

Consolidated Financial Statements of

VERSABANK

Years ended October 31, 2017 and 2016



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INDEPENDENT AUDITORS' REPORT

To the Shareholders of VersaBank

We have audited the accompanying consolidated financial statements of VersaBank, which comprise the consolidated balance sheets as at October 31, 2017 and October 31, 2016, the consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and notes, comprising 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 our 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, we 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 consolidated financial position of VersaBank as at October 31, 2017 and October 31, 2016, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards.

KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

December 13, 2017

London, Canada

VERSABANK

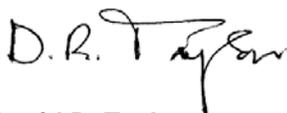
Consolidated Balance Sheets
As at October 31, 2017 and 2016

(thousands of Canadian dollars)

	2017	2016
Assets		
Cash and cash equivalents (note 5)	\$ 159,909	\$ 93,964
Securities (note 6)	262	9,958
Loans, net of allowance for credit losses (note 7)	1,520,857	1,563,612
Other assets (note 8)	44,021	36,866
	<u>\$ 1,725,049</u>	<u>\$ 1,704,400</u>
Liabilities and Shareholders' Equity		
Deposits (note 10)	\$ 1,376,006	\$ 1,369,647
Subordinated notes payable (note 11)	9,786	14,067
Securitization liabilities (note 12)	33,256	43,585
Other liabilities (note 13)	97,460	91,217
	<u>1,516,508</u>	<u>1,518,516</u>
Shareholders' equity:		
Share capital (note 14)	182,094	176,706
Retained earnings	26,443	9,172
Accumulated other comprehensive income	4	6
	<u>208,541</u>	<u>185,884</u>
	<u>\$ 1,725,049</u>	<u>\$ 1,704,400</u>

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

On behalf of the Board:



David R. Taylor
President and Chief Executive Officer



Hon. Thomas A. Hockin
Chairman of the Board

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Consolidated Statements of Income
Years ended October 31, 2017 and 2016

(thousands of Canadian dollars, except per share amounts)

	2017	2016
Interest income:		
Loans	\$ 70,424	\$ 68,496
Cash and securities	1,341	1,166
	<u>71,765</u>	<u>69,662</u>
Interest expense:		
Deposits and other	26,473	29,855
Subordinated notes	1,309	1,403
	<u>27,782</u>	<u>31,258</u>
Net interest income	43,983	38,404
Non-interest income (loss) (note 16)	(141)	1,273
Total revenue	<u>43,842</u>	<u>39,677</u>
Provision for (recovery of) credit losses (note 7(b))	(125)	871
	<u>43,967</u>	<u>38,806</u>
Non-interest expenses:		
Salaries and benefits	13,656	14,090
General and administrative	11,399	9,481
Premises and equipment	2,135	2,385
	<u>27,190</u>	<u>25,956</u>
Restructuring charges (note 17)	2,045	1,092
	<u>29,235</u>	<u>27,048</u>
Income before income taxes	14,732	11,758
Income taxes (note 18)	(4,740)	3,288
Net income	<u>\$ 19,472</u>	<u>\$ 8,470</u>
Basic and diluted income per common share (note 19)	\$ 0.83	\$ 0.32
Weighted average number of common shares outstanding	20,864,000	19,861,000

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

VERSABANK

Consolidated Statements of Comprehensive Income
Years ended October 31, 2017 and 2016

(thousands of Canadian dollars)

	2017	2016
Net income	\$ 19,472	\$ 8,470
Other comprehensive income (loss), net of tax		
Net unrealized gains (losses) on assets held as available-for-sale ⁽¹⁾	(2)	(7)
	(2)	(7)
Comprehensive income	\$ 19,470	\$ 8,463

⁽¹⁾ Net of income tax benefit of \$1 (2016 - \$3).

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

VERSABANK

Consolidated Statements of Changes in Shareholders' Equity
Years ended October 31, 2017 and 2016

(thousands of Canadian dollars)

	2017	2016
Common shares (note 14):		
Balance, beginning of year	\$ 147,224	\$ 142,224
Issued for cash	–	5,000
Impact of amalgamation of PWC Capital Inc. (note 27)	5,388	–
Balance, end of year	\$ 152,612	\$ 147,224
Preferred shares (note 14):		
<i>Series 1 preferred shares</i>		
Balance, beginning and end of year	\$ 13,647	\$ 13,647
<i>Series 3 preferred shares</i>		
Balance, beginning and end of year	\$ 15,690	\$ 15,690
Contributed surplus (note 14):		
Balance, beginning and end of year	\$ 145	\$ 145
Total share capital	\$ 182,094	\$ 176,706
Retained earnings:		
Balance, beginning of year	\$ 9,172	\$ 2,903
Net income	19,472	8,470
Dividends paid on preferred shares	(2,201)	(2,201)
Balance, end of year	\$ 26,443	\$ 9,172
Accumulated other comprehensive income, net of taxes:		
Balance, beginning of year	\$ 6	\$ 13
Other comprehensive loss	(2)	(7)
Balance, end of year	\$ 4	\$ 6
Total shareholders' equity	\$ 208,541	\$ 185,884

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

VERSABANK

Consolidated Statements of Cash Flows
Years ended October 31, 2017 and 2016

(thousands of Canadian dollars)

	2017	2016
Cash provided by (used in):		
Operations:		
Net income	\$ 19,472	\$ 8,470
Adjustments to determine net cash flows:		
Items not involving cash (note 20)	(48,295)	(33,469)
Interest received	70,541	68,268
Interest paid	(29,192)	(31,418)
Change in operating assets and liabilities:		
Loans	44,096	(114,892)
Deposits	7,925	44,146
Change in other assets and liabilities	13,333	12,422
	<u>77,880</u>	<u>(46,473)</u>
Investing:		
Purchase of securities	–	(9,583)
Proceeds from sale and maturity of securities	9,593	21,846
Purchase of property, plant and equipment	(2,243)	(246)
Cash acquired on amalgamation (note 27)	1,569	–
Transaction costs associated with amalgamation (note 27)	(1,852)	–
	<u>7,067</u>	<u>12,017</u>
Financing:		
Repayment of subordinated notes	(4,500)	–
Redemption of securitization liability	(10,307)	–
Proceeds of shares issued	–	5,000
Dividends paid	(2,201)	(2,201)
Income taxes paid	(1,994)	(1,457)
	<u>(19,002)</u>	<u>1,342</u>
Increase (decrease) in cash and cash equivalents	65,945	(33,114)
Cash and cash equivalents, beginning of year	93,964	127,078
Cash and cash equivalents, end of year (note 5)	<u>\$ 159,909</u>	<u>\$ 93,964</u>

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

1. Reporting entity:

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

The Bank is incorporated and domiciled in Canada, and maintains its registered office at Suite 2002, 140 Fullarton Street, London, Ontario, Canada, N6A 5P2. On January 31, 2017, the Bank and PWC Capital Inc. ("PWC"), whose shares also traded on the Toronto Stock Exchange, amalgamated pursuant to section 228 of the *Bank Act (Canada)* ("the Amalgamation") with the amalgamated entity continuing under the name VersaBank (note 27). Prior to the Amalgamation PWC owned approximately 63% (October 31, 2016 – 63%) of the common shares of the Bank.

2. Basis of preparation:

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

a) Statement of compliance:

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

b) Date authorized for issuance:

These Consolidated Financial Statements were approved and authorized for issue by the Board of Directors of the Bank on December 13, 2017.

c) Basis of measurement:

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

d) Functional and presentation currency:

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

2. Basis of preparation – continued:

e) Use of estimates and judgments:

In preparing these Consolidated Financial Statements, management has exercised judgment and developed estimates in applying accounting policies and generating reported amounts of assets and liabilities at the date of the financial statements and income and expenses during the reporting periods. Areas where significant judgment was applied were in the assessments of impairment of financial instruments. Estimates were developed in the calculation of the allowance for credit losses and the measurement of deferred income taxes.

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

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

3. Significant accounting policies:

The significant accounting policies used in the preparation of these Consolidated Financial Statements were applied consistently to all years presented and are summarized below:

a) Principles of consolidation:

The Bank holds 100% of the common shares of VersaJet Inc., PW Capital Inc., AMSDMS Software Inc., and Pacific & Western Public Sector Financing Corp. The Consolidated Financial Statements include the accounts of these subsidiaries.

All significant intercompany accounts and transactions have been eliminated.

b) Revenue recognition:

Interest income on securities and loans is recognized in net interest income using the effective interest rate method over the expected life of the instrument. Interest income earned but not yet collected on securities and loans is included in the respective securities and loans categories on the Consolidated Balance Sheets. Non-interest income from credit cards is recognized over the expected term of the balance of the card and included in non-interest income.

Interest income from credit cards is calculated based on a pre-determined rate and is recognized as earned and included in net interest income.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

b) Revenue recognition – continued:

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

c) Financial instruments:

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

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

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

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

c) Financial instruments – continued:

The Bank has no Level 3 financial instruments. Fair value measurements that fall into Level 2 of the fair value hierarchy include Canadian municipal debt that is classified as available-for-sale (note 6(d)). For Canadian municipal debt, fair value measurement is primarily based on quotes received from brokers that represent transaction prices in markets for identical instruments.

i) Cash and cash equivalents:

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

Cash includes deposits with Canadian chartered banks, net of cheques and other items in transit. Cash equivalents include government treasury bills with less than ninety days to maturity from the date of acquisition.

ii) Securities:

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

The Bank holds securities primarily for liquidity purposes and for investment purposes with the intention of holding the securities to maturity or until market conditions render alternative investments more attractive. Settlement date accounting is used for all securities transactions.

At the end of each reporting period, the Bank assesses whether or not there is any objective evidence to suggest that a security may be impaired. Objective evidence of impairment results from one or more events that occur after the initial recognition of the security which has an impact that can be reliably estimated on the estimated future cash flows of the security such as financial difficulty of the issuer. An impairment loss is recognized for an equity instrument if the decline in fair value is significant or prolonged, as such circumstances provide objective evidence of impairment.

Impairment losses on a held-to-maturity security are recognized in income in the period they are identified. When there is objective evidence of impairment of an available-for-sale security, the cumulative loss that has been recorded in Accumulated Other Comprehensive Income is reclassified to income. For available-for-sale debt securities, if in a subsequent period the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was first recognized, then the previously recognized impairment loss is adjusted through income to reflect the net recoverable amount of the impaired security. No adjustments of impairment losses are recognized for available-for-sale equity securities.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

c) Financial instruments – continued:

iii) Loans:

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

The Bank assesses whether or not there is any objective evidence to suggest that the carrying value of the loans may be impaired. Impairment assessments are facilitated through the identification of loss events and assessments of their impact on the estimated future cash flows of the loans.

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

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

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

c) Financial instruments – continued:

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

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

iv) Allowance for credit losses:

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

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

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

v) Transaction costs:

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability. Transaction costs related to held-to-maturity securities, loans and receivables, and available-for-sale financial assets, as well as financial liabilities are capitalized and amortized over the expected life of the instrument using the effective interest method. Transaction costs related to financial assets and liabilities at fair value through income are expensed in the Consolidated Statements of Income as incurred.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

c) Financial instruments – continued:

vi) Securitized mortgages and securitization liabilities:

In previous years, the Bank transferred pools of Government of Canada guaranteed residential mortgages to the Canada Housing Trust (“CHT”), a Canada Mortgage and Housing Corporation (“CMHC”) sponsored entity.

When the derecognition criteria were not met, these transactions resulted in securitized mortgages being maintained on the Bank’s Consolidated Balance Sheets and in the recognition of securitization liabilities when cash was received from counterparties to the transaction. Securitized mortgages are presented and accounted for as loans on the Consolidated Balance Sheets. Securitization liabilities are presented as a separate line item in the liabilities section on the Consolidated Balance Sheets.

Interest income earned on securitized mortgages and interest expense incurred on securitization liabilities are recognized using the effective interest method over the expected life of the underlying instrument.

vii) Embedded derivatives:

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

d) Property and equipment:

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

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

e) Income taxes:

Current income taxes are calculated based on taxable income for the reporting period. Taxable income differs from accounting income because of differences in the inclusion and deductibility of certain components of income which are established by Canadian taxation authorities. Current income taxes are measured at the amount expected to be recovered or paid using statutory tax rates at the reporting period end.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

e) Income taxes – continued:

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

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

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

f) Employee benefits:

i) Short-term benefits:

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

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

ii) Share-based payment transactions:

Equity-settled stock options

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

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Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

3. Significant accounting policies – continued:

f) Employee benefits – continued:

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

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

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

g) Share capital:

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

i) Share issuance costs:

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

ii) Contributed surplus:

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

h) Segment reporting:

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

4. Future changes in accounting policies:

There have been a number of standards and amendments that have been issued by the IASB that were not effective for the Bank's fiscal year end of October 31, 2017 and therefore have not been applied in preparing these consolidated financial statements. The following standards are expected to be applicable to the Bank:

Financial Instruments (IFRS 9)

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

IFRS 9 will be mandatorily effective for the Bank's fiscal year beginning on November 1, 2018. The Bank has assembled a multi-disciplinary implementation team comprised of key management personnel across a range of the Bank's operational areas and has retained the services of external consultants with expertise in IFRS 9. Having established a time and implementation framework, the Bank's implementation team has commenced assessing the expected impact of IFRS 9 on the Bank's operations, including, but not limited to the Bank's accounting policies and procedures, credit and impairment risk models as well as on the Bank's business and information technology systems, processes and procedures. While the Bank has performed preliminary evaluations of the impact of IFRS 9, the impact on the Bank's consolidated financial statements cannot be quantified at this time given the Bank continues to assess key variables such as credit quality of financial instruments held by the Bank when IFRS 9 becomes effective. The Bank plans to adopt IFRS 9 on November 1, 2018.

Leases (IFRS 16)

In January 2016, the IASB issued IFRS 16, requiring most leases to be recorded on the balance sheet. For lessees, most operating leases other than a short-term or low value leases will be capitalized, and will result in a balance sheet increase in lease assets and lease liabilities, and a decrease in operating lease expenses and increase in financing costs and amortization expense on the income statement. The new standard will not impact lessor accounting beyond additional disclosures. The new standard is effective for the Bank's fiscal year beginning November 1, 2019 with early adoption permitted if IFRS 15 *Revenue from Contracts with Customers* is also applied. The Bank is currently reviewing IFRS 16 to determine the impact of adoption on its consolidated financial statements.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

5. Cash and cash equivalents:

(thousands of dollars)

	2017	2016
Deposits with regulated financial institutions	\$ 154,909	\$ 93,964
Treasury bills guaranteed by federal government	5,000	–
	\$ 159,909	\$ 93,964

6. Securities:

a) Portfolio analysis:

(thousands of dollars)

	2017	2016
Available-for-sale securities		
Securities issued or guaranteed by:		
Canadian provincial governments	\$ –	\$ 9,687
Canadian municipal governments	262	271
Total available-for-sale securities	\$ 262	\$ 9,958

b) Maturities and yields:

(thousands of dollars)

	2017	Yield	2016	Yield
Available-for-sale securities				
Within 3 months	\$ 262	2.25%	\$ 9,687	0.59%
3 months - 1 year	–	–	–	–
1 year - 2 years	–	–	271	2.08%
2 years - 5 years	–	–	–	–
Total available-for-sale securities	\$ 262	2.25%	\$ 9,958	0.63%

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

6. Securities – continued:

c) Unrealized gains and losses on securities:

(thousands of dollars)

	2017				2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Available-for-sale securities								
Securities issued or guaranteed by:								
Canadian provinces	\$ –	\$ –	\$ –	\$ –	\$ 9,687	\$ –	\$ –	\$ 9,687
Canadian municipalities	257	5	–	262	263	8	–	271
Total available-for-sale securities	\$ 257	\$ 5	\$ –	\$ 262	\$ 9,950	\$ 8	\$ –	\$ 9,958

There were no impairment charges during the years ended October 31, 2017 and October 31, 2016 related to the Bank's securities portfolio.

d) Fair value hierarchy:

Available-for-sale securities measured at fair value are classified into the fair value hierarchy as follows:

(thousands of dollars)

2017	Total	Level 1	Level 2	Level 3
Available-for-sale securities				
Securities issued or guaranteed by:				
Canadian municipal governments	262	–	262	–
Total available-for-sale securities	\$ 262	\$ –	\$ 262	\$ –

(thousands of dollars)

2016	Total	Level 1	Level 2	Level 3
Available-for-sale securities				
Securities issued or guaranteed by:				
Canadian provincial governments	\$ 9,687	\$ 9,687	\$ –	\$ –
Canadian municipal governments	271	–	271	–
Total available-for-sale securities	\$ 9,958	\$ 9,687	\$ 271	\$ –

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

7. Loans:

a) Portfolio analysis:

(thousands of dollars)

	2017	2016
Government loans	\$ 22,574	\$ 66,016
Loan and lease receivables	806,347	783,669
Residential mortgages	81,190	95,624
Commercial mortgages	284,329	227,816
Construction mortgages	224,727	256,429
Commercial loans	95,293	102,265
Credit card receivables and other	3,012	29,373
	1,517,472	1,561,192
Allowance for credit losses	(2,425)	(3,031)
Accrued interest	5,810	5,451
Total loans, net allowance for credit losses	\$ 1,520,857	\$ 1,563,612

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

(thousands of dollars)

	2017	2016
Government loans	\$ 5	\$ 14
Loan and lease receivables	361	344
Residential mortgages	314	165
Commercial mortgages	445	412
Construction mortgages	769	765
Commercial loans	522	276
Credit card receivables and other	9	1,055
	\$ 2,425	\$ 3,031

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

The Bank terminated its credit card program with Home Hardware Stores Limited in December 2016 and sold the outstanding credit card receivables portfolio in April 2017.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

7. Loans – continued:

b) Allowance for credit losses:

The allowance for credit losses results from the following:

(thousands of dollars)

	Collective	Individual	2017 Total Allowance	2016 Total Allowance
Balance, beginning of year	\$ 3,031	\$ -	\$ 3,031	\$ 3,212
Recovery for credit losses	(325)	200	(125)	871
Write-offs	(481)	-	(481)	(1,052)
Balance, end of year	\$ 2,225	\$ 200	\$ 2,425	\$ 3,031

c) Maturities and yields:

(thousands of dollars)

	Floating	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Over 5 years	2017 Total	2016 Total
Total loans	\$ 494,091	\$ 43,187	\$ 59,247	\$ 90,227	\$ 695,386	\$ 135,334	\$1,517,472	\$ 1,561,192
Average effective yield	5.34%	4.61%	4.69%	4.53%	4.37%	4.06%	4.69%	4.48%

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

d) Impaired loans:

At October 31, 2017, impaired loans were \$627,000 (2016 - \$nil). Past due for all other loans were \$nil as at October 31, 2017 (October 31, 2016 - \$936,000).

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

8. Other assets:

(thousands of dollars)

	2017	2016
Accounts receivable	\$ 504	\$ 1,820
Funds held for securitization liabilities (note 12)	5,227	14,719
Prepaid expenses and other	5,812	9,599
Property and equipment (note 9)	8,020	4,330
Deferred income tax asset (note 18)	24,458	6,398
	\$ 44,021	\$ 36,866

9. Property and equipment:

(thousands of dollars)

	2017	2016
Cost	\$ 15,145	\$ 10,902
Accumulated amortization	(7,125)	(6,572)
	\$ 8,020	\$ 4,330

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

Total amortization expense recorded for property and equipment for the year ended October 31, 2017 totalled \$553,000 (2016 - \$776,000).

10. Deposits:

(thousands of dollars)

	Demand/ Floating	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Accrued Interest	2017 Total	2016 Total
Total deposits	\$ 294,164	\$ 204,947	\$ 280,086	\$ 246,752	\$ 339,000	\$ 11,057	\$ 1,376,006	\$ 1,369,647
Average effective interest rate	0.43%	1.62 %	1.61 %	1.96 %	2.10 %		1.53%	1.71%

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

11. Subordinated notes payable:

(thousands of dollars)

	2017	2016
Ten year term, unsecured, callable, subordinated notes payable, principal amount of \$4.5 million, interest rate of 11%, maturing 2019	\$ -	\$ 4,335
Ten year term, unsecured, callable, subordinated notes payable, principal amount of \$10.0 million, interest rate of 8%, maturing 2021	\$ 9,786	\$ 9,732
	\$ 9,786	\$ 14,067

In May 2017 the Bank redeemed the 11% subordinated note for \$4.5 million. The remaining subordinated note payable has an effective interest rate of 8.77%.

12. Securitization liabilities:

Securitization liabilities include amounts payable to counterparties for cash received upon initiation of securitization transactions, accrued interest on amounts payable to counterparties, and the unamortized balance of deferred costs and discounts that arose upon initiation of the securitization transactions. The amounts payable to counterparties bear interest at rates ranging from 3.55% - 3.95% and mature in 2020. Securitized insured mortgages and other assets with a carrying value of \$33.1 million (2016 - \$43.4 million) are pledged as collateral for these liabilities.

13. Other liabilities:

(thousands of dollars)

	2017	2016
Accounts payable and other	\$ 3,737	\$ 4,540
Cash collateral and amounts held in escrow	4,945	4,113
Holdbacks payable on loan and lease receivables	88,778	82,564
	\$ 97,460	\$ 91,217

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

14. Share capital:

a) Authorized:

Common shares:

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

Series 1 Preferred shares:

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

The holders of the Series 1 preferred shares are entitled to receive a non-cumulative fixed dividend in the amount of \$0.70 annually per share, payable quarterly, as and when declared by the Board of Directors for the initial period ending October 31, 2019. The quarterly dividend represents an annual yield of 7.0% based on the stated issue price per share. Thereafter, the dividend rate will reset every five years at a level of 543 basis points over the then five year Government of Canada bond yield.

The Bank maintains the right to redeem, subject to the approval of OSFI, up to all of the outstanding Series 1 preferred shares on October 31, 2019 and on October 31 every five years thereafter at a price of \$10.00 per share. Should the Bank choose not to exercise its right to redeem the Series 1 preferred shares, holders of these shares will have the right to convert their shares into an equal number of non-cumulative, floating rate Series 2 preferred shares, subject to certain conditions, on October 31, 2019 and on every October 31 every five years thereafter. Holders of Series 2 preferred shares will be entitled to receive quarterly floating dividends, as and when declared by the Board of Directors, equal to the 90-day Government of Canada Treasury bill rate plus 543 basis points.

Upon the occurrence of a trigger event (as defined by OSFI), each Series 1 or 2 preferred share will be automatically converted, without the consent of the holders, into common shares of the Bank. Conversion to common shares will be determined by dividing the preferred share conversion value (\$10.00 per share plus any declared but unpaid dividends) by the common share value (the greater of (i) the floor price of \$0.75 and (ii) the current market value price calculated as the volume weighted average trading price for the ten consecutive trading days ending on the day immediately prior to the date of the conversion).

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

14. Share capital (continued):

Series 3 Preferred shares:

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

The holders of the Series 3 preferred shares are entitled to receive a non-cumulative fixed dividend in the amount of \$0.70 annually per share, payable quarterly, as and when declared by the Board of Directors for the initial period ending April 30, 2021. The quarterly dividend represents an annual yield of 7.0% based on the stated issue price per share. Thereafter, the dividend rate will reset every five years at a level of 569 basis points over the then five year Government of Canada bond yield.

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

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

14. Share capital – continued:

b) Issued and outstanding:

(thousands of dollars)

	2017		2016	
	Shares	Amount	Shares	Amount
<i>Common shares:</i>				
Outstanding, beginning of year	20,095,065	\$ 147,224	19,437,171	\$ 142,224
Issued for cash proceeds under private placement	–	–	657,894	5,000
Impact of amalgamation of PWC Capital Inc. (note 27)	1,028,494	5,388	–	–
Outstanding, end of year	21,123,559	\$ 152,612	20,095,065	\$ 147,224
<i>Series 1 Preferred shares:</i>				
Outstanding, beginning and end of year	1,461,460	\$ 13,647	1,461,460	\$ 13,647
<i>Series 3 Preferred shares</i>				
Outstanding, beginning and end of year	1,681,320	\$ 15,690	1,681,320	\$ 15,690
<i>Contributed surplus:</i>				
Balance, beginning and end of year		\$ 145		\$ 145
Total share capital		\$ 182,094		\$ 176,706

Transaction costs of \$1.4 million (2016 - \$nil) net of income taxes of \$500,000 (2016 - \$nil) have been recorded in share capital.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

15. Stock-based compensation:

Equity-settled stock options:

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

For the year ended October 31, 2017, the Bank recognized stock-based compensation expense of \$nil (2016 - \$nil). As at October 31, 2017, the outstanding options totaled 46,617 compared to 40,000 a year ago. The increase in options reflect the options to purchase PWC common shares that were converted into options to purchase Bank common shares pursuant to the Amalgamation. The initial 40,000 options granted were to an officer who is a member of the Bank's key management personnel. The options are fully exercisable into common shares at approximately \$7.00 per share and expire between 2018 and 2023. No stock options were granted during the year ended October 31, 2017 or October 31, 2016.

16. Non-interest income (loss):

(thousands of dollars)

	2017	2016
Credit card non-interest revenue (loss)	\$ (214)	\$ 1,234
Other income	73	39
	\$ (141)	\$ 1,273

17. Restructuring charges:

Restructuring charges for the year ended October 31, 2017 totalling \$2.0 million (2016 - \$1.1 million) relate primarily to termination benefits for employees and key management personnel incurred as a function of the sale of the credit card portfolio and the Bank's corporate reorganization. The restructuring charges incurred in the prior year were primarily costs associated with the Bank's corporate rebranding and strategic review that resulted in the Amalgamation.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

18. Income taxes:

Income taxes, including both the current and deferred portions, vary from the amounts that would be computed by applying the aggregated statutory federal and provincial tax rate of 27% (2016 – 27%) to income before income taxes. Income taxes have been computed as follows:

(thousands of dollars)

	2017	2016
Income before income taxes	\$ 14,732	\$ 11,758
Income tax rate	27%	27%
Expected income tax provision	3,978	3,175
Re-measurement of deferred income tax assets subsequent to the Amalgamation	(8,831)	–
Tax rate differential	(45)	(36)
Other permanent differences	158	149
Income tax provision (recovery)	\$ (4,740)	\$ 3,288

Movement in current and deferred income tax assets (liabilities) is as follows:

(thousands of dollars)

	2017	2016
Current income taxes	\$ –	\$ –
Deferred income taxes:		
Origination and reversal of temporary differences	4,091	3,288
Change in estimate of deferred income tax assets	(8,831)	–
Deferred income tax provision (recovery)	\$ (4,740)	\$ 3,288
Total income taxes	\$ (4,740)	\$ 3,288

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

18. Income taxes – continued:

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

(thousands of dollars)

	November 1, 2016	Recognized in net income	Recognized directly to equity	Acquired on amalgamation with PWC	October 31, 2017
Allowance for credit losses \$	809	\$ (170)	\$ –	\$ –	\$ 639
Loss carry forwards	4,693	4,624	881	11,939	22,137
Share issue and financing costs	499	(491)	500	–	508
Deposit commissions	(835)	7	–	–	(828)
Other	1,232	770	–	–	2,002
Total deferred income tax assets	\$ 6,398	\$ 4,740	\$ 1,381	\$ 11,939	\$ 24,458

(thousands of dollars)

	November 1, 2015	Recognized in net income	Recognized directly to equity	Acquired on amalgamation with PWC	October 31, 2016
Allowance for credit losses \$	857	\$ (48)	\$ –	\$ –	\$ 809
Loss carry forwards	7,183	(3,373)	883	–	4,693
Share issue and financing costs	764	(265)	–	–	499
Deposit commissions	(890)	55	–	–	(835)
Other	889	343	–	–	1,232
Total deferred income tax assets	\$ 8,803	\$ (3,288)	\$ 883	\$ –	\$ 6,398

The Bank is subject to Part VI.1 tax which is a 40% tax on dividends paid on taxable preferred shares under the Income Tax Act (Canada). The Part VI.1 tax of \$880,000 (2016 - \$880,000) and related deferred tax recovery is recorded through equity. Tax adjustments recorded through comprehensive income of \$1,000 (2016 - \$3,000) are also reflected in equity.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

18. Income taxes – continued:

At October 31, 2017, the Bank had income tax losses which can be carried forward to reduce taxable income in future years. These loss carry forwards of the Bank will expire, if unused, as follows:

(thousands of dollars)

2028	\$	4,622
2029		7,593
2030		14,983
2031		9,870
2032		12,555
2033		13,983
2034		11,419
2035		9,145
	\$	84,170

In addition the Bank has approximately \$9.5 million (2016 - \$7.0 million) of capital loss carry forwards which may be applied against future capital gains and for which the deferred tax asset of \$1.3 million (2016 - \$935,000) has not been recognized.

19. Per share amounts:

Basic and diluted income per common share

(thousands of dollars except per share amounts)

	2017	2016
Net income	\$ 19,472	\$ 8,470
Preferred share dividends paid	(2,201)	(2,201)
Net income available to common shareholders	17,271	6,269
<u>Average number of common shares outstanding</u>	<u>20,864,000</u>	<u>19,861,000</u>
Basic and diluted income per common share	\$ 0.83	\$ 0.32

Employee stock options do not have a dilutive impact as the exercise price is greater than the average market price. The Series 1 and Series 3 NVCC preferred shares are contingently issuable shares and do not have a dilutive impact.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

20. Items not involving cash:

(thousands of dollars)

	2017	2016
Provision for (recovery of) credit losses	\$ (125)	\$ 871
Income taxes	(4,740)	3,288
Interest income	(71,765)	(69,662)
Interest expense	27,782	31,258
Amortization of property and equipment	553	776
	<u>\$ (48,295)</u>	<u>\$ (33,469)</u>

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

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

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

Credit Risk

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

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

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

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

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

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

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

Liquidity Risk

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

See note 22 for information relating to liquidity risk associated with the Bank's asset and liability gaps in maturities.

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

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

Market Risk

Market risk is the risk of a loss resulting from changes in interest rates, and market prices and volatilities that arise from the Bank's funding and investment activities.

The Bank's principal market risk arises from interest rate risk as the Bank does not undertake foreign exchange or trading activities. The Risk Oversight Committee is charged with recommending policies to the Board of Directors for approval that govern market risk and with reviewing the policies on an ongoing basis.

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

The management of interest rate risk against interest rate gap limits is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to various standard and non-standard interest rate scenarios. Standard scenarios that are considered include a 100 basis point (bps) parallel fall or rise in all yield curves applicable to the Bank. An analysis of the Bank's sensitivity to an increase or decrease in market interest rates, assuming no asymmetrical movement in yield curves and a constant balance sheet is as follows:

Interest Rate Position

(thousands of dollars)

	2017		2016	
	Increase 100 bps	Decrease 100 bps	Increase 100 bps	Decrease 100 bps
Sensitivity of projected net interest income during a 12 month period	\$ 3,043	\$ (3,060)	\$ 2,387	\$ (2,243)
Sensitivity of reported equity during a 60 month period	(1,445)	1,572	(1,631)	1,667
Duration difference between assets and liabilities (months)	0.1		0.6	

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

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

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

As at October 31, 2017 and October 31, 2016 the Bank did not have any outstanding contracts to hedge fair value exposure attributed to interest rate risk. The Bank uses on-balance sheet strategies to manage its interest rate risk.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

22. Interest rate and liquidity risk:

The Bank is exposed to interest rate risk as a consequence of the mismatch, or gap, between assets and liabilities scheduled to mature or reset on particular dates. The gaps, which existed at October 31, 2017 are as follows:

(thousands of dollars)

	Floating rate	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Over 5 years	Non-interest rate sensitive	Total
Assets								
Cash and								
cash equivalents	\$ 159,909	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 159,909
Effective rate	1.39%							
Securities	-	262	-	-	-	-	-	262
Effective rate		2.25%						
Loans	494,091	43,187	59,247	90,227	695,386	135,334	3,385	1,520,857
Effective rate	5.34%	4.61%	4.69%	4.53%	4.37%	4.06%		
Other	-	5,227	-	-	-	-	38,794	44,021
Effective rate		0.89%						
Total assets	\$ 654,000	\$ 48,676	\$ 59,247	\$ 90,227	\$ 695,386	\$ 135,334	\$ 42,179	\$ 1,725,049
Liabilities								
Deposits	\$ 294,164	\$ 204,947	\$ 280,086	\$ 246,752	\$ 339,000	\$ -	\$ 11,057	\$ 1,376,006
Effective rate	0.43%	1.62%	1.61%	1.96%	2.10%			
Subordinated notes	-	-	-	-	9,786	-	-	9,786
Effective rate					8.77%			
Securitization liabilities	-	-	-	-	33,256	-	-	33,256
Effective rate					3.85%			
Other	88,778	-	-	-	-	-	8,682	97,460
Effective rate	1.20%							
Equity	-	-	-	-	29,337	-	179,204	208,541
Effective rate					7.00%			
Total liabilities and equity	\$ 382,942	\$ 204,947	\$ 280,086	\$ 246,752	\$ 411,379	\$ -	\$ 198,943	\$ 1,725,049
October 31, 2017 gap	\$ 271,058	\$ (156,271)	\$ (220,839)	\$ (156,525)	\$ 284,007	\$ 135,334	\$ (156,764)	\$ -
Cumulative	\$ 271,058	\$ 114,787	\$ (106,052)	\$ (262,577)	\$ 21,430	\$ 156,764	\$ -	\$ -
October 31, 2016 gap	\$ 268,319	\$ (169,712)	\$ (316,287)	\$ (39,882)	\$ 251,087	\$ 159,731	\$ (153,256)	\$ -
Cumulative	\$ 268,319	\$ 98,607	\$ (217,680)	\$ (257,562)	\$ (6,475)	\$ 153,256	\$ -	\$ -

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

23. Fair value of financial instruments:

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

(thousands of dollars)

	2017		2016	
	Book Value	Fair value of assets and liabilities	Book value	Fair value of assets and liabilities
Assets				
Cash and cash equivalents	\$ 159,909	\$ 159,909	\$ 93,964	\$ 93,964
Securities	262	262	9,958	9,958
Loans	1,520,857	1,513,175	1,563,612	1,563,299
Other financial assets	5,731	5,731	16,539	16,539
Liabilities				
Deposits	\$ 1,376,006	\$ 1,365,690	\$ 1,369,647	\$ 1,380,685
Subordinated notes payable	9,786	10,000	14,067	14,500
Securitization liabilities	33,256	34,469	43,585	46,923
Other financial liabilities	97,460	97,460	91,217	91,217

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

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

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

24. Related party transactions:

During the year and prior to the Amalgamation, the Bank paid management and other fees totalling \$675,000 (2016 - \$751,000) to PWC and a subsidiary of PWC.

The Bank's Boards of Directors and Senior Executive Officers represent key management personnel.

At October 31, 2017, amounts due from related parties totalled \$746,000 (2016 - \$2.5 million).

The interest rates charged on related party loans are similar to that charged in an arms-length transaction. Interest income earned on related party loans for the year ended October 31, 2017 totalled \$21,000 (2016 - \$70,000). There were no provisions for credit losses related to loans issued to key management personnel (2016 - \$nil).

Total compensation expense recognized for key management personnel for the year was \$5.7 million (2016 - \$4.4 million).

25. Commitments and contingencies:

a) Credit commitments:

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

(thousands of dollars)

	2017	2016
Loan commitments	\$ 249,682	\$ 265,631
Undrawn credit card lines	-	127,116
Letters of credit	45,442	42,808
	<u>\$ 295,124</u>	<u>\$ 435,555</u>

b) Lease commitments:

The Bank leases a number of premises under operating leases, with current leasing arrangements expiring between June 30, 2019 and January 31, 2045 with an option to renew the leases after the initial lease period. Lease payments are increased every three to five years to reflect market rates. The Bank does not have any material subleases.

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

25. Commitments and contingencies - continued:

b) Lease commitments (continued):

Total operating lease expense recognized for the year ended October 31, 2017 totalled \$958,000 (2016 - \$816,000)

Minimum future lease commitments are as follows:

(thousands of dollars)

	2017	2016
Within 1 year	\$ 560	\$ 888
Between 1 and 5 years	464	1,707
Greater than 5 years	339	–
Total lease commitments	\$ 1,363	\$ 2,595

c) Pledged assets:

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

(thousands of dollars)

	2017	2016
Securitized contracts	\$ 4,049	\$ 4,033
Letters of credit	5,905	4,460
	\$ 9,954	\$ 8,493

26. Capital management:

a) Overview

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

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

26. Capital management – continued:

a) Overview (continued):

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

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

During the year ended October 31, 2017, there were no material changes in the Bank's management of capital.

b) Risk-Based Capital Ratio:

The Basel Committee on Banking Supervision has published the Basel III rules supporting more stringent global standards on capital adequacy and liquidity (Basel III). OSFI requires that all Canadian banks must comply with the Basel III standards on an "all-in" basis that became effective January 1, 2013 for purposes of determining their risk-based capital ratios. Required minimum regulatory capital ratios are a 7.0% Common Equity Tier 1 (CET1) capital ratio and effective January 1, 2014, an 8.5% Tier 1 capital ratio and 10.5% total capital ratio, all of which include a 2.50% capital conservation buffer. The Basel III rules provide for "transitional" adjustments whereby certain aspects of the new rules will be phased in between 2013 and 2019. The only available transition allowed by OSFI for capital ratios is related to the 10 year phase out of non-qualifying capital instruments.

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

26. Capital management – continued:

b) Risk-Based Capital Ratio – continued:

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

(thousands of dollars)

	2017		2016	
	"All-in"	"Transitional"	"All-in"	"Transitional"
Common Equity Tier 1 (CET1) capital				
Directly issued qualifying common share capital	\$ 152,757	\$ 152,757	\$ 147,369	\$ 147,369
Retained earnings	26,443	26,443	9,172	9,172
Accumulated other comprehensive income	4	4	6	6
CET1 before regulatory adjustments	179,204	179,204	156,547	156,547
Regulatory adjustments applied to CET1	(26,415)	(21,132)	(6,562)	(3,937)
Total Common Equity Tier 1 capital	\$ 152,789	\$ 158,072	\$ 149,985	\$ 152,610
Additional Tier 1 capital				
Directly issued qualifying Additional Tier 1 instruments	\$ 29,337	\$ 29,337	\$ 29,337	\$ 29,337
Total Tier 1 capital	\$ 182,126	\$ 187,409	\$ 179,322	\$ 181,947
Tier 2 capital				
Directly issued capital instruments subject to phase out from Tier 2	\$ 10,000	\$ 10,000	\$ 14,500	\$ 14,500
Tier 2 capital before regulatory adjustments	10,000	10,000	14,500	14,500
Regulatory adjustments applied to Tier 2	(4,000)	(4,000)	(4,700)	(4,700)
Total Tier 2 capital	\$ 6,000	\$ 6,000	\$ 9,800	\$ 9,800
Total capital	\$ 188,126	\$ 193,409	\$ 189,122	\$ 191,747
Total risk-weighted assets	\$1,420,276	\$ 1,425,559	\$1,425,171	\$ 1,427,796
Capital ratios				
CET1 ratio	10.76%	11.09%	10.52%	10.69%
Tier 1 capital ratio	12.82%	13.15%	12.58%	12.74%
Total capital ratio	13.25%	13.57%	13.27%	13.43%

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

26. Capital management – continued:

c) Leverage ratio:

The leverage ratio is a supplementary measure to the risk-based capital requirements and is defined as the ratio of Tier 1 capital to its total exposures. The Bank is in compliance with its leverage ratio that is calculated as follows:

(thousands of dollars)

	2017	2016
On-balance sheet assets	\$ 1,725,049	\$ 1,704,400
Assets amounts deducted in determining the Basel III “all in” Tier 1 capital	(26,415)	(6,562)
Total on-balance sheet exposures	1,698,634	1,697,838
Off-balance sheet exposure at gross notional amount	295,124	435,556
Adjustments for conversion to credit equivalent amount	(182,977)	(306,877)
Off-balance sheet exposures	112,147	128,679
Tier 1 Capital	182,126	179,322
Total exposures	1,810,781	1,826,517
Leverage Ratio	10.06%	9.82%

The Bank was in compliance with the leverage ratio prescribed by OSFI throughout the years presented.

27. Amalgamation of PWC and the Bank:

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

VERSABANK

Notes to Consolidated Financial Statements
Years ended October 31, 2017 and 2016

27. Amalgamation of PWC and the Bank (continued)

In addition, each outstanding option to acquire PWC common shares was converted into an option to purchase Bank common shares resulting in 7,059 additional options being issued (as at October 31, 2017, 6,617 of the 7,059 additional options remain outstanding).

The estimated fair value of securities held by dissenting shareholders was settled during the year.

The fair values of the assets and liabilities acquired by the Bank on Amalgamation are as follows:

(thousands of dollars)

	January 31, 2017
Incremental assets recognized:	
Cash	\$ 1,569
Deferred income tax asset	11,939
Other assets	2,025
Other net liabilities assumed	(8,793)
Transaction costs, net of income taxes of \$500	(1,352)
Total impact of amalgamation	\$ 5,388

28. Subsequent event:

On November 28, 2017, the Board of Directors declared quarterly cash dividends on the Bank's common shares and 7.0% Series 1 and Series 3 preferred shares. The common share dividend of \$0.01 per share and the Series 1 preferred share and Series 3 preferred share dividends of \$0.175 per share are payable, subject to the approval of the Toronto Stock Exchange ("TSX"), as of January 31, 2018 to shareholders of record at the close of business on January 5, 2018.