.39 <sup>5</sup>	8/1/2019
782,500	556,750	\$ 35.29	

<sup>1</sup> In 2007, the Company granted certain employees the right to receive stock options if certain performance criteria were met. As at December 31, 2012, four levels of performance had been met for 195,000 options. As a result, 100% of these contingently assumable options have been included in the computation of diluted income per common share.

<sup>2</sup> In 2008, the Company granted certain employees the right to receive stock options if certain performance criteria were met. As at December 31, 2012, four levels of performance had been met for 165,000 options. As a result, 100% of these contingently assumable options have been included in the computation of diluted income per common share.

<sup>3</sup> In 2009, the Company granted certain employees the right to receive stock options if certain performance criteria were met. As at December 31, 2012, three levels of performance had been met for 47,500 options. As a result, 75% of these contingently assumable options have been included in the computation of diluted income per common share.

<sup>4</sup> In 2010, the Company granted certain employees the right to receive stock options if certain performance criteria were met. As at December 31, 2012, two levels of performance criteria had been met for 324,000 options. As a result, 50% of these contingently assumable options have been included in the computation of diluted income per common share.

<sup>5</sup> In 2012, the Company granted certain employees the right to receive stock options if certain performance criteria were met. As at December 31, 2012, none of the performance criteria had been met for 51,000 options. As a result, the contingently assumable options have not been included in the computation of diluted income per common share.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

The Company determines the fair value of options granted using a Black-Scholes option pricing model. The weighted-average fair value of the options granted during the year was \$15.37 (2011 – \$14.93).

The following assumptions were used to determine the fair value of each of the following option grants on the date of grant:

Canadian dollars, except % and years	August 2012	March 2012	February 2012	November 2011
Fair value of options granted	\$ 14.70	\$ 17.10	\$ 17.87	\$ 14.93
Share price	\$ 45.32	\$ 49.73	\$ 51.00	\$ 44.69
Exercise price	\$ 46.39	\$ 49.55	\$ 50.23	\$ 46.35
Expected share price volatility	35.9%	36.0%	36.1%	36.1%
Option life	7.0	7.0	7.0	7.0
Expected period until exercise in years	7.0	7.0	7.0	7.0
Forfeiture rate	6.8%	6.8%	6.8%	6.8%
Expected dividend yield	2.03%	1.77%	1.73%	1.62%
Risk-free rate of return	1.40%	1.69%	1.73%	2.07%

The above assumptions for expected volatility were determined on the basis of historical volatility.

The Company determines the fair value of stock options on the grant date and records this amount as compensation expense over the period that the stock options vest, with a corresponding increase to contributed surplus. When these stock options are exercised, the Company records the amount of proceeds, together with the amount recorded in contributed surplus, in capital stock.

## (E) Deferred Share Units

The Company grants DSUs to Directors of the Company. Under the plan, the Directors may elect annually to accept remuneration in the form of cash, cash and DSUs or DSUs prior to the beginning of the year. DSUs earn dividend equivalents in the form of additional DSUs at the same rate as dividends on common shares. The participant is not allowed to settle the DSUs until retirement or termination of directorship. The cash value of the DSUs is equivalent to the market value of common shares when settlement takes place. The value of the DSU liability as at December 31, 2012 was \$1.02 million (2011 – \$0.53 million). As of December 31, 2012, there were 17,275 DSUs outstanding (2011 – 10,765).

## (F) Restricted Share Units

The Company grants restricted share units (RSUs) to certain key members of management. The RSUs vest at a rate of one-third each year over a three-year period. The vested amount is settled on the vesting date. RSUs earn dividend equivalents in the form of additional RSUs at the same rate as dividends on common shares. The cash value of the RSUs is equivalent to the market value of common shares on the vesting date. The value of the RSU liability as at December 31, 2012 was \$34 thousand. As of December 31, 2012, there were 4,986 RSUs outstanding. The Company did not issue RSUs prior to 2012.

## (G) Share-based Compensation Expense

The expense recognized in the consolidated statements of income in relation to share-based compensation was as follows:

thousands of Canadian dollars	2012	2011
Expense arising from equity-settled share-based payment transactions	\$ 1,759	\$ 2,400
DSUs and RSUs (representing all expenses arising from cash-settled share-based payment transactions)	209	50
	\$ 1,968	\$ 2,450

## (H) Income per Common Share

Basic income per common share is determined as net income for the year divided by the average number of common shares outstanding of 34,692 thousand (2011 – 34,677 thousand).

Diluted income per common share is determined as net income for the year divided by the average number of common shares outstanding of 34,692 thousand (2011 – 34,677 thousand) plus the stock options potentially exercisable, as determined under the treasury stock method, of 128 thousand (2011 – 110 thousand) for a total of 34,820 thousand (2011– 34,787 thousand) diluted common shares.

## (I) Capital Management

The Company has a capital management policy that governs the quantity and quality of capital held. The objective of the policy is to meet regulatory capital requirements, while also providing a sufficient return to investors. The Risk and Capital Committee and the Board annually review the policy and monitor compliance with the policy on a quarterly basis.

The Company's subsidiary, Home Trust, is subject to the regulatory capital requirements governed by the Office of the Superintendent of Financial Institutions Canada (OSFI). These requirements are consistent with international standards (Basel II) set by the Bank for International Settlements. Home Trust follows the Standardized Approach for calculating credit risk and the Basic Indicator Approach for operational risk.

The regulatory capital position of Home Trust was as follows:

thousands of Canadian dollars, except ratios and multiple	<b>December 31 2012</b>	December 31 2011
<b>Tier 1 capital</b>		
Capital stock	\$ 23,497	\$ 23,497
Contributed surplus	951	951
Retained earnings	909,728	717,223
Accumulated other comprehensive loss <sup>1</sup>	-	(4,229)
IFRS transition adjustment	-	49,188
<b>Total</b>	<b>934,176</b>	786,630
<b>Tier 2 capital</b>		
Collective allowance for credit losses <sup>2</sup>	30,000	29,440
Accumulated other comprehensive income <sup>3</sup>	337	-
Subordinated debentures	171,000	115,000
<b>Total</b>	<b>201,337</b>	144,440
<b>Total regulatory capital</b>	<b>\$ 1,135,513</b>	\$ 931,070
<b>Risk-weighted assets for</b>		
Credit risk	\$ 4,870,575	\$ 4,068,823
Operational risk	620,938	480,873
<b>Total risk-weighted assets</b>	<b>\$ 5,491,513</b>	\$ 4,549,696
<b>Regulated capital to risk-weighted assets</b>		
Tier 1 capital	17.01%	17.29%
Tier 2 capital	3.67%	3.17%
<b>Total regulatory capital ratio</b>	<b>20.68%</b>	20.46%
<b>Assets to regulatory capital multiple</b>	<b>13.98</b>	14.44

<sup>1</sup> Accumulated other comprehensive loss relates to unrealized losses on certain available for sale equity securities, net of tax, which decrease Tier 1 capital.

<sup>2</sup> The Company is allowed to include its collective allowance for credit losses up to a prescribed percentage of risk-weighted assets in Tier 2 capital. At December 31, 2012, the Company's collective allowance represented 0.55% of risk-weighted assets.

<sup>3</sup> Accumulated other comprehensive income relates to unrealized gains on certain available for sale equity securities, net of tax, which increase Tier 2 capital.

OSFI considers a financial institution to be well-capitalized if it maintains a Tier 1 capital ratio of 7% and a Total capital ratio of 10%. Home Trust is in compliance with the OSFI capital guidelines.

Under IFRS transition relief permitted by OSFI, the Company elected to amortize the December 31, 2010 IFRS retained earnings transition adjustment over eight quarters beginning March 31, 2011. The IFRS retained earnings transition adjustment for regulatory capital calculation purposes is the difference between retained earnings under Canadian GAAP and under IFRS at December 31, 2010. This adjustment was fully amortized as at December 31, 2012.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## NOTE 15 ACCUMULATED OTHER COMPREHENSIVE INCOME

thousands of Canadian dollars	December 31 2012	December 31 2011
Unrealized gains (losses) on		
Available for sale securities	\$ 584	\$ (5,764)
Income tax expense (recovery)	152	(1,623)
	<b>432</b>	<b>(4,141)</b>
Unrealized losses on		
Cash flow hedges	<b>(5,676)</b>	(6,768)
Income tax recovery	<b>(1,499)</b>	(1,718)
	<b>(4,177)</b>	(5,050)
Accumulated other comprehensive loss	<b>\$ (3,745)</b>	<b>\$ (9,191)</b>

## NOTE 16 INCOME TAXES

### (A) Reconciliation of Income Taxes

The combined federal and provincial income tax rate varies each year depending on changes in the statutory tax rate imposed by the federal and provincial governments. The effective rate of income tax in the consolidated statements of income is different from the combined federal and provincial income tax rate of 26.43% (2011 - 28.14%).

thousands of Canadian dollars	2012	2011
Income before income taxes	\$ 299,919	\$ 256,313
Income taxes at statutory combined federal and provincial income tax rates	\$ 79,254	\$ 72,126
Increase (decrease) in income taxes at statutory income tax rates resulting from		
Tax-exempt income	<b>(3,744)</b>	(5,182)
Non-deductible expenses	495	743
Future tax rate changes	1,906	(878)
Other	25	(576)
Income tax	<b>\$ 77,936</b>	<b>\$ 66,233</b>

### (B) Reconciliation of Income Tax Rates

	2012	2011
Statutory income tax rate	<b>26.43%</b>	28.14%
Increase (reduction) in income tax rate resulting from		
Tax-exempt income	<b>(1.26%)</b>	(2.02%)
Non-deductible expenses	<b>0.17%</b>	0.29%
Future tax rate changes	<b>0.64%</b>	(0.34%)
Other	<b>0.01%</b>	(0.23%)
Effective income tax	<b>25.99%</b>	25.84%



### (C) Sources of Deferred Tax Balances

thousands of Canadian dollars	December 31 2012	December 31 2011
Deferred tax liabilities		
Commissions	\$ 6,921	\$ 6,058
Finders' fees, net of commitment fees	7,905	11,855
Securitization transaction costs	5,932	8,419
Swaps	5,525	4,046
Development costs	16,656	15,855
Other	304	500
	<b>43,243</b>	46,733
Deferred tax assets		
Allowance for credit losses	7,443	6,693
	<b>7,443</b>	6,693
Net deferred tax liability	\$ <b>35,800</b>	\$ 40,040

Capital losses totalling \$2.8 million are available to reduce capital gains in future years. The future tax benefits arising from application of these losses have not been reflected in the financial statements.

### NOTE 17 EMPLOYEE BENEFITS

#### (A) Employee Share Purchase Plan

Under the Employee Share Purchase Plan, every year qualifying employees can choose each year to have up to 10% of their annual base earnings withheld to purchase common shares. The Company matches 50% of the employees' contribution amount. During each pay period, all contributions are used by the plan's trustee to purchase the common shares in the open market. The Company's contributions are fully vested immediately. The Company's contributions are expensed as paid and totalled \$0.8 million for 2012 (2011 - \$0.7 million).

#### (B) Employee Retirement Savings Plan

During the year, Home Trust contributed \$0.8 million (2011 - \$0.7 million) to the employee group registered retirement savings plan.

### NOTE 18 COMMITMENTS AND CONTINGENCIES

#### (A) Lease Commitments

The Company has entered into commercial leases on premises and property. There are no restrictions imposed by lease arrangements. Future minimum lease payments under non-cancellable operating leases are as follows:

thousands of Canadian dollars	December 31 2012	December 31 2011
Within one year	\$ 4,562	\$ 3,283
After one year but not more than five years	15,285	10,658
More than five years	15,811	16,305
	<b>\$ 35,658</b>	\$ 30,246

Lease payments recognized as expense in the consolidated statements of income in 2012 amounted to \$8.8 million (2011 - \$7.7 million).

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## (B) Credit Commitments

Outstanding commitments for funding on mortgages amounted to \$571.8 million as at December 31, 2012 (2011 – \$612.4 million). Commitments for loans remain open for various periods. The average rate on mortgage commitments is 4.88% (2011 – 5.02%).

The Company also has contractual commitments to extend credit to its clients for its credit card products. The contractual commitments for these products represent the maximum potential credit risk, assuming that all the contractual amounts are fully utilized, the clients default and collection efforts are unsuccessful. At December 31, 2012, these contractual commitments in aggregate were \$403.1 million (2011 – \$476.6 million), of which \$75.7 million (2011 – \$89.6 million) had not been drawn by customers. Outstanding commitments for future advances for the Equityline Visa portfolio were \$4.8 million at December 31, 2012 (2011 – \$10.5 million).

These amounts in aggregate are not indicative of total future cash requirements. Management does not expect any material adverse consequence to the Company's financial position to result from these commitments. Secured credit cards have spending limits restricted by collateral held by the Company.

## (C) Directors' and Officers' Indemnification

The Company indemnifies Directors and officers, to the extent permitted by law, against certain claims that may be made against them as a result of their being, or having been, Directors and officers at the request of the Company. The nature of this indemnification prevents the Company from making a reasonable estimate of the maximum potential amount the Company could be required to pay to third parties. Management believes that the likelihood that the Company would incur a significant liability under these indemnifications is remote. The Company has purchased Directors' and officers' liability insurance.

## (D) Contingencies

During 2011, the Company became aware of alleged irregularities regarding three of its loans with a total principal amount of \$4.6 million. The borrowers are disputing the validity of the Company's loans and security in the Ontario Court. It is not currently possible to reasonably determine the outcome of this matter or to estimate the amount of loss, if any. A specific provision has not been recorded for these loans but these loans have been classified as non-performing residential loans.

## NOTE 19 DERIVATIVE FINANCIAL INSTRUMENTS

The Company utilizes interest rate swaps and forward contracts to hedge exposures to interest rate risk. The Company generally uses its derivative instruments in hedge accounting relationships to minimize volatility in earnings caused by changes in interest rates. When a hedging derivative functions effectively, gains, losses, revenues or expenses of the hedging derivative will offset the gains, losses, revenues or expenses of the hedged item. To qualify for hedge accounting treatment, the hedging relationship is formally designated and documented at its inception. The documentation describes the particular risk management objective and strategy for the hedge and the specific asset, liability or cash flow being hedged and how effectiveness of the hedge is assessed. Changes in the fair value of the derivative instruments must be highly effective at offsetting either the changes in the fair value of the risk on the on-balance sheet asset or liability being hedged or the changes in the amount of future cash flows.

Fair value represents point-in-time estimates that may change in subsequent reporting periods due to market conditions or other factors. Fair value for derivatives is determined from swap curves adjusted for credit risks. Swap curves are obtained directly from market sources or calculated from market prices.

Hedge effectiveness is assessed at the inception of the hedge and on an ongoing basis, retrospectively and prospectively, over the life of the hedge. Any ineffectiveness in the hedging relationship is recognized immediately through non-interest expense in net realized and unrealized gain or loss on derivatives.

### Cash Flow Hedging Relationships

The Company uses bond forward contracts or interest rate swaps to hedge the economic value exposure of movements in interest rates between the time that the Company determines that it will likely incur liabilities pursuant to asset securitization, and the time the securitization transaction is complete and the liabilities are incurred. The intent of the bond forward or interest rate swap is to manage the change in cash flows of the future interest payments on the anticipated secured borrowings through asset securitization. Fair value changes recorded in AOCI are reclassified into net interest income over the term of the hedged item up to a maximum of the year 2016.

The following table presents gains or losses related to cash flow hedges included in the Company's financial results:

thousands of Canadian dollars	<b>2012</b>	2011
Fair value losses recorded in OCI	<b>\$ (370)</b>	\$ (7,386)
Fair value losses recorded in non-interest income (ineffectiveness)	-	(545)
Losses reclassified from OCI to net interest income	<b>(1,462)</b>	(618)

#### ***Fair Value Hedging Relationships***

The Company uses interest rate swaps to hedge changes in the fair value of long-term fixed-rate liabilities including CMB liabilities and senior debt, which changes are associated with changes in market interest rates.

The following table presents gains or losses related to fair value hedges included in the Company's financial results:

thousands of Canadian dollars	<b>2012</b>	2011
Fair value changes recorded on interest rate swaps <sup>1</sup>	<b>\$ (26,923)</b>	\$ 53,561
Fair value changes of hedged fixed-rate liabilities for interest rate risk <sup>2</sup>	<b>30,393</b>	(53,326)
<b>Hedge ineffectiveness gain recognized in non-interest income</b>	<b>\$ 3,470</b>	\$ 235

<sup>1</sup> Unrealized gains and losses on hedging derivatives (interest rate swaps) are recorded as derivative assets or liabilities, as appropriate, on the consolidated balance sheets.

<sup>2</sup> Unrealized gains and losses on hedged items (fixed-rate liabilities) for the risk being hedged are recorded as part of the associated fixed-rate liability on the consolidated balance sheets.

#### ***Other Derivative Gains and Losses***

From time to time, the Company enters into derivative positions to hedge interest rate risk and such derivatives are not designated as hedges for accounting purposes. The changes in fair value of such derivatives flow directly to the consolidated statements of income. The Company recorded unrealized gains of \$0.3 million in the year on these derivatives (2011 - \$3.6 million unrealized loss).

The Company may also enter into bond forwards or interest rate swaps to hedge interest rate risk on loans held for securitization. These derivatives are not designated in hedge accounting relationships. The fair value changes of these derivatives are mostly offset by the fair value changes related to loans classified as held for trading for accounting purposes. The net impact in the year for these derivatives and loans outstanding was a net unrealized gain of \$0.1 million. The Company did not enter into these transactions in 2011. The unrealized gains or losses on the derivatives are recorded in net realized and unrealized gain or loss on derivatives, and the fair value change of the loans held for sale is recorded in net realized and unrealized gains or losses on securities and mortgages on the consolidated statement of income. When the loans are securitized and sold, the net realized gain or loss on the derivatives and mortgages held for sale are reclassified to the gain on sale, which is recorded in fees and other income on the consolidated statement of income.

In early 2011, interest rate swaps were restructured to rebalance the interest rate hedges and to meet hedge accounting requirements. This restructuring resulted in an unrealized loss on fair value changes of \$3.7 million recorded in income through net realized and unrealized loss on derivatives.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

As at December 31, 2012 and 2011, the outstanding interest rate swap and bond forward contract positions were as follows:

thousands of Canadian dollars								As at December 31, 2012
Year of Maturity	Notional Amount	Current Replacement Cost	Credit Equivalent Amount	Risk-weighted Balance	Derivative Asset	Derivative Liability	Net Fair Market Value	
Swaps designated as hedges								
Maturing in 2013	\$ 265,200	\$ 4,305	\$ 4,305	\$ 861	\$ 4,305	\$ -	\$ 4,305	
Maturing in 2014	230,500	5,851	7,004	1,401	5,851	-	5,851	
Maturing in 2015	798,914	21,522	25,484	5,097	21,522	(20)	21,502	
Maturing in 2016	192,200	5,954	6,797	1,359	5,954	(200)	5,754	
Maturing in 2018	25,700	1,671	2,057	411	1,671	-	1,671	
Maturing in 2020	59,000	6,015	6,900	1,380	6,015	-	6,015	
	<b>1,571,514</b>	<b>45,318</b>	<b>52,547</b>	<b>10,509</b>	<b>45,318</b>	<b>(220)</b>	<b>45,098</b>	
Undesignated swaps								
Maturing in 2016	100,000	-	-	-	-	(2,156)	(2,156)	
	<b>100,000</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(2,156)</b>	<b>(2,156)</b>	
Bond forwards <sup>1</sup>								
Maturing in 2023	17,500	70	202	40	70	(10)	60	
	<b>17,500</b>	<b>70</b>	<b>202</b>	<b>40</b>	<b>70</b>	<b>(10)</b>	<b>60</b>	
<b>Total</b>	<b>\$ 1,689,014</b>	<b>\$ 45,388</b>	<b>\$ 52,749</b>	<b>\$ 10,549</b>	<b>\$ 45,388</b>	<b>\$ (2,386)</b>	<b>\$ 43,002</b>	

thousands of Canadian dollars								As at December 31, 2011
Year of Maturity	Notional Amount	Current Replacement Cost	Credit Equivalent Amount	Risk-weighted Balance	Derivative Asset	Derivative Liability	Net Fair Market Value	
Swaps designated as hedges								
Maturing in 2012	\$ 64,400	\$ 2,682	\$ 2,682	\$ 536	\$ 2,682	\$ -	\$ 2,682	
Maturing in 2013	265,200	10,031	11,358	2,271	10,031	-	10,031	
Maturing in 2014	230,500	10,032	11,004	2,201	9,766	-	9,766	
Maturing in 2015	798,914	33,786	37,781	7,556	33,786	-	33,786	
Maturing in 2016	192,200	8,302	9,113	1,823	8,302	(92)	8,210	
Maturing in 2018	25,700	1,714	2,099	420	1,714	-	1,714	
Maturing in 2020	59,000	6,134	7,019	1,404	6,134	-	6,134	
	<b>1,635,914</b>	<b>72,681</b>	<b>81,056</b>	<b>16,211</b>	<b>72,415</b>	<b>(92)</b>	<b>72,323</b>	
Undesignated swaps								
Maturing in 2012	18,100	9	9	2	9	-	9	
Maturing in 2016	100,000	-	-	-	-	(3,366)	(3,366)	
	<b>118,100</b>	<b>9</b>	<b>9</b>	<b>2</b>	<b>9</b>	<b>(3,366)</b>	<b>(3,357)</b>	
<b>Total</b>	<b>\$ 1,754,014</b>	<b>\$ 72,690</b>	<b>\$ 81,065</b>	<b>\$ 16,213</b>	<b>\$ 72,424</b>	<b>\$ (3,458)</b>	<b>\$ 68,966</b>	

<sup>1</sup> The term of the bond forward contracts is based on the term of the underlying bonds.

The notional amount represents the amount to which the rate or price is applied in order to calculate the amount of cash exchanged under the contract. Notional amounts do not represent an asset or liability recorded on the consolidated balance sheets.

**NOTE 20 CURRENT AND NON-CURRENT ASSETS AND LIABILITIES**

The following table presents an analysis of each asset and liability line item by amounts expected to be recovered or settled within one year or after one year as at December 31, 2012 and 2011.

thousands of Canadian dollars	As at December 31, 2012			As at December 31, 2011		
	Within 1 Year	After 1 Year	Total	Within 1 Year	After 1 Year	Total
<b>Assets</b>						
Cash resources	\$ 439,287	\$ -	\$ 439,287	\$ 665,806	\$ -	\$ 665,806
Available for sale securities	162,368	251,976	414,344	66,769	324,985	391,754
Pledged securities	407,639	435,908	843,547	320,535	21,053	341,588
Loans held for sale	21,921	-	21,921	-	-	-
Residential mortgages	6,113,424	2,730,499	8,843,923	3,862,265	2,477,618	6,339,883
Securitized residential mortgages	1,663,961	4,786,721	6,450,682	1,333,116	6,910,234	8,243,350
Non-residential mortgages	580,828	407,588	988,416	472,390	473,832	946,222
Personal and credit card loans	342,757	256,736	599,493	398,446	161,747	560,193
Collective allowance for credit losses	(20,000)	(10,000)	(30,000)	(19,627)	(9,813)	(29,440)
Derivative assets	4,305	41,083	45,388	2,682	69,742	72,424
Other assets	94,405	-	94,405	79,650	-	79,650
Capital assets	-	6,578	6,578	-	5,372	5,372
Intangible assets	-	66,343	66,343	-	63,917	63,917
Goodwill	-	15,752	15,752	-	15,752	15,752
<b>Total assets</b>	<b>\$ 9,810,895</b>	<b>\$ 8,989,184</b>	<b>\$18,800,079</b>	<b>\$ 7,182,032</b>	<b>\$10,514,439</b>	<b>\$17,696,471</b>
<b>Liabilities</b>						
Deposits payable on demand	\$ 105,923	\$ -	\$ 105,923	\$ 75,965	\$ -	\$ 75,965
Deposits payable on a fixed date	5,806,019	4,224,657	10,030,676	4,576,116	3,270,043	7,846,159
Senior debt	-	150,684	150,684	-	153,336	153,336
Mortgage-backed security liabilities	469,790	831,903	1,301,693	484,974	1,932,827	2,417,801
Canada Mortgage Bond liabilities	912,419	5,121,783	6,034,202	175,492	6,055,782	6,231,274
Derivative liabilities	-	2,386	2,386	-	3,458	3,458
Income taxes payable	21,912	-	21,912	17,628	-	17,628
Other liabilities	148,590	-	148,590	136,025	-	136,025
Deferred tax liabilities	-	35,800	35,800	-	40,040	40,040
<b>Total liabilities</b>	<b>\$ 7,464,653</b>	<b>\$10,367,213</b>	<b>\$17,831,866</b>	<b>\$ 5,466,200</b>	<b>\$11,455,486</b>	<b>\$16,921,686</b>
<b>Net</b>	<b>\$ 2,346,242</b>	<b>\$ (1,378,029)</b>	<b>\$ 968,213</b>	<b>\$ 1,715,832</b>	<b>\$ (941,047)</b>	<b>\$ 774,785</b>

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## NOTE 21 INTEREST RATE SENSITIVITY

The Company is exposed to interest rate risk as a result of a difference, or gap, between the maturity or repricing date of interest-sensitive assets and liabilities. The following tables show the gap positions at December 31, 2012 and 2011 for selected period intervals. Figures in parentheses represent an excess of liabilities over assets or a negative gap position.

This schedule reflects the contractual maturities of both assets and liabilities, adjusted for assumptions regarding the effective change in the maturity date as a result of a mortgage becoming impaired and for credit commitments and derivatives.

Based on the current interest rate gap position at December 31, 2012, the Company estimates that a 100 basis point decrease in interest rates would decrease net interest income after tax, other comprehensive income and net present value of shareholders' equity over the next 12 months by \$12.6 million, \$0.8 million and \$11.4 million, respectively. A 100 basis point increase in interest rates would increase net interest income after tax, other comprehensive income and net present value of shareholders' equity over the next 12 months by \$12.6 million, \$0.8 million and \$9.7 million, respectively.

As at December 31, 2012								
thousands of Canadian dollars, except %	Floating Rate	0 to 3 Months	3 to 6 Months	6 to 12 Months	1 to 3 Years	Over 3 Years	Non- interest Sensitive	Total
<b>Assets</b>								
Cash resources	\$ 133,900	\$ 305,387	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 439,287
Weighted-average interest rate	1.0%	1.0%	-	-	-	-	-	1.0%
Securities	-	456,578	83,592	29,837	267,643	420,241	-	1,257,891
Weighted-average interest rate	-	1.3%	2.0%	2.6%	2.7%	2.9%	-	2.2%
Loans held for sale	-	-	-	-	-	21,921	-	21,921
Weighted-average interest rate	-	-	-	-	-	3.0%	-	3.0%
<b>Non-securitized mortgages and loans</b>								
	-	1,779,351	1,382,405	3,539,715	2,893,053	820,039	(12,731)	10,401,832
Weighted-average interest rate	-	6.1%	5.3%	5.5%	5.2%	5.5%	-	5.5%
Securitized residential mortgages	-	2,488,249	248,657	743,190	1,855,921	1,114,665	-	6,450,682
Weighted-average interest rate	-	2.8%	4.9%	4.9%	4.0%	4.6%	-	3.8%
Other assets	-	45,388	-	-	-	-	183,078	228,466
Weighted-average interest rate	-	-	-	-	-	-	-	-
<b>Total</b>	<b>\$ 133,900</b>	<b>\$ 5,074,953</b>	<b>\$ 1,714,654</b>	<b>\$ 4,312,742</b>	<b>\$ 5,016,617</b>	<b>\$ 2,376,866</b>	<b>\$ 170,347</b>	<b>\$ 18,800,079</b>
Weighted-average interest rate	1.0%	3.7%	5.1%	5.4%	4.6%	4.6%	-	4.5%
<b>Liabilities and shareholders' equity</b>								
Deposits payable on demand	\$ 19,825	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 86,098	\$ 105,923
Weighted-average interest rate	1.7%	-	-	-	-	-	-	-
Deposits payable at a fixed rate	-	706,686	1,729,232	3,370,101	3,581,002	643,655	-	10,030,676
Weighted-average interest rate	-	2.0%	2.1%	2.0%	2.5%	2.7%	-	2.2%
Senior debt	-	-	-	-	-	150,684	-	150,684
Weighted-average interest rate	-	-	-	-	-	5.2%	-	5.2%
Securitization liabilities	-	2,531,345	387,283	944,636	2,151,375	1,321,256	-	7,335,895
Weighted-average interest rate	-	1.9%	3.2%	2.9%	2.9%	3.2%	-	2.6%
Other liabilities	-	2,386	-	-	-	-	206,302	208,688
Weighted-average interest rate	-	-	-	-	-	-	-	-
Shareholders' equity	-	-	-	-	-	-	968,213	968,213
Weighted-average interest rate	-	-	-	-	-	-	-	-
<b>Total</b>	<b>\$ 19,825</b>	<b>\$ 3,240,417</b>	<b>\$ 2,116,515</b>	<b>\$ 4,314,737</b>	<b>\$ 5,732,377</b>	<b>\$ 2,115,595</b>	<b>\$ 1,260,613</b>	<b>\$ 18,800,079</b>
Weighted-average interest rate	1.7%	1.9%	2.3%	2.2%	2.6%	3.2%	-	2.2%
Credit commitments	\$ 114,075	\$ 1,834,536	\$ (401,861)	\$ (1,995)	\$ (715,760)	\$ 261,271	\$(1,090,266)	\$ -
Weighted-average interest rate	-	4.8%	5.5%	-	5.9%	4.8%	-	-
<b>Interest rate sensitivity gap</b>	<b>\$ 114,075</b>	<b>\$ 1,267,495</b>	<b>\$ (399,519)</b>	<b>\$ (1,995)</b>	<b>\$ (695,391)</b>	<b>\$ 805,601</b>	<b>\$(1,090,266)</b>	<b>\$ -</b>
<b>Cumulative gap</b>	<b>\$ 114,075</b>	<b>\$ 1,381,570</b>	<b>\$ 982,051</b>	<b>\$ 980,056</b>	<b>\$ 284,665</b>	<b>\$ 1,090,266</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Cumulative gap as a percentage of total assets</b>								
	0.6%	7.3%	5.2%	5.2%	1.5%	5.8%	-	-

As at December 31, 2011

thousands of Canadian dollars, except %	Floating Rate	0 to 3 Months	3 to 6 Months	6 to 12 Months	1 to 3 Years	Over 3 Years	Non-interest Sensitive	Total
<b>Assets</b>								
Cash resources	\$ 192,095	\$ 473,551	\$ 144	\$ -	\$ -	\$ -	16	\$ 665,806
Weighted-average interest rate	0.8%	1.0%	1.1%	-	-	-	-	0.9%
Securities	-	362,340	13,113	11,851	185,950	160,088	-	733,342
Weighted-average interest rate	-	1.5%	5.7%	5.0%	4.8%	4.5%	-	3.1%
Loans held for sale	-	-	-	-	-	-	-	-
Weighted-average interest rate	-	-	-	-	-	-	-	-
Non-securitized mortgages and loans	-	1,363,234	693,149	2,480,044	2,536,926	747,292	(3,787)	7,816,858
Weighted-average interest rate	-	6.8%	5.6%	5.5%	4.4%	5.2%	-	5.4%
Securitized residential mortgages	-	2,721,818	161,040	491,943	2,748,791	2,119,758	-	8,243,350
Weighted-average interest rate	-	2.8%	5.1%	4.8%	4.5%	4.3%	-	3.9%
Other assets	-	72,424	-	-	-	-	164,691	237,115
Weighted-average interest rate	-	-	-	-	-	-	-	-
<b>Total</b>	<b>\$ 192,095</b>	<b>\$ 4,993,367</b>	<b>\$ 867,446</b>	<b>\$ 2,983,838</b>	<b>\$ 5,471,667</b>	<b>\$ 3,027,138</b>	<b>\$ 160,920</b>	<b>\$ 17,696,471</b>
<b>Weighted-average interest rate</b>	<b>0.8%</b>	<b>3.6%</b>	<b>5.5%</b>	<b>5.4%</b>	<b>4.5%</b>	<b>4.5%</b>	<b>-</b>	<b>4.4%</b>
<b>Liabilities and shareholders' equity</b>								
Deposits payable on demand	\$ 6	\$ -	\$ -	\$ -	\$ -	\$ -	75,959	\$ 75,965
Weighted-average interest rate	-	-	-	-	-	-	-	-
Deposits payable at a fixed rate	-	422,920	1,074,219	3,078,977	2,853,969	416,074	-	7,846,159
Weighted-average interest rate	-	2.4%	2.4%	2.1%	2.7%	3.2%	-	2.4%
Senior debt	-	-	-	-	-	153,336	-	153,336
Weighted-average interest rate	-	-	-	-	-	5.3%	-	5.3%
Securitization liabilities	-	2,581,640	154,101	468,760	3,128,642	2,315,932	-	8,649,075
Weighted-average interest rate	-	1.9%	3.3%	2.9%	2.9%	3.2%	-	2.7%
Other liabilities	-	3,458	-	-	-	-	193,693	197,151
Weighted-average interest rate	-	-	-	-	-	-	-	-
Shareholders' equity	-	-	-	-	-	-	774,785	774,785
Weighted-average interest rate	-	-	-	-	-	-	-	-
<b>Total</b>	<b>\$ 6</b>	<b>\$ 3,008,018</b>	<b>\$ 1,228,320</b>	<b>\$ 3,547,737</b>	<b>\$ 5,982,611</b>	<b>\$ 2,885,342</b>	<b>\$ 1,044,437</b>	<b>\$ 17,696,471</b>
<b>Weighted-average interest rate</b>	<b>-</b>	<b>2.0%</b>	<b>2.5%</b>	<b>2.2%</b>	<b>2.8%</b>	<b>3.3%</b>	<b>-</b>	<b>2.4%</b>
Credit commitments	\$ 192,089	\$ 1,985,349	\$ (360,874)	\$ (563,899)	\$ (510,944)	\$ 141,796	\$ (883,517)	\$ -
Weighted-average interest rate	-	4.8%	4.8%	5.2%	5.1%	4.1%	-	-
Interest rate sensitivity gap	\$ 192,089	\$ 1,464,298	\$ (174,312)	\$ (546,127)	\$ (279,484)	\$ 227,053	\$ (883,517)	\$ -
Cumulative gap	\$ 192,089	\$ 1,656,387	\$ 1,482,075	\$ 935,948	\$ 656,464	\$ 883,517	\$ -	\$ -
Cumulative gap as a percentage of total assets	1.1%	9.4%	8.4%	5.3%	3.7%	5.0%	-	-

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

## NOTE 22 FAIR VALUE OF FINANCIAL INSTRUMENTS

The amounts set out in the following table represent the fair values of the Company's financial instruments. The valuation methods and assumptions are described below.

The estimated fair value amounts approximate amounts at which the financial instruments could be exchanged in a current transaction between willing parties that are under no compulsion to act. For financial instruments that lack an available trading market, the Company applies present value and valuation techniques that use observable market inputs. Because of the estimation process and the need to use judgement, the aggregate fair value amounts should not be interpreted as being necessarily realizable in an immediate settlement of the instruments.

thousands of Canadian dollars	As at December 31, 2012			As at December 31, 2011		
	Carrying Value	Fair Value	Fair Value Over (Under) Carrying Value	Carrying Value	Fair Value	Fair Value Over (Under) Carrying Value
<b>Assets</b>						
Cash resources	\$ 439,287	\$ 439,287	\$ -	\$ 665,806	\$ 665,806	\$ -
Securities	1,257,891	1,257,891	-	733,342	733,342	-
Loans held for sale	21,921	21,921	-	-	-	-
Non-securitized mortgages and loans	10,401,832	10,534,681	132,849	7,816,858	7,976,732	159,874
Securitized residential mortgages	6,450,682	7,320,756	870,074	8,243,350	8,908,502	665,152
Derivative assets	45,388	45,388	-	72,424	72,424	-
Other	183,078	183,078	-	164,691	164,691	-
<b>Liabilities</b>						
Deposits	10,136,599	10,331,151	194,552	7,922,124	8,128,223	206,099
Senior debt	150,684	167,307	16,623	153,336	156,615	3,279
Securitization liabilities	7,335,895	7,207,578	(128,317)	8,649,075	8,585,033	(64,042)
Derivative liabilities	2,386	2,386	-	3,458	3,458	-
Other	206,302	206,302	-	193,693	193,693	-

The following methods and assumptions were used to estimate the fair values of financial instruments:

- > Cash resources approximate their carrying values due to their short-term nature. The fair value of treasury bills is determined using rates from the Bank of Canada.
- > Securities are valued based on the quoted bid price as described in Note 4.
- > Fair value of loans is determined by discounting the expected future cash flows of the loans at market rates for loans with similar terms and credit risks.
- > Other assets approximate their carrying values due to their short-term nature.
- > Fair value of deposits payable on demand approximates their carrying value; the fair value of fixed-rate deposits is determined by discounting the contractual cash flows using the market interest rates currently offered for deposits with similar terms and risks.
- > Fair value of senior debt is based on quoted bid price.
- > Fair value of securitization liabilities is determined by reference to the quoted price of the liability in the market.
- > Other liabilities approximate their carrying values due to their short-term nature.
- > Fair value of derivative financial instruments is calculated as described in Note 19.

The Company uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: Quoted (Unadjusted) Prices in Active Markets for Identical Assets or Liabilities: This level includes equity securities traded on the Toronto Stock Exchange and quoted corporate and government-backed debt instruments.

Level 2: Valuation Techniques with Observable Parameters: This level includes loans, commitments, interest rate swaps and bond forwards and certain corporate debt instruments.

Level 3: Valuation Techniques with Significant Unobservable Parameters: Instruments classified in this category have a parameter input or inputs that are unobservable and have more than insignificant impact on either the fair value of the instrument or the profit or loss of the instrument. The Company did not have any Level 3 financial instruments in 2012 or 2011.



The following table presents the carrying value of financial instruments carried at fair value across the levels of the fair value hierarchy.

				<b>As at December 31, 2012</b>		
thousands of Canadian dollars	<b>Level 1</b>	<b>Level 2</b>	<b>Total</b>			
<b>Financial assets held for trading</b>						
Interest rate swaps (hedge swaps)	\$ -	\$ 45,388	\$	<b>45,388</b>		
<b>Financial instruments available for sale</b>						
Securities issued or guaranteed by						
Canada	<b>5,047</b>	-	<b>5,047</b>			
Corporations	<b>99,785</b>	-	<b>99,785</b>			
Equity securities						
Common	<b>8,836</b>	-	<b>8,836</b>			
Preferred	<b>299,557</b>	-	<b>299,557</b>			
Mutual funds	-	<b>1,119</b>	<b>1,119</b>			
Pledged securities	<b>369,717</b>	<b>473,830</b>	<b>843,547</b>			
Retained interest	-	<b>9,172</b>	<b>9,172</b>			
<b>Total</b>	<b>\$ 782,942</b>	<b>\$ 529,509</b>	<b>\$</b>	<b>1,312,451</b>		
<b>Financial liabilities at fair value</b>						
Interest rate swaps	-	<b>2,386</b>	<b>2,386</b>			
<b>Total</b>	<b>\$ -</b>	<b>\$ 2,386</b>	<b>\$</b>	<b>2,386</b>		

				As at December 31, 2011		
thousands of Canadian dollars	Level 1	Level 2	Total			
<b>Financial assets held for trading</b>						
Interest rate swaps (hedge swaps)	\$ -	\$ 72,424	\$	72,424		
<b>Financial instruments available for sale</b>						
Securities issued or guaranteed by						
Canada	5,196	-	5,196			
Corporations	-	8,060	8,060			
Equity Securities						
Common	8,851	-	8,851			
Preferred	368,473	-	368,473			
Mutual funds	-	1,174	1,174			
Pledged securities	319,981	21,607	341,588			
<b>Total</b>	<b>\$ 702,501</b>	<b>\$ 103,265</b>	<b>\$</b>	<b>805,766</b>		
<b>Financial liabilities at fair value</b>						
Interest rate swaps	-	3,458	3,458			
<b>Total</b>	<b>\$ -</b>	<b>\$ 3,458</b>	<b>\$</b>	<b>3,458</b>		

As at December 31, 2012 and 2011, the Company did not have any Level 3 financial instruments nor did the Company transfer any financial instrument from Level 1 or Level 2 to Level 3 of the fair value hierarchy during 2012 or 2011.

## NOTE 23 EARNINGS BY BUSINESS SEGMENT

The Company operates principally through two segments – mortgage lending and consumer lending. The mortgage lending segment consists of mortgage lending, securitization of insured mortgage loans and secured loans. The consumer lending segment consists of credit cards, PSiGate and individual loans to customers of retail businesses. These operating segments are supported by other activities including treasury and security investments and general corporate activities.

# Notes to the Consolidated Financial Statements

(unless otherwise stated, all amounts are in Canadian dollars)

The following table details the earnings of the Company by business segment.

	2012			
thousands of Canadian dollars	Mortgage Lending	Consumer Lending	Other	Total
Net interest income	\$ 328,087	\$ 43,598	\$ 9,787	\$ 381,472
Provision for credit losses	(13,164)	(1,556)	-	(14,720)
Fees and other income	27,465	16,527	2	43,994
Securitization income	8,131	-	-	8,131
Net gain on securities and other	944	-	2,833	3,777
Non-interest expenses	(78,573)	(14,056)	(30,106)	(122,735)
Income before income taxes	272,890	44,513	(17,484)	299,919
Income taxes	(74,534)	(11,821)	8,419	(77,936)
Net income (loss)	\$ 198,356	\$ 32,692	\$ (9,065)	\$ 221,983
Goodwill	\$ 2,324	\$ 13,428	\$ -	\$ 15,752
Total assets	\$17,198,250	\$ 769,098	\$ 832,731	\$18,800,079

	2011			
thousands of Canadian dollars	Mortgage Lending	Consumer Lending	Other	Total
Net interest income	\$ 273,738	\$ 41,782	\$ 18,432	\$ 333,952
Provision for credit losses	(5,916)	(1,603)	-	(7,519)
Fees and other income	19,457	18,051	489	37,997
Net (loss) gain on securities and other	(4,821)	-	1,706	(3,115)
Non-interest expenses	(67,851)	(16,255)	(20,896)	(105,002)
Income before income taxes	214,607	41,975	(269)	256,313
Income taxes	(59,331)	(11,872)	4,970	(66,233)
Net income	\$ 155,276	\$ 30,103	\$ 4,701	\$ 190,080
Goodwill	\$ 2,324	\$ 13,428	\$ -	\$ 15,752
Total assets	\$15,997,106	\$ 614,626	\$ 1,084,739	\$17,696,471

## NOTE 24 RELATED PARTY TRANSACTIONS

Compensation of key management personnel of the Company is as follows:

thousands of Canadian dollars	2012	2011
Short-term employee benefits	\$ 6,646	\$ 6,969
Share-based payment	2,147	503
Other long-term benefits	203	154
	\$ 8,996	\$ 7,626

## NOTE 25 RISK MANAGEMENT

The Company is exposed to various types of risk owing to the nature of the business activities it carries on. Types of risk to which the Company is subject include credit, liquidity, interest rate and other price risks. The Company has adopted enterprise risk management (ERM) as a discipline for managing risk. The Company's ERM structure is supported by a governance framework that includes policies, management standards, guidelines and procedures appropriate to each business activity. The policies are reviewed and approved annually by the Board of Directors.

A description of the Company's risk management policies and procedures is included in the shaded text of the Risk Management section of the MD&A. Significant exposures to credit, liquidity and interest rate risks are described in Notes 4, 5, 19 and 21.

## NOTE 26 COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative audited consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2012 audited consolidated financial statements.

# Corporate Directory

## HOME CAPITAL GROUP INC.

### Directors:



**Kevin P.D. Smith**<sup>3,4</sup>  
Chair of the Board  
Chief Executive Officer  
St. Joseph's Health System  
Hamilton, Ontario



**James C. Baillie**<sup>2,3</sup>  
Counsel  
Torys LLP  
Toronto, Ontario



**Hon. William G. Davis**  
**P.C., C.C., Q.C.**<sup>3,4</sup>  
Counsel  
Davis Webb LLP  
Brampton, Ontario



**William Falk**<sup>2,3</sup>  
Corporate Director  
Grand Valley, Ontario



**John M.E. Marsh**<sup>1,4</sup>  
Corporate Director  
Port Colborne, Ontario



**Robert A. Mitchell, C.A.**<sup>1,2,3</sup>  
Corporate Director  
Oakville, Ontario



**Gerald M. Soloway**  
Chief Executive Officer  
Home Capital Group Inc.  
Toronto, Ontario



**Bonita Then**<sup>1,2</sup>  
Corporate Director  
Toronto, Ontario



**Leslie Thompson**<sup>2,4</sup>  
President  
LESRISK, Debt and Risk  
Management Inc.  
Toronto, Ontario

<sup>1</sup> Member of the Audit Committee

<sup>2</sup> Member of the Risk and Capital Committee

<sup>3</sup> Member of the Governance, Nominating and Conduct Review Committee

<sup>4</sup> Member of the Human Resources and Compensation Committee

### Committees:

#### Audit Committee

Robert A. Mitchell, C.A.  
Chair

Bonita Then  
Vice Chair

#### Risk and Capital Committee

Bonita Then  
Chair

#### Governance, Nominating and Conduct Review Committee

Hon. William G. Davis  
Chair

#### Human Resources and Compensation Committee

Kevin P.D. Smith  
Chair

John M.E. Marsh  
Vice Chair

### Officers:

**Gerald M. Soloway**  
Chief Executive Officer

**Martin Reid**  
President

**Brian R. Mosko**  
Chief Operating Officer and  
Executive Vice President

**Robert Blowes, C.A., C.P.A.**  
Chief Financial Officer and  
Executive Vice President

**Pino Decina**  
Executive Vice President,  
Residential Mortgage Lending

**John R.K. Harry**  
Senior Vice President,  
Commercial Mortgage Lending

**Chris Ahlvik, LL.B**  
Senior Vice President,  
Corporate Counsel and  
Corporate Secretary

**Marie Holland, C.A.**  
Senior Vice President,  
Internal Audit

### John Hong

Senior Vice President,  
Chief Compliance Officer and  
Chief Anti-Money Laundering  
Officer

**Stephen Copperthwaite,  
CMA, ORMP**  
Senior Vice President,  
Relationship Manager

**Greg Parker**  
Senior Vice President,  
Treasurer

**Sanjiv Purba**  
Senior Vice President,  
Chief Information Officer

### Chair Emeritus:

**William A. Dimma**

### Annual Meeting Notice

The Annual Meeting of Shareholders of Home Capital Group Inc. will be held at the Design Exchange, Trading Floor, Second Floor, 234 Bay Street, Toronto, Ontario, on Wednesday, May 15, 2013 at 11:00 a.m. local time. Shareholders and guests are invited to join Directors and Management for lunch and refreshments following the Annual Meeting. All shareholders are encouraged to attend.

# Corporate Directory

## HOME TRUST COMPANY

### Directors:

**Hon. William G. Davis  
P.C., C.C., Q.C.**  
*Chairman of the Board*

**James C. Baillie**

**William Falk**

**John M.E. Marsh**

**Robert A. Mitchell, C.A.**

**Martin Reid**

**Kevin P.D. Smith**

**Gerald M. Soloway**

**Bonita Then**

**Leslie Thompson**

### Officers:

**Gerald M. Soloway**  
*Chief Executive Officer*

**Martin Reid**  
*President*

**Brian R. Mosko**  
*Chief Operating Officer and  
Executive Vice President*

**Robert Blowes, C.A., C.P.A.**  
*Chief Financial Officer and  
Executive Vice President*

**Pino Decina**  
*Executive Vice President,  
Residential Mortgage  
Lending*

**John R.K. Harry**  
*Senior Vice President,  
Commercial Mortgage  
Lending*

**Chris Ahlvik, LL.B**  
*Senior Vice President,  
Corporate Counsel and  
Corporate Secretary*

**Marie Holland, C.A.**  
*Senior Vice President,  
Internal Audit*

**John Hong**  
*Senior Vice President,  
Chief Compliance Officer  
and Chief Anti-Money  
Laundering Officer*

**Stephen Copperthwaite,  
CMA, ORMP**  
*Senior Vice President,  
Relationship Manager*

**Greg Parker**  
*Senior Vice President,  
Treasurer*

**Sanjiv Purba**  
*Senior Vice President, Chief  
Information Officer*

### Branches:

#### Toronto:

145 King Street West  
Suite 2300  
Toronto, Ontario M5H 1J8  
Tel: 416-360-4663  
1-800-990-7881  
Fax: 416-363-7611  
1-888-470-2092

#### Corporate

Donald Correia  
*Vice President, Chief Credit  
Officer*

Dinah Henderson, CGA  
*Senior Vice President,  
Operations*

Marissa Lauder, C.A.  
*Vice President, Finance*

Shawn Lyons, C.A.  
*Vice President, Financial  
Operations and Corporate  
Accounting*

Samar Smith  
*Vice President, Internal Audit*

Johannes Tekle  
*Asst. Vice President,  
Operational Risk*

David Cluff  
*Asst. Vice President,  
Credit Risk Governance*

#### Credit

Nick McIlveen  
*Vice President, Credit and  
Risk*

Jeff Barbour  
Alex Godfrey  
*Asst. Vice Presidents, Credit  
and Risk*

#### Commercial Mortgage Lending

Shaun Gonsalves  
*Asst. Vice President*

#### Residential Mortgage Lending

Michael Forshee  
James Hill  
Marguerite Ryan  
Agostino Tuzi  
*Vice Presidents*

Ron Cuadra  
*Vice President, National  
Sales*

Laurie Chalabardo  
Bobby Ramgoolam  
Greg Schultz  
*Directors*

Brendon Callender  
Jean-Pierre Vico  
*Asst. Vice Presidents*

Frank Femia  
Aman Gill

Joseph Kumar  
Ivano Metallo  
Tim Nason  
Paul Onorati  
Scott Smith  
Julie Soragnese

Frank Tuzi  
*Senior Managers*

Massimo DeNigris  
Monica Gairola  
Michael Hewitt  
Michael Pagliocca  
Vince Santacroce  
*Managers*

#### Sales and Service

Domenic Cosentino  
*Director*

#### Direct Client Services

Frank Lee  
*Asst. Vice President*

#### Visa Operations

Raymond St. Aubin  
*Asst. Vice President*

#### PSiGate

Paul Birkness  
*Vice President*

Angela Weidner  
*Manager, Operations*

#### Equityline Visa

Armando Diseri  
*Senior Vice President*

#### Retail Credit Services

Cathy Boon  
*Senior Vice President*

Wayne Dickie  
*Asst. Vice President*

#### Deposits

Benjy Katchen  
*Vice President*

Chandran Devan  
*Asst. Vice President,  
Deposits*

Melonie Dixon  
Nicole Kotsifas  
*Business Development  
Managers*

# Corporate Directory

## **Calgary:**

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Fax: 403-244-6542

1-866-544-3081

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*Branch Manager*

Corbin Raison

*Senior Mortgage Underwriter*

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Fax: 604-484-4664

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Jim Bearman

*Branch Manager*

Renu Paruthi

*Team Leader*

## **Halifax:**

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Scott Congdon

*Asst. Vice President,*

*Mortgages*

David Neville

*Senior Business*

*Development Manager*

## **Montreal:**

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1-866-620-7620

Danny Antoniazzi

*Senior Branch Manager*

Carlo Vignone

*Team Leader*

## **Winnipeg:**

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R3B 3K6

Tel: 204-942-1619

Fax: 204-942-1638

Darryl Bazylko

*Business Development*

*Manager*

## **Auditors:**

Ernst & Young LLP

Chartered Accountants

Toronto, Ontario

## **Principal Bankers:**

Bank of Montreal

Bank of Nova Scotia

## **Transfer Agent:**

Computershare Investor

Services Inc.

100 University Avenue

Toronto, Ontario M5J 2Y1

Tel: 1-800-564-6253

## **Stock Listing:**

Toronto Stock Exchange

Ticker Symbol: HCG

## **Capital Stock:**

As at December 31, 2012,

there were 34,630,440

Common Shares outstanding

## **Memberships:**

Canada Deposit Insurance

Corporation

Trust Companies Association

of Canada

## **For Shareholder**

**Information, Please**

**Contact:**

Chris Ahlvik

*Senior Vice President,*

*Corporate Counsel*

Home Capital Group Inc.

145 King Street West

Toronto, Ontario M5H 1J8

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