CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

For the three-month and nine-month period ended September 30, 2012

Interim Consolidated Balance Sheets
(unaudited)

As at *(in thousands of Canadian dollars)*	**September 30 2012 $**	December 31 2011 $
ASSETS		
Cash resources (note 4)		
Cash and cash equivalents	**44,974**	27,556
Interest bearing deposits with banks	**9,995**	2,968
	54,969	30,524
Securities (note 5)	**3,006**	5,989
Loans (note 6)		
Residential reverse mortgages	**1,338,742**	1,232,292
Allowance for credit losses	**(4,003)**	(3,454)
	1,334,739	1,228,838
Goodwill and intangible assets (note 7)	**19,721**	19,753
Other		
Derivative instruments (note 17)	**18,766**	28,693
Computer hardware and other property, net	**645**	502
Income taxes receivable	**871**	260
Prepaid expenses and other assets	**820**	1,221
	21,102	30,676
	1,433,537	1,315,780
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits (notes 8, 16 and 17)		
Payable on a fixed date	**849,923**	596,073
	849,923	596,073
Other		
Derivative instruments (note 17)	**263**	577
Deferred income tax liabilities (note 9)	**5,247**	5,339
Dividends payable	**—**	999
Accounts payable and accrued liabilities	**18,493**	12,679
	24,003	19,594
Medium-term debt (notes 10, 16 and 17)	**398,628**	521,148
Subordinated debt (notes 11 and 16)	**20,373**	40,432
Unsecured subordinated debt (notes 12, 16 and 17)	**31,917**	31,298
Bank term loan (notes 13, 16 and 17)	**10,243**	10,100
	461,161	602,978
	1,335,087	1,218,645
Shareholders' equity		
Common shares (note 14)	**104,644**	104,615
Contributed surplus (note 15)	**146**	107
Deficit	**(6,340)**	(7,587)
	98,450	97,135
	1,433,537	1,315,780

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

Interim Consolidated Statements of Comprehensive Income (unaudited)

(in thousands of Canadian dollars except per share amounts)	For the three-month period ended September 30 2012 $	September 30 2011 $	For the nine-month period ended September 30 2012 $	September 30 2011 $
Interest income				
Mortgage interest (note 6)	**15,806**	14,409	**46,425**	41,693
Securities	**39**	28	**132**	183
Deposits with banks	**179**	82	**391**	442
	16,024	14,519	**46,948**	42,318
Interest expense				
Deposits	**5,184**	3,195	**13,541**	8,413
Medium-term debt	**2,790**	3,354	**9,163**	11,874
Subordinated debt	**316**	613	**1,284**	1,852
Unsecured subordinated debt	**678**	427	**2,033**	1,283
Bank term loan	**197**	196	**585**	585
	9,165	7,785	**26,606**	24,007
Net interest income before provision for losses	**6,859**	6,734	**20,342**	18,311
Provision for credit losses, net of recoveries (note 6)	**137**	254	**771**	385
Net interest income	**6,722**	6,480	**19,571**	17,926
Non-interest income				
Mortgage administration fees	**43**	37	**120**	103
	43	37	**120**	103
Net interest income and non-interest income	**6,765**	6,517	**19,691**	18,029
Non-interest expenses				
Salaries and benefits (notes 15, 20 and 23)	**1,976**	1,730	**5,489**	4,993
Selling, general and administration (note 21)	**1,827**	1,646	**7,461**	5,458
Amortization of intangible assets	**69**	54	**197**	153
Amortization of computer hardware and other property	**72**	60	**192**	178
	3,944	3,490	**13,339**	10,782
Income before unrealized losses on derivative financial instruments and income taxes	**2,821**	3,027	**6,352**	7,247
Unrealized losses on derivative financial instruments (note 17)	**987**	584	**2,900**	3,871
Income before income taxes	**1,834**	2,443	**3,452**	3,376
Current income tax expense	**348**	728	**1,260**	1,693
Deferred income tax expense (recovery)	**146**	(4)	**(92)**	(562)
Income tax expense	**494**	724	**1,168**	1,131
Net income and total comprehensive income	**1,340**	1,719	**2,284**	2,245
Average number of common shares outstanding	**14,569**	14,535	**14,562**	14,491
Basic and diluted earnings per share	**$0.09**	$0.12	**$0.16**	$0.15

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

Interim Consolidated Statements of Changes in Shareholders' Equity (unaudited)

	For the three-month period ended		For the nine-month period ended	
(in thousands of Canadian dollars)	**September 30 2012 $**	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Common shares (note 14)				
Balance, beginning of period	**104,533**	104,386	**104,615**	103,844
Issued during the period	**111**	290	**519**	832
Acquisition of common shares for long-term incentive plan	**—**	—	**(490)**	—
Balance, end of period	**104,644**	104,676	**104,644**	104,676
Contributed surplus (note 15)				
Balance, beginning of period	**136**	66	**107**	31
Amortization of fair value of employee stock options	**10**	20	**39**	55
Balance, end of period	**146**	86	**146**	86
Deficit				
Balance, beginning of period	**(7,680)**	(8,461)	**(7,587)**	(6,962)
Net income for the period	**1,340**	1,719	**2,284**	2,245
Dividends declared	**—**	(1,017)	**(1,037)**	(3,042)
Balance, end of period	**(6,340)**	(7,759)	**(6,340)**	(7,759)
Total shareholders' equity	**98,450**	97,003	**98,450**	97,003

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

Interim Consolidated Statements of Cash Flows
(unaudited)

(in thousands of Canadian dollars)	**For the three-month period ended September 30 2012 $**	For the three-month period ended September 30 2011 $	**For the nine-month period ended September 30 2012 $**	For the nine-month period ended September 30 2011 $
OPERATING ACTIVITIES				
Net income for the period	**1,340**	1,719	**2,284**	2,245
Adjustments for non-cash items				
Amortization				
Purchase price premiums and origination fees	**858**	889	**2,498**	2,544
Deferred origination commissions and mortgage fees and costs	**692**	569	**1,992**	1,641
Deferred deposit commissions	**466**	296	**1,218**	781
Debt issue costs	**121**	146	**433**	594
Intangible assets	**69**	54	**197**	153
Computer hardware and other property	**72**	60	**192**	178
Provision for credit losses	**(11)**	254	**549**	385
Compensation expense related to long-term incentive plans	**121**	155	**341**	429
Deferred income tax expense (recovery)	**146**	(4)	**(92)**	(562)
Unrealized losses on derivative financial instruments	**987**	584	**2,900**	3,871
	4,861	4,722	**12,512**	12,259
Changes in non-cash working capital				
Accrual of interest payable on debt and derivatives	**(1,693)**	(2,184)	**(2,838)**	(744)
Accrual of interest on mortgages	**(17,145)**	(15,652)	**(50,189)**	(45,121)
Repayments of accrued interest on mortgages	**11,660**	9,320	**32,810**	27,668
Other (note 22)	**3,727**	2,328	**5,604**	4,358
	(3,451)	(6,188)	**(14,613)**	(13,839)
Cash provided by (used in) operating activities	**1,410**	(1,466)	**(2,101)**	(1,580)
INVESTING ACTIVITIES				
Mortgages originated	**(64,563)**	(54,538)	**(166,237)**	(168,103)
Purchase of Mortgage Portfolio	**—**	—	**—**	(3,732)
Mortgage principal repayments	**28,189**	21,623	**76,492**	66,196
Origination commissions and deferred mortgage fees and costs	**(1,219)**	(922)	**(3,816)**	(2,769)
Disposal of securities, net	**—**	2,988	**2,983**	(2,996)
Decrease (increase) in interest bearing deposits with banks, net	**18,672**	9,992	**(7,027)**	11,994
Purchase of intangible assets	**—**	(58)	**(165)**	(151)
Purchase of computer hardware and other property	**(27)**	(43)	**(335)**	(142)
Cash used in investing activities	**(18,948)**	(20,958)	**(98,105)**	(99,703)
FINANCING ACTIVITIES				
Increase in deposits, net	**68,194**	33,081	**254,962**	180,343
Gross proceeds from medium-term debt	**—**	—	**—**	175,000
Repayment of medium-term debt	**(46,187)**	(912)	**(48,817)**	(284,697)
Repurchase of medium-term debt	**(15,509)**	—	**(66,212)**	—
Repayment of subordinated debt	**—**	—	**(20,000)**	—
Increase in debt issue costs	**—**	—	**—**	(847)
Proceeds from shares issued under dividend reinvestment plan	**—**	156	**217**	458
Acquisition of common shares for long-term incentive plan	**—**	—	**(490)**	—
Dividends paid	**—**	(1,015)	**(2,036)**	(3,034)
Cash provided by financing activities	**6,498**	31,310	**117,624**	67,223
Net increase (decrease) in cash and cash equivalents during the period	**(11,040)**	8,886	**17,418**	(34,060)
Cash and cash equivalents, beginning of period	**56,014**	23,128	**27,556**	66,074
Cash and cash equivalents, end of period (note 4)	**44,974**	32,014	**44,974**	32,014
Supplemental cash flow information:				
Interest paid	**7,322**	6,127	**21,473**	13,065
Income taxes paid	**511**	539	**1,887**	659

Amounts paid for interest and taxes are included in cash flows from operating activities in the interim consolidated statements of cash flows.
The accompanying notes are an integral part of these interim consolidated financial statements.

1. CORPORATE INFORMATION

HOMEQ Corporation (the Company) is a public holding company traded on the Toronto Stock Exchange. The Company was incorporated on March 10, 2009 under the laws of the Province of Ontario and is domiciled in Canada with its registered and principal business offices located at 45 St. Clair Ave. West, Suite 600, Toronto, Ontario. On June 30, 2009, Home Equity Income Trust (the Trust) converted to a corporation by way of a Plan of Arrangement continuing its business operations as HOMEQ Corporation (the Conversion). Under the Conversion, the unitholders of the Trust exchanged each of their trust units for common shares of the Company on a one-for-one basis.

The Company operates primarily through its federally regulated subsidiary, HomEquity Bank, which originates and administers reverse mortgages and offers guaranteed investment certificate deposits. The Company is the ultimate parent of the group.

On March 30, 2012, the Company entered into an arrangement agreement (the Arrangement) under which Birch Hill Equity Partners Management Inc will indirectly acquire all of the outstanding common shares of the Company (note 25). Following completion of the Arrangement, it is anticipated that the Company's shares will be delisted from the Toronto Stock Exchange and Company will apply to cease to be a reporting issuer.

These interim consolidated financial statements for the three-month and nine-month periods ended September 30, 2012 were authorized for issuance by the Board of Directors of the Company on November 12, 2012. The Board of Directors has the power to amend the financial statements after their issuance only in the case of discovery of an error.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Statement of compliance

These condensed interim consolidated financial statements have been prepared to comply with International Accounting Standard 34, *Interim Financial Reporting* (IAS 34) as issued by the International Accounting Standards Board (IASB) using accounting policies consistent with International Financial Reporting Standards (IFRS). These interim consolidated financial statements should be read together with the Company's audited annual consolidated financial statements and accompanying notes for the year ended December 31, 2011.

Basis of presentation

These interim consolidated financial statements have been prepared on a historical cost basis, except for the following:

Derivative financial instruments and available-for-sale financial assets

Financial assets designated as available-for-sale as well as derivative financial instruments and those financial assets classified or designated at fair value through profit or loss (FVTPL) are measured at fair value.

Assets and liabilities designated as part of an effective and designated hedging relationship

Assets and liabilities that are designated as hedging instruments in effective fair value hedge relationships are measured at fair value.

Basis of consolidation

These interim consolidated financial statements reflect the financial position and results of operations of the Company consolidated with the financial position and results of operations of its subsidiaries and special purpose entities (SPEs). The Company's principal subsidiary is HomEquity Bank. All of the Company's subsidiaries are directly or indirectly wholly owned.

The Company consolidates SPEs in accordance with the guidance provided by the Standing Interpretations Committee Interpretation 12, *Consolidation – Special Purposes Entities* (SIC-12), using the prescribed criteria. An SPE is an entity of which an enterprise has control even if the Company owns one-half or less of the voting power.

The Company has established an employee benefit trust (EBT) (note 15) to fulfil obligations arising from its long-term incentive plans. The EBT has been consolidated in accordance with SIC-12, as its meets the definition of an SPE and the Company is the primary beneficiary of the EBT.

Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Company obtains control, and continue to be consolidated until the date that such control ceases. All intra-company transactions and balances are eliminated in full.

3. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

In the preparation of these interim consolidated financial statements, management has made judgments, aside from those that involve estimates, in the process of applying the accounting policies. These judgments can have an effect on the amounts recognized in the interim consolidated financial statements.

Allowance for credit losses

The specific and general allowances for credit losses are maintained at a level that is considered adequate to absorb incurred credit-related losses to the mortgage loan portfolio. The determination of the allowances requires management to make estimates when assessing whether or not there is reasonable assurance of the collection of the full amount of principal and interest. Significant judgment is involved in estimating factors such as the expected realizable value of properties and the expected term of the mortgages.

As at September 30, 2012, the specific and general allowances for credit losses were $690 and $3,313, respectively. The use of different estimates and assumptions could have a significant effect on the measurement of the allowance for credit losses.

Fair value of financial instruments

Where possible, the fair value of publicly traded financial instruments is based on quoted prices in an active market. The fair value for a substantial majority of financial instruments is based on quoted market prices or valuation models that use observable market inputs such as interest rate yield curves. Valuation models incorporate prevailing market rates and may require estimates for economic risks and projected cash flows.

As at September 30, 2012, the fair value of the derivative instrument assets was $18,766 and the fair value of the derivative instrument liabilities was $263. The fair value adjustments to deposits, medium-term debt, unsecured subordinated debt and bank term loan subject to hedge accounting were increases of $4,558, $12,166, $304 and ($4), respectively. The use of different estimates and assumptions could have an effect on the determination of the fair value of financial instruments and the application of hedge accounting.

Amortization of purchase price premiums and transaction costs

In the application of the effective interest rate method to measure amortized cost, purchase price premiums, mortgage origination fees and transaction costs are included in the carrying value of the mortgages and deferred and expensed over the estimated period that mortgages earn interest.

The amounts, net of accumulated amortization, of purchase price premiums, mortgage origination fees and transaction costs included in the carrying value of the mortgages as at September 30, 2012 were $24,984, $1,665 and $19,944, respectively. The use of different estimates and assumptions related to the expected lives of the mortgages could have a significant effect on the measurement of deferred purchase price premiums and transaction costs included in the carrying value of the mortgages.

Income taxes

The Company measures income taxes payable and deferred income tax assets and liabilities at each reporting date. The actual amount of income taxes only becomes final upon filing and acceptance of the tax return by the relevant authorities, which usually occurs subsequent to the issuance of the financial statements. Related carrying amounts as at September 30, 2012 were income taxes receivable of $871 and deferred income tax liabilities of $5,247.

Additionally, estimation of income taxes includes evaluating the recoverability of deferred income tax assets based on an assessment of the ability to use the underlying future tax deductions before they expire against future taxable income. The assessment is based upon existing tax laws and estimates of future taxable income. The use of different estimates and assumptions could have a significant effect on the measurement of the deferred income tax assets.

The measurement of income taxes payable and deferred income tax assets and liabilities requires management to make judgments in the interpretation and application of the relevant tax laws. The actual amount of income taxes only becomes final upon filing and acceptance of the tax return by the relevant authorities, which occurs subsequent to the issuance of the financial statements.

Valuation of goodwill and intangible assets

Goodwill and the bank license costs are tested for impairment at least annually or when there is a loss event by comparing their carrying amount, together with the carrying amount of associated assets, to the recoverable amount. Recoverable amount is defined as the higher of the fair value less costs to sell and the value in use. The determination of recoverable amount requires management to make estimates of forecasted cash flows, growth rates and discount rates. These estimates include assumptions regarding such factors as market risk, credit risk and operational risk.

For the purposes of impairment testing, goodwill and the bank license costs are allocated to the associated cash-generating units, or group of cash-generating units. Management is required to make judgments regarding the appropriate allocation of goodwill and other intangible assets for impairment testing. Different conclusions on the appropriate allocation could lead to different results of the impairment testing, and have a significant effect on the measurement of goodwill and intangible assets.

3. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS (continued)

The value in use calculation is determined using discounted estimated future cash flows and includes the following key assumptions: future cash flows and growth projections, including economic risk assumptions and estimates of achieving key operating metrics and drivers; the future weighted average cost of capital; and earnings multiples. The Company considers a range of reasonably possible amounts to use for key assumptions and decides upon amounts that represent management's best estimate. In the normal course, changes are made to key assumptions to reflect current economic conditions, updating of historical information used to develop the key assumptions and any changes in the Company's debt ratings.

The carrying value of the goodwill and the bank license costs at September 30, 2012 were $19,109 and $427, respectively. The use of different estimates and assumptions could lead to different results in impairment testing, and have a significant effect on the measurement of goodwill and intangible assets.

Share-based payment transactions

The Company measures the cost of equity-settled transactions for its long-term incentive plans, by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value for share-based payment transactions requires determining the most appropriate valuation model, which is dependent on the terms and conditions of the grant. This estimate also requires the determination of the most appropriate inputs to the valuation model including expected life of the share option, volatility, forfeiture rate and dividend yield and making assumptions about them. The assumptions and models used for estimating fair value for stock option transactions are disclosed in note 15.

4. CASH RESOURCES

Included in cash and cash equivalents are securities with terms of 90 days or less from the date of acquisition. For the nine-month period ended September 30, 2012, the yield earned on these investments ranged between 1.02% and 1.32% (September 30, 2011 – ranged between 0.95% and 1.23%) with a weighted average rate of 1.13% (September 30, 2011 – 1.06%).

	September 30 2012 $	December 31 2011 $
Cash and non-interest bearing deposits with banks	**39,974**	19,662
Corporate notes	**5,000**	7,894
Cash and cash equivalents	**44,974**	27,556
Interest bearing deposits with banks	**9,995**	2,968
Total cash resources	**54,969**	30,524

5. SECURITIES

For the nine-month period ended September 30, 2012, the yield earned on investments ranged between 0.98% and 1.37% (September 30, 2011 – ranged between 1.30% and 1.35%) with a weighted average rate of 1.17% (September 30, 2011 – 1.32%).

	Remaining term to maturity				
	Within 1 year $	**1 to 5 years $**	**Over 5 years $**	**September 30 2012 $**	December 31 2011 $
Treasury bills issued or guaranteed by provinces	—	—	—	—	2,989
Other debt securities	**3,006**	—	—	**3,006**	3,000
	3,006	—	—	**3,006**	5,989

6. LOANS

Residential reverse mortgages

	September 30 2012 $	December 31 2011 $
Mortgage principal plus accrued interest	**1,292,149**	1,185,024
Mortgage purchase price premiums, net of accumulated amortization	**24,984**	27,308
Mortgage origination fees, net of accumulated amortization	**1,665**	1,840
Deferred origination commissions and mortgage fees and costs, net of accumulated amortization	**19,944**	18,120
	1,338,742	1,232,292

Geographic region and loan-to-value

The following tables show the composition of the residential reverse mortgage portfolio by geographic distribution and loan-to-value ratio range, which measures the outstanding mortgage balance as a percentage of the most recent appraised value of the property:

Province	**September 30 2012 $**	December 31 2011 $	**September 30 2012 %**	December 31 2011 %
Ontario	**469,024**	440,992	**36.3**	37.2
British Columbia	**461,074**	425,199	**35.7**	35.9
Alberta	**165,176**	149,293	**12.8**	12.6
Quebec	**124,863**	107,363	**9.7**	9.1
Other	**72,012**	62,177	**5.5**	5.2
	1,292,149	1,185,024	**100.0**	100.0

Loan-to-value	**September 30 2012 $**	December 31 2011 $	**September 30 2012 %**	December 31 2011 %
Less than 30.0%	**216,132**	205,729	**16.7**	17.4
30.1% - 40.0%	**352,758**	339,169	**27.3**	28.6
40.1% - 50.0%	**387,272**	353,605	**30.0**	29.8
50.1% - 60.0%	**233,747**	199,882	**18.1**	16.9
60.1% - 70.0%	**72,582**	67,174	**5.6**	5.7
Greater than 70.1%	**29,658**	19,465	**2.3**	1.6
	1,292,149	1,185,024	**100.0**	100.0

Impaired loans

The following table shows residential reverse mortgages with a loan-to-value ratio of greater than 83%, which management considers impaired, and the appraised value of those underlying properties:

	September 30 2012 $	December 31 2011 $
Mortgage principal plus accrued interest	**7,128**	3,344
Specific allowance	**(690)**	(485)
	6,438	2,859
Appraised value of underlying properties	**7,757**	3,419

6. LOANS (continued)

Allowance for credit losses

	September 30 2012 $	December 31 2011 $
Specific allowances		
Balance, beginning of period	**(485)**	(638)
Provision for credit losses	**(436)**	(276)
Write-offs	**222**	252
Recoveries	**9**	177
Balance, end of period	**(690)**	(485)
General allowances		
Balance, beginning of period	**(2,969)**	(2,547)
Provision for credit losses	**(344)**	(422)
Balance, end of period	**(3,313)**	(2,969)
Total allowances	**(4,003)**	(3,454)

Mortgage interest

	For the three-month period ended		**For the nine-month period ended**	
	September 30 2012 $	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Interest income	**17,145**	15,652	**50,189**	45,121
Early repayment fees	**211**	215	**726**	757
	17,356	15,867	**50,915**	45,878
Less:				
Amortization of deferred origination commissions and mortgage fees and costs, net	**(692)**	(569)	**(1,992)**	(1,641)
Amortization of purchase price premiums and origination fees	**(858)**	(889)	**(2,498)**	(2,544)
	(1,550)	(1,458)	**(4,490)**	(4,185)
	15,806	14,409	**46,425**	41,693

7. GOODWILL AND INTANGIBLE ASSETS

(a) Goodwill and intangible assets, net

	September 30 2012 $	December 31 2011 $
Goodwill	**19,109**	19,109
Intangible assets with indefinite lives - bank license costs	**427**	427
Intangible assets subject to amortization - software (1)	**185**	217
	19,721	19,753

(1) As at September 30, 2012, software had a cost of $785 (December 31, 2011 – $620) and accumulated amortization of $600 (December 31, 2011 – $403).

(b) Intangible assets subject to amortization

Aggregate amortization expense for software, calculated upon such assets held as at September 30, 2012, for each of the next three fiscal years and thereafter is as follows:

	$
2012	47
2013	83
2014 and thereafter	55

(c) Intangible assets with indefinite lives

Costs incurred by HomEquity Bank in obtaining its bank license have been capitalized and are recorded at cost. Bank license costs are considered to be intangible assets with indefinite lives, and as such, are not amortized but are tested for impairment annually. The bank license is issued by the Office of the Superintendent of Financial Institutions Canada.

(d) Impairment testing of intangible assets with indefinite lives and goodwill

Goodwill and the bank license costs are tested at least annually for impairment and this test represents a significant estimate for the Company. The carrying amounts, together with the carrying amount of associated assets, are compared to the recoverable amount. Recoverable amount is defined as the higher of the fair value less costs to sell and the value in use. There is a material degree of uncertainty with respect to the estimates of the recoverable amounts of assets given the necessity of making key economic assumptions about the future.

The cash flow projection key assumptions are based upon the Company's approved financial forecasts, which span a period of five years and are discounted, for the December 31, 2011 annual test purposes, at 12% (December 31, 2010 – 12%). For impairment testing valuation purposes, the cash flows subsequent to the five-year projection period are expected to remain constant, for the December 31, 2011 annual test purposes.

The Company believes that any reasonable possible change in key assumptions on which its cash-generating unit's recoverable amounts are based would not cause the cash-generating unit's carrying amounts (including the intangible assets with indefinite lives and the goodwill allocated to the cash-generating unit) to exceed their recoverable amounts. If the future was to adversely differ from management's best estimate of key assumptions and associated cash flows were to be materially adversely affected, the Company could potentially experience future material impairment charges in respect of its intangible assets with indefinite lives and goodwill.

8. DEPOSITS

Deposits are contractually payable on a fixed date and consist of fixed-interest rate guaranteed investment certificates. The terms of these deposits range from one year to five years. All deposits are issued in Canada.

	Maturity term				
	Within 1 year $	2 to 3 years $	4 to 5 years $	September 30 2012 $	December 31 2011 $
Individuals	**184,029**	**425,855**	**235,481**	**845,365**	589,185
Adjustment in carrying value of hedged deposits (note 17)	**166**	**3,105**	**1,287**	**4,558**	6,888
	184,195	**428,960**	**236,768**	**849,923**	596,073
Fair value of deposits (1)	**185,758**	**433,503**	**239,944**	**859,205**	600,309
Effective interest rate	**2.11%**	**2.60%**	**2.73%**	**2.53%**	2.54%

(1) Management determines fair value of deposits by discounting the contractual cash flows using the market interest rates currently offered for deposits with similar terms.

9. INCOME TAXES

Components of deferred income taxes

Deferred income tax relates to the following:

	September 30 2012 $	December 31 2011 $
Deferred income tax assets		
Allowance for credit losses	**897**	764
Debt issue and deferred costs	**88**	154
Long-term incentive plan	**34**	33
Mortgages	**3,116**	3,416
Non-capital losses	**—**	132
Intra-group guarantee fee	**420**	—
	4,555	4,499
Deferred income tax liabilities		
Computer hardware and other property	**87**	55
Debt issue and deferred costs	**32**	22
Derivative instruments	**387**	1,122
Mortgages	**9,296**	8,639
	9,802	9,838
Net deferred income tax liability position	**5,247**	5,339
Reported in the consolidated balance sheets as:		
Deferred income tax liabilities	**5,247**	5,339

During the three-month and nine-month periods ended September 30, 2012 an indirect subsidiary of the Company paid a guarantee fee to the Company for providing a guarantee of its medium-term and subordinated debt issued. The guarantee fee was fully taxable in the Company but not deductible in the subsidiary until amortized over the remaining maturity term of the medium-term and subordinated debt issued. As a result of this transaction, there is a temporary difference in the accounting value and tax basis of the deferred guarantee fee. As is required under IFRS, a deferred tax asset of $420 has been recognized on this temporary difference.

Deferred income tax movement in the interim consolidated statements of comprehensive income is as follows:

	For the three-month period ended		**For the nine-month period ended**	
Expense (recovery)	**September 30 2012 $**	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Allowance for credit losses	**21**	(39)	**(133)**	(87)
Computer hardware and other property	**10**	(18)	**32**	(39)
Debt issue and deferred costs	**36**	54	**76**	112
Derivative instruments	**(261)**	(155)	**(735)**	(980)
Long-term incentive plan	**—**	—	**(1)**	—
Mortgages	**220**	159	**957**	476
Non-capital losses	**540**	(5)	**132**	(42)
Intra-group guarantee fee	**(420)**	—	**(420)**	—
Net deferred income tax expense (recovery)	**146**	(4)	**(92)**	(560)

Reconciliation of net deferred income tax asset (liability):

	For the three-month period ended		**For the nine-month period ended**	
	September 30 2012 $	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Opening balance, beginning of period	**(5,101)**	(5,373)	**(5,339)**	(5,929)
Tax (expense) recovery during the period recognized in profit or loss	**(146)**	4	**92**	560
Closing balance, end of period	**(5,247)**	(5,369)	**(5,247)**	(5,369)

10. MEDIUM-TERM DEBT

Series	Expected final payment	Interest basis	Interest rate	Current Fair value $	September 30 2012 $	December 31 2011 $
2006-3	—	—	—	—	—	96,890
2007-2	—	—	—	—	—	2,630
2006-1	Feb 1, 2013	Fixed rate	4.637%	**86,072**	**85,217**	100,726
2010-1	Aug 4, 2015	Fixed rate	4.490%	**131,910**	**125,000**	125,000
2011-1	Feb 1, 2016	Fixed rate	3.973%	**182,373**	**175,000**	175,000
				400,355	**385,217**	500,246
Interest payable					**2,706**	8,973
Interest payable on derivative instruments					**22**	36
Interest receivable on derivative instruments					**(447)**	(3,148)
Debt issue costs, net of accumulated amortization					**(1,036)**	(1,338)
Adjustment in carrying value of hedged debt (note 17)					**12,166**	16,379
Medium-term debt					**398,628**	521,148

The Company has a best efforts obligation to refinance the series 2010-1 and 2011-1 notes on the respective expected final payment dates. If a note remains outstanding after the expected final payment date, the interest will become the one-month Bankers' Acceptance rate plus the following spreads calculated and payable monthly: 2010-1 – 3.00% and 2011-1 – 3.00% until legal maturity. The legal maturity dates of these notes range from August 1, 2031 to February 1, 2036. Management determines the fair value of medium-term debt using average quoted market rates based on expected final payment dates, provided to the Company by capital markets dealers.

During the three-month and nine-month period ended September 30, 2012, the Company repurchased $nil and $50,703 series 2006-3 medium-term notes respectively, prior to its expected final payment date of August 1, 2012. On August 1, 2012, the Company repaid all of the series 2006-3 medium-term notes for a cash consideration of $47,236, consisting of principal and accrued interest. For the three-month and nine-month period ended September 30, 2012, included in medium-term debt interest expense is a cost of $nil and $500, respectively due to a loss on the repurchase.

During the nine-month period ended September 30, 2012, the Company repaid all of the series 2007-2 medium-term notes for a cash consideration of $2,637, consisting of principal and accrued interest. For the three-month and nine-month period ended September 30, 2012, included in medium-term debt interest expense is a cost of $nil and $31 respectively due to the recognition of unamortized debt issue costs.

During the three-month period ended September 30, 2012, the Company repurchased $15,509 series 2006-1 medium-term notes, prior to its expected final payment date of February 13, 2012. For the three-month and nine-month period ended September 30, 2012, included in medium-term debt interest expense is a cost of $274 due to a loss on the repurchase.

11. SUBORDINATED DEBT

Series	Expected final payment	Interest basis	Interest rate	Fair value $	September 30 2012 $	December 31 2011 $
2007-2B	—	—	—	—	—	20,000
2007-1B	Nov 1, 2012	Fixed rate	6.663%	**10,022**	**10,000**	10,000
2006-2B	Aug 1, 2013	Fixed rate	5.803%	**10,111**	**10,000**	10,000
				20,133	**20,000**	40,000
Interest payable					**374**	477
Debt issue costs, net of accumulated amortization					**(1)**	(45)
Subordinated debt					**20,373**	40,432

The Company has a best efforts obligation to refinance the series 2006-2B and 2007-1B notes on their respective expected final payment dates. If a note remains outstanding after the expected final payment date, the interest will become the one-month Bankers' Acceptance rate plus the following spreads calculated and payable monthly: 2006-2B – 1.75% and 2007-1B – 3.50% until legal maturity. The legal maturity dates of these notes range from August 1, 2031 to November 1, 2032. Management determines the fair value of subordinated debt using average quoted market rates based on expected final payment dates, provided to the Company by capital market dealers.

During the nine-month period ended September 30, 2012, the Company repaid all of the series 2007-2B medium-term notes for a cash consideration of $20,181, consisting of principal and accrued interest. For the three-month and nine-month period ended September 30, 2012, included in subordinated debt interest expense is a cost of $nil and $25 respectively, due to the recognition of unamortized debt issue costs.

12. UNSECURED SUBORDINATED DEBT

Maturity	Interest basis	Interest rate	Fair value $	September 30 2012 $	December 31 2011 $
Oct 31, 2014	Fixed rate	9.713%	**10,396**	**10,000**	10,000
May 31, 2016	Fixed rate	8.600%	**10,250**	**10,000**	10,000
Oct 31, 2021	Fixed rate	8.550%	**11,198**	**10,975**	10,975
			31,844	**30,975**	30,975
Interest payable				**1,090**	398
Interest receivable on derivative instruments				**(41)**	(11)
Debt issue costs, net of accumulated amortization				**(411)**	(498)
Adjustments in carrying value of hedged debt (note 17)				**304**	434
Unsecured subordinated debt				**31,917**	31,298

Management determines the fair value of the unsecured subordinated debt using quoted market rates provided to the Company by a capital markets dealer.

13. BANK TERM LOAN

Maturity	Interest basis	Interest rate	Fair value $	September 30 2012 $	December 31 2011 $
Nov 15, 2016	Fixed rate	8.210%	**10,380**	**10,000**	10,000
Interest payable				**276**	71
Interest receivable on derivative instruments				**(29)**	(7)
Adjustment in carrying value of hedged debt (note 17)				**(4)**	36
Bank term loan				**10,243**	10,100

During the year ended December 31, 2010, the Company entered into a non-revolving term loan for $10,000, maturing on May 31, 2016 with a coupon of 8.21%. The proceeds of the loan were used to invest in unsecured subordinated debt issued by HomEquity Bank, constituting subordinated indebtedness within the meaning of the *Bank Act* (Canada) and qualifying as Tier 2 B Capital. The Company has provided a promissory note, a general security agreement, and a pledge of all investments made in HomEquity Bank, including the unsecured subordinated debt and all of the issued and outstanding shares in the capital of HomEquity Bank. Management determines the fair value of the term loan using quoted market rates provided to the Company by a capital markets dealer.

14. SHARE CAPITAL

A summary of the changes to the Company's share capital is as follows:

Authorized: An unlimited number of common shares with no par value

Common shares	Number of shares	Amount $
Balance, December 31, 2011	**14,521,885**	**104,615**
Shares issued under Dividend Re-investment Plan	**11,541**	**75**
Shares earned and granted under the long-term incentive plans (1)	**18,147**	**137**
Balance, March 31, 2012 (2)	**14,551,573**	**104,827**
Shares issued under Dividend Re-investment Plan	**15,723**	**142**
Shares earned and granted under the long-term incentive plans (1)	**41,432**	**54**
Acquisition of common shares for long-term incentive plan	**(39,661)**	**(490)**
Balance, June 30, 2012 (2)	**14,569,067**	**104,533**
Shares issued under Dividend Re-investment Plan	—	—
Shares earned and granted under the long-term incentive plans (1)	—	**111**
Balance, September 30, 2012 (2)	**14,569,067**	**104,644**

(1) Includes re-invested dividends and vested, unvested and cancelled shares.
(2) Includes 10,195 restricted shares issued under the Restricted Share Plan and 229,777 deferred shares issued under the Deferred Share Plan.

The Company has three long-term incentive plans: a Restricted Share Plan (RSP) for management, a Deferred Share Plan (DSP) for Directors and an Option and Share Appreciation Rights Plan for management.

14. SHARE CAPITAL (continued)

A restricted share granted through the RSP entitles the holder to receive one share on the vesting date. Subject to the achievement of performance conditions, if any, restricted shares vest equally over three years and the total cost of the grant is recognized over the vesting period.

During 2011, an employee benefit trust (EBT) was established in connection with the RSP. The Company funded the EBT with cash, which was used by a trustee to acquire common shares of the Company on the open market that are held in trust by the trustee until the restricted share vests. Dividends earned on the common shares in the EBT are reinvested in additional shares. As at September 30, 2012, 255,277 restricted shares were issued since the inception of the plan and 10,195 shares remain within the plan, none of which have vested. For the nine-month period ended September 30, 2012, 2,189 restricted shares were issued (September 30, 2011 – 38,268).

The non-employee Directors may elect to receive their compensation in whole or in part in the form of deferred shares under the DSP in lieu of cash compensation. On retiring from the Board of Directors, a Director will receive all deferred shares accumulated in the plan. The maximum number of shares that may be issued under the DSP is limited to 500,000. As at September 30, 2012, the Directors have earned 229,777 shares under the DSP. For the nine-month period ended September 30, 2012, 17,729 deferred shares were issued (September 30, 2011 – 39,703).

For the three-month and nine-month period ended September 30, 2012, Directors' fees and executive compensation expense under the long-term incentive plans was $111 and $302 respectively (September 30, 2011 – $135 and $374 respectively). Until they vest, non-funded restricted shares and deferred shares do not trade on the Toronto Stock Exchange, have no voting rights and cannot be sold or liquidated early. The restricted shares held in the EBT are voted following instructions from the Company.

The Option and Share Appreciation Rights Plan was established to reinforce the alignment of interests between key executives and shareholders, reward achievement of shareholder value creation and provide competitive compensation opportunities to enable the Company to attract, retain and motivate leaders that are critical to the long-term success of the Company. A summary of the Company's Option and Share Appreciation Rights Plan and related information is described in note 15.

Pursuant to the terms of the Arrangement Agreement described in note 25, restricted shares, deferred shares and options held under the respective plans will be distributed, disposed and cancelled in exchange for a cash payment of $9.50.

The Company has an optional Dividend Re-investment Plan (the Plan) for shareholders. The Plan allows eligible Canadian shareholders to elect to have their cash dividends from the Company automatically reinvested in additional shares. Shareholders who participate in the Plan will receive a further bonus of shares equal in value to 4% of each dividend that was reinvested.

15. OPTION AND SHARE APPRECIATION RIGHTS PLAN

Stock options vest equally over three years and have a maximum term of seven years from the date of grant. Options under the Plan are granted at the closing price of the Company's common shares on the business day prior to the date of the grant. A summary of the Plan and related information is as follows:

	Stock options	Weighted average exercise price
		$
Outstanding, December 31, 2011	170,100	7.21
Granted	—	—
Exercised	—	—
Forfeited	—	—
Outstanding, September 30, 2012	**170,100**	**7.21**
Exercisable, end of period	**84,031**	**7.20**

The Company expenses the fair value of stock options that are expected to vest over the vesting period using the Black-Scholes option pricing model to estimate fair value for each option at the date of grant. There were no stock options granted during the three-month and nine-month periods ended September 30, 2012. The weighted average remaining contractual life of options previously granted is 4.9 years.

For the three-month and nine-month period ended September 30, 2012, the Company has recorded a share-based compensation expense of $10 and $39 respectively (September 30, 2011 – $20 and $55 respectively) related to grants of options under the Option and Share Appreciation Rights Plan. This amount is included in salaries and benefits on the interim consolidated statements of comprehensive income and in contributed surplus on the consolidated balance sheets.

16. CAPITAL MANAGEMENT

The overall objective of capital management is to ensure that the Company has sufficient capital to maintain its operations based on current activities and expected business developments in the future and to provide a return to shareholders commensurate with the risk of the business and comparable to other, similar companies.

The Company's capital resources consist of deposits, medium-term notes, subordinated debt, unsecured subordinated debt, bank term loan and equity. Historically, the Company has used cash flows from operating activities to fund its operations and distributions, and the excess of those cash flows coupled with borrowings under its debt programs have been used to fund growth in the mortgage portfolio.

The Company's subsidiary, HomEquity Bank, has access to retail deposits sourced through deposit brokers, which are part of capital resources. The regulatory capital requirements of HomEquity Bank are specified by the Office of the Superintendent of Financial Institutions (OSFI) in its *Guideline A, Capital Adequacy Requirement (CAR) – Simpler Approaches*. The Guideline specifies the types of items included in capital and the measures OSFI will consider in reviewing capital adequacy.

There are two capital standards addressed in HomEquity Bank's capital management policy: risk-based capital ratios and assets-to-capital multiple. The Company has implemented policies and procedures to monitor compliance with regulatory capital requirements. HomEquity Bank has implemented an Internal Capital Adequacy Assessment Process which is based on the Company's assessment of the business risks of HomEquity Bank.

The total regulatory capital of HomEquity Bank is comprised of Tier 1 and Tier 2 capital as follows:

	September 30 2012 $	December 31 2011 $
Shareholders' equity per HomEquity Bank's consolidated balance sheets	**81,296**	76,760
Deductions	**507**	422
Tier 1 capital	**80,789**	76,338
Book value of unsecured subordinated debt	**40,975**	40,975
Less: accumulated amortization for capital adequacy purposes	**10,000**	8,000
	30,975	32,975
Eligible general allowance	**3,313**	—
Tier 2 capital	**34,288**	32,975
Total regulatory capital	**115,077**	109,313
Credit risk	**633,006**	583,106
Off-balance sheet exposure	**4,400**	6,454
Operational risk	**46,263**	43,987
Total risk-weighted assets	**683,669**	633,547
Capital ratios		
Tier 1 Capital Ratio (1)	**11.8%**	12.1%
Total Capital Ratio (2)	**16.8%**	17.3%
Assets-to-Capital Multiple (3)	**12.4x**	11.9x

(1) The Tier 1 Capital Ratio is defined as Tier 1 capital divided by total risk-weighted assets.
(2) The Total Capital Ratio is defined as total regulatory capital divided by total risk-weighted assets.
(3) The Assets-to-Capital Multiple is calculated by dividing total assets, including specified off-balance sheet items net of other specified deductions, by total capital.

During the three-month period ended September 30, 2012, HomEquity Bank complied with the OSFI guideline related to capital ratios and the assets-to-capital multiple. Both the Tier 1 and Total Capital Ratios remain above OSFI's stated minimum capital ratios of 7% and 10%, respectively. HomEquity Bank's Assets-to-Capital Multiple remains below the maximum permitted by OSFI.

HomEquity Bank's wholly owned subsidiary, CHIP Mortgage Trust's (CMT) borrowings are subject to debt-to-mortgage covenants. The covenants are: a maximum senior debt-to-mortgage ratio of 93% when it has commercial paper outstanding, a maximum of 95% when its senior rated debt consists only of medium-term notes, and a maximum total debt-to-mortgage ratio of 98%. CMT is also required to maintain minimum cash on hand equivalent to 2% of its mortgage portfolio value. As at September 30, 2012, the senior debt-to-mortgage ratio was 90.3% (December 31, 2011 – 85.9%), the total debt-to-mortgage ratio was 94.9% (December 31, 2011 – 92.9%) and CMT held more than the required amount of cash. The Company closely monitors business performance to manage compliance with these covenants.

17. DERIVATIVE INSTRUMENTS

In the normal course of business, the Company enters into interest rate derivative contracts to manage interest rate risk. Derivative financial instruments are financial contracts that derive their value from underlying changes in interest rates or other financial measures.

Interest rate swaps are contracts in which two counterparties agree to exchange cash flows over a period of time based on rates applied to a specified notional principal amount. A typical interest rate swap would require one counterparty to pay interest based on a fixed rate and receive interest based on a variable market interest rate determined from time to time with both calculated on a specified notional principal amount. No exchange of principal amount takes place at inception.

Forward rate agreements (FRAs) are contracts that effectively fix a future interest rate for a period of time. A typical forward rate agreement provides that at a pre-determined future date, a cash settlement will be made between counterparties based upon the difference between a contracted rate and a market rate to be determined in the future, calculated on a specified notional principal amount. No exchange of principal amount takes place at inception.

Fair values

Fair values of the interest rate derivatives are determined using an internal valuation model with observable inputs. Changes in fair value resulting in unrealized gains or losses are recorded in the interim consolidated statements of comprehensive income.

Notional amounts

The notional value of derivative financial instruments represents an amount to which a rate or price is applied in order to calculate the exchange of cash flows. Notional principal amounts do not represent the potential gain or loss associated with market risk and is not indicative of the credit risk associated with derivative financial instruments. The notional amounts are not recorded as assets or liabilities on the consolidated balance sheets.

The following table summarizes the fair values, notional principal and weighted average rates of the derivative instruments outstanding as at September 30, 2012. The floating rate for all instruments is based on the CDOR-BA rate for terms ranging from one to twelve months.

	September 30 2012		
Interest rate contracts	**Weighted average rate**	**Notional principal $**	**Fair values $**
Receive fixed			
Swaps	**3.24%**	**765,000**	**18,659**
Pay fixed			
Swaps	**1.12%**	**170,000**	**107**
ASSETS		**935,000**	**18,766**
Pay fixed			
Swaps	**1.83%**	**69,500**	**263**
LIABILITIES		**69,500**	**263**

	December 31 2011		
Interest rate contracts	Weighted average rate	Notional principal $	Fair values $
Receive fixed			
Swaps	3.57%	763,700	28,537
Pay fixed			
Swaps	1.10%	135,000	143
FRAs	1.17%	50,000	13
ASSETS		948,700	28,693
Pay fixed			
Swaps	3.03%	26,500	577
LIABILITIES		26,500	577

17. DERIVATIVE INSTRUMENTS (continued)

Maturity terms

The following table summarizes the notional principal and fair value by term to maturity of derivative financial instruments outstanding as at September 30, 2012. Maturity dates range from April 2012 to May 2016.

	Remaining term to maturity					
	Within 1 year	1 to 3 years	3 to 5 years	Over 5 years	September 30 2012	December 31 2011
Notional principal	$	$	$	$	$	$
Swaps	**288,500**	**353,000**	**293,500**	—	**935,000**	898,700
FRAs	—	—	—	—	—	50,000
Derivative assets	**288,500**	**353,000**	**293,500**	—	**935,000**	948,700
Swaps	**69,500**	—	—	—	**69,500**	26,500
Derivative liabilities	**69,500**	—	—	—	**69,500**	26,500
Fair values						
Swaps	**1,035**	**8,762**	**8,969**	—	**18,766**	28,680
FRAs	—	—	—	—	—	13
Derivative assets	**1,035**	**8,762**	**8,969**	—	**18,766**	28,693
Swaps	**263**	—	—	—	**263**	577
Derivative liabilities	**263**	—	—	—	**263**	577

Hedge accounting results

The Company's fair value hedges consist of interest rate swaps that are used to protect against changes in fair value of fixed-rate medium-term debt, deposits, unsecured subordinated debt and the bank term loan due to movements in market interest rates. Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded as unrealized losses (gains) on derivative financial instruments in the consolidated statements of comprehensive income, along with adjustments to the carrying value of the financial instruments that are attributable to the hedged risk. The Company has elected under IAS 39 *Financial Instruments: Recognition and Measurement,* to apply hedge accounting to the interest rate swaps detailed below. All hedging relationships to which the Company has chosen to apply hedge accounting are fair value hedges, used to protect against changes in the fair value of fixed-rate deposits, medium-term debt, unsecured subordinated debt and the bank term loan due to movements in interest rates.

Unrealized losses on derivative instruments

The following table summarizes the unrealized (gains) and losses on non-hedged and hedged derivative instruments which are included in unrealized losses on derivative financial instruments on the interim consolidated statements of comprehensive income.

	For the three-month period ended		For the nine-month period ended	
	September 30 2012	September 30 2011	**September 30 2012**	September 30 2011
	$	$	**$**	$
Non-hedged derivative instruments	**767**	680	**2,882**	4,100
Hedged derivative instruments	**220**	(96)	**18**	(229)
Unrealized losses on derivative financial instruments	**987**	584	**2,900**	3,871

17. DERIVATIVE INSTRUMENTS (continued)

Hedge accounting results (continued)

Medium-term debt

As at September 30, 2012, the Company has interest rate swaps having a notional amount of $300,000 that hedge series 2010-1 and series 2011-1. The fair value of these swaps is recorded as derivative instrument assets on the interim consolidated balance sheets. The hedges were effective on September 30, 2012. During the three-month and nine-month period ended September 30, 2012, the Company recorded a hedge ineffectiveness loss of $213 and $208 respectively (September 30, 2011 – gain of $217 and $1,242 respectively), which is included in unrealized losses on derivative financial instruments on the interim consolidated statements of comprehensive income.

Deposits

During the three-month period ended September 30, 2012, the Company entered into interest rate swaps having a notional amount of $35,000 to hedge $35,000 of deposits issued during the period. As at September 30, 2012, the Company has interest rate swaps having a notional amount of $330,000 that hedge deposits. The fair value of these swaps is recorded as derivative instruments assets on the interim consolidated balance sheets. The hedges were effective on September 30, 2012. During the three-month and nine-month period ended September 30, 2012, the Company recorded a hedge ineffectiveness gain of $24 and $271 respectively (September 30, 2011 – loss of $233 and $734 respectively), which is included in unrealized losses on derivative financial instruments on the interim consolidated statements of comprehensive income.

Unsecured subordinated debt

As at September 30, 2012, the Company has interest rate swaps having a notional amount of $10,000 to hedge $10,000 of unsecured subordinated debt. The fair value of these swaps is recorded as derivative instruments assets on the interim consolidated balance sheets. The hedges were effective on September 30, 2012. During the three-month and nine-month period ended September 30, 2012, the Company recorded a hedge ineffectiveness loss of $5 and loss of $22 respectively (September 30, 2011 – gain of $58 and $158 respectively), which is included in unrealized losses on derivative financial instruments on the interim consolidated statements of comprehensive income.

Bank term loan

As at September 30, 2012, the Company has interest rate swaps having a notional amount of $10,000 to hedge $10,000 of the bank term loan. The fair value of this swap is recorded as derivative instruments assets on the interim consolidated balance sheets. The hedges were effective on September 30, 2012. During the three-month and nine-month period ended September 30, 2012, the Company recorded a hedge ineffectiveness loss of $15 and $59 respectively (September 30, 2011 – gain of $54 and $121), which is included in unrealized losses on derivative financial instruments on the interim consolidated statements of comprehensive income.

Derivative-related risks

Market risk

Derivative financial instruments have either no or an insignificant market value at inception. Their value changes in response to relevant interest rate, foreign exchange rate or credit price changes, such that the previously contracted terms of the derivative transactions have become more or less favourable than what can be negotiated under current market conditions for contracts with the same terms and the same remaining period to expiry. The potential for derivatives to increase or decrease in value as a result of the foregoing factors is generally referred to as market risk. This market risk exposure to earnings is mitigated as the Company does not hold or use any derivative contracts for speculative trading purposes.

Credit risk

Credit risk on derivative financial instruments is the risk of a financial loss occurring as a result of a default of a counterparty on its obligation to the Company. Credit risk is limited by dealing only with Schedule I Canadian chartered banks as counterparties. The maximum derivative credit exposure to the Company is the fair value of derivative contracts presented in the summary table below.

17. DERIVATIVE INSTRUMENTS (continued)

Credit risk (continued)

The Company's exposure to risks arising from other financial instruments is disclosed in note 18.

September 30, 2012 Interest rate contracts	Notional principal	Replacement cost (1)	Credit risk equivalent (2)	Risk-weighted assets (3)	Fair value
	$	$	$	$	$
Swaps					
Maturing within 1 year	**288,500**	**1,035**	**1,035**	**207**	**1,035**
Maturing in 1 to 3 years	**353,000**	**8,762**	**10,526**	**2,106**	**8,762**
Maturing in 3 to 5 years	**293,500**	**8,969**	**10,437**	**2,087**	**8,969**
FRAs					
Maturing within 1 year	—	—	—	—	—
	935,000	**18,766**	**21,998**	**4,400**	**18,766**
December 31, 2011					
Swaps					
Maturing within 1 year	183,700	1,600	1,600	320	1,600
Maturing in 1 to 3 years	322,500	5,742	7,354	1,471	5,742
Maturing in 3 to 5 years	392,500	21,338	23,301	4,660	21,338
FRAs					
Maturing within 1 year	50,000	13	13	3	13
	948,700	28,693	32,268	6,454	28,693

(1) Replacement cost represents the cost of replacing all contracts that have a positive fair value, using current market rates.
(2) Credit risk equivalent represents the total replacement cost plus an amount representing the potential future credit exposure, as outlined in OSFI's Capital Adequacy Guideline.
(3) Risk-weighted assets represent the credit risk equivalent, weighted based on the creditworthiness of the counterparty, as prescribed by OSFI.

18. FINANCIAL INSTRUMENTS – FINANCIAL RISKS

The Company performs regular monitoring of its risks, assessments, and related action plans. Senior management and the Board of Directors obtain information that allows them to keep informed regarding the effectiveness of their risk management process and activities. The Company has a Conduct Review and Risk Management Committee to assist the Board of Directors in fulfilling its responsibilities.

Credit risk (non-derivative)

Credit risk is the potential for financial loss if a borrower or counterparty in a transaction fails to meet its obligations in accordance with agreed terms. Credit risk on the Company's cash and cash equivalents is mitigated by maintaining cash balances at Schedule I Canadian chartered banks. Credit risk on the mortgage loans is mitigated by following Board approved underwriting policies. In particular, during the underwriting process every property is appraised by a certified appraiser with particular attention paid to the property type, location and days on market of each comparative property. The initial appraised value is subsequently discounted, typically by between 7.5% and 30%. A rate of future property appreciation assumed for the life of the mortgage is low in comparison with the Canadian average of approximately 4.6% for the past 20 years. The average rate of assumed appreciation used in the initial underwriting of the existing mortgage portfolio is approximately 0.9%. Each mortgage originated is limited in maximum dollar amount and loan-to-value ratio in accordance with internal guidelines. The Company also obtains a first charge on the underlying property securing the mortgage. Credit risk is mitigated further by the geographic diversity and the collateralization of the portfolio.

Interest rate risk

The Company's operating margin is primarily derived from the spread between interest earned on the mortgage portfolio and the interest paid on the debt and deposits used to fund the portfolio. Mortgages have various interest rate reset terms, ranging from variable to five-year. Interest on the majority of the Company's debt is fixed until maturity. The Company uses derivative financial instruments to alter the fixed rate on the debt to match the rate reset terms of the mortgage portfolio, to mitigate any fluctuations that changes to the underlying benchmark rates may have on its operating margin at the time of the mortgage resets. Interest rates on approximately 66% of the mortgage portfolio are based on the Government of Canada Treasury-bill and bond rates whereas interest rates on the debt and derivative financial instruments are based on the Bankers' Acceptance rates. Historically, changes in interest rates do not impact each benchmark rate equally, which may result in a variation in spread.

18. FINANCIAL INSTRUMENTS – FINANCIAL RISKS (continued)

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its obligations when they are due. With respect to medium-term and subordinated debt, the Company mitigates these risks by issuing only highly rated debt, by using a syndicate of several dealers to issue debt, and by staggering the maturities of its debt obligations. With respect to deposits, the Company mitigates risk by holding a required amount of cash and cash equivalents to meet maturing deposit liabilities.

The following table summarizes the expected final payment dates of debt principal and interest payable, derivative instruments and deposit maturities on the consolidated balance sheets:

September 30, 2012	Within 1 year $	1 to 3 years $	4 to 5 years $	Over 5 years $	Total $
Deposits	**184,195**	**428,960**	**236,768**	**—**	**849,923**
Interest payable on medium-term debt	**2,706**	**—**	**—**	**—**	**2,706**
Interest payable on subordinated debt	**374**	**—**	**—**	**—**	**374**
Interest payable on unsecured subordinated debt	**1,090**	**—**	**—**	**—**	**1,090**
Interest payable on bank term loan	**276**	**—**	**—**	**—**	**276**
Interest payable on derivative instruments	**22**	**—**	**—**	**—**	**22**
Derivative instruments	**263**	**—**	**—**	**—**	**263**
Debt principal (1)					
Medium-term debt	**85,217**	**125,000**	**175,000**	**—**	**385,217**
Subordinated debt	**20,000**	**—**	**—**	**—**	**20,000**
Unsecured subordinated debt	**—**	**10,000**	**10,000**	**10,975**	**30,975**
Bank term loan	**—**	**—**	**10,000**	**—**	**10,000**
Total	**294,143**	**563,960**	**431,768**	**10,975**	**1,300,846**
December 31, 2011					
Deposits	158,750	296,657	140,666	—	596,073
Interest payable on medium-term debt	8,973	—	—	—	8,973
Interest payable on subordinated debt	477	—	—	—	477
Interest payable on unsecured subordinated debt	398	—	—	—	398
Interest payable on bank term loan	71	—	—	—	71
Interest payable on derivative instruments	36	—	—	—	36
Derivative instruments	53	524	—	—	577
Debt principal (1)					
Medium-term debt	99,520	100,726	300,000	—	500,246
Subordinated debt	30,000	10,000	—	—	40,000
Unsecured subordinated debt	—	—	30,975	—	30,975
Bank term loan	—	—	10,000	—	10,000
Total	298,278	407,907	481,641	—	1,187,826

(1) Certain tranches of debt have refinancing terms upon their expected final payment dates. See notes 10 and 11.

18. FINANCIAL INSTRUMENTS – FINANCIAL RISKS (continued)

Interest rate sensitivity

The Company is exposed to interest rate risk as a result of the mismatch, or gap, between the maturity or repricing date of interest sensitive assets and liabilities. The following tables summarize the gap position at period end for the selected period intervals. Figures in parentheses represent an excess of liabilities over assets or a negative gap position.

The Company estimates that an annualized 100 basis point decrease in interest rates would increase net interest income after tax over the next twelve months by $228 (December 31, 2011 - $67). A 100 basis point increase in interest rates would decrease net income after tax over the next twelve months by a similar amount. These sensitivities are hypothetical and should be used with caution.

(in thousands except % amounts)	Floating	0 to 3 months	4 to 12 months	1 to 3 years	Over 3 years	Non-interest rate sensitive	Total
September 30, 2012	$	$	$	$	$	$	$
Total assets	**313,526**	**202,900**	**483,416**	**237,508**	**131,540**	**64,647**	**1,433,537**
Total liabilities and equity	—	**48,222**	**241,452**	**563,960**	**442,743**	**137,160**	**1,433,537**
Derivative instruments	—	**(474,000)**	**(122,500)**	**303,000**	**293,500**	—	—
Interest rate sensitivity gap	**313,526**	**(319,322)**	**119,464**	**(23,452)**	**(17,703)**	**(72,513)**	—
Cumulative gap	**313,526**	**(5,796)**	**113,668**	**90,216**	**72,513**	—	—
Cumulative gap as a percentage of total assets	**21.9%**	**(0.4%)**	**7.9%**	**6.3%**	**5.1%**	—	—
December 31, 2011							
Total assets	306,164	177,539	472,413	188,360	105,754	65,550	1,315,780
Total liabilities and equity	—	38,102	250,221	407,907	481,641	137,909	1,315,780
Derivative instruments	—	(410,500)	(160,000)	178,000	392,500	—	—
Interest rate sensitivity gap	306,164	(271,063)	62,192	(41,547)	16,613	(72,359)	—
Cumulative gap	306,164	35,101	97,293	55,746	72,359	—	—
Cumulative gap as a percentage of total assets	23.3%	2.7%	7.4%	4.2%	5.5%	—	—

19. FAIR VALUE OF FINANCIAL INSTRUMENTS

Estimated fair value amounts are designed to approximate amounts at which financial instruments could be exchanged in a current transaction between willing parties who are under no compulsion to act.

The Company uses a fair value hierarchy to categorize the inputs used in valuation techniques to measure fair value of financial instruments. The classifications are as follows: the use of quoted prices in an active market for identical financial instruments (Level 1), internal models using observable market information as inputs (Level 2) and internal models without observable market information as inputs (Level 3). The Company had no Level 1 or Level 3 financial instruments at September 30, 2012 and there have been no transfers between levels for the three-month or nine month period ended September 30, 2012. Due to the estimation process and the need to use judgment, the aggregate fair value amounts should not be interpreted as being necessarily realizable in an immediate settlement of the instruments.

The following table summarizes the Level 2 financial assets and liabilities carried at fair value:

	September 30 2012 $	December 31 2011 $
Financial assets		
Cash resources (1)	**54,969**	30,524
Securities (1)	**3,006**	5,989
Derivative instruments (2)	**18,766**	28,693
Financial assets carried at fair value	**76,741**	65,206
Financial liabilities		
Derivative instruments (2)	**263**	577
Financial liabilities carried at fair value	**263**	577

The fair value amounts of the Company's financial instruments have been determined using the following methods and assumptions:

(1) Cash resources and securities are valued using internal models using observable market information as inputs (Level 2).

(2) Fair value of derivative instruments is determined using an internal valuation model with observable inputs (Level 2).

20.SALARIES AND BENEFITS

	For the three-month period ended		For the nine-month period ended	
	September 30 2012 $	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Origination	**349**	322	**997**	978
Mortgage administration	**75**	72	**234**	201
Overhead	**1,552**	1,336	**4,258**	3,814
	1,976	1,730	**5,489**	4,993

21.SELLING, GENERAL AND ADMINISTRATION

	For the three-month period ended		For the nine-month period ended	
	September 30 2012 $	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Marketing	**624**	647	**2,198**	2,052
Professional services	**645**	485	**3,449**	1,694
Office expenses	**357**	328	**1,095**	1,053
Other	**116**	108	**436**	427
Business and capital taxes	**23**	8	**52**	40
Mortgage administration	**62**	70	**231**	192
	1,827	1,646	**7,461**	5,458

22. INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS - OTHER

	For the three-month period ended		For the nine-month period ended	
	September 30 2012 $	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Prepaid expenses and other assets	**98**	22	**401**	22
Income taxes receivable	**(148)**	189	**(611)**	1,034
Accounts payable and accrued liabilities	**3,777**	2,117	**5,814**	3,302
	3,727	2,328	**5,604**	4,358

23. RELATED PARTY TRANSACTIONS

Related party transactions conducted in the normal course of operations are measured at the exchange value (the amount established and agreed to by the related parties). Related party transactions during year ended September 30, 2012 were compensation transactions with the Company's Directors and executive management and funding of the EBT established for awards under a long-term incentive plan (note 15).

Included in salaries and benefits on the consolidated statements of comprehensive income are the following amounts for remuneration of Directors and executive management comprising of vice-presidents, senior vice-presidents and the president and chief executive officer:

	For the three-month period ended		For the nine-month period ended	
	September 30 2012 $	September 30 2011 $	**September 30 2012 $**	September 30 2011 $
Salaries and benefits	**659**	659	**1,970**	1,892
Share-based payments	**206**	175	**571**	519
	865	834	**2,541**	2,411

24. FUTURE ACCOUNTING CHANGES

IAS 1, *Presentation of Financial Statements*

In June 2011, the IASB issued the revised IAS 1. The amendments may result in changes in the way other comprehensive income is presented in the consolidated statements of comprehensive income. Revisions to IAS 1 are applicable to annual periods beginning on or after July 1, 2012, with early adoption permitted. Management is currently evaluating the potential impact IAS 1 will have on the presentation of the Company's consolidated financial statements.

IFRS 7, *Financial Instruments: Disclosures*

In October 2010, the IASB issued amendments to IFRS 7 regarding *Disclosures – Transfer of Financial Assets*, which are effective for annual periods beginning on or after July 1, 2011, with earlier application permitted. These amendments comprise additional disclosures on transfer transactions of financial assets. In December 2011, the IASB issued further amendments to IFRS 7 which contain new disclosure requirements for financial assets and liabilities that are offset in the statement of financial position or subject to master netting arrangements or similar arrangements. These amendments will not have an impact on the results of operations or financial position of the Company as they are only disclosure requirements.

IFRS 9, *Financial Instruments*

In November 2009, the IASB issued, and subsequently revised in October 2010, 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 uses a single approach to determine whether a financial asset is measured at amortized cost or fair value, replacing the multiple rules in IAS 39. The approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. The IASB continues to deliberate on amendments to impairment and hedge accounting requirements. The standard also adds guidance on the classification and measurement of financial liabilities. 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 which replaces portions of IAS 27, *Consolidated and Separate Financial Statements* and interpretation SIC-12 *Consolidation — Special Purpose Entities,* effective for annual periods beginning on or after January 1, 2013. IFRS 10 builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. There will not be an impact on the results of operations or financial position of the Company as this standard does not change the entities consolidated as part of the Company's consolidated financial statements.

IFRS 12, *Disclosure of Interests in Other Entities*

In May 2011, the IASB issued IFRS 12 a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities, replacing existing disclosure requirements. This standard is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. Management is currently evaluating the potential impact that the adoption of IFRS 12 will have on the Company's consolidated financial statements.

IFRS 13, *Fair Value Measurement*

In May 2011, the IASB issued IFRS 13 which is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. This standard does not impact when fair value is used, but rather establishes requirements on how to measure fair value. Management is currently evaluating the potential impact that the adoption of IFRS 13 will have on the Company's consolidated financial statements.

IAS 32, *Offsetting Financial Assets and Financial Liabilities*

In December 2011, the IASB issued amendments to IAS 32. The amendments are effective for annual periods beginning on or after January 1, 2014. The amendments clarify that an entity currently has a legally enforceable right to set-off if that right is 1) not contingent on a future event, and 2) enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all counterparties. Management is currently assessing the potential impact the amendments would have on the Company's consolidated financial statements.

25. ARRANGEMENT AGREEMENT

On March 30, 2012, the Company entered into an arrangement agreement (the Arrangement Agreement) under which Birch Hill Equity Partners Management Inc. (Birch Hill) proposed to indirectly acquire all of the outstanding common shares (the Shares) of the Company (the Arrangement) for cash at a price of $9.50 per Share (the Transaction) representing total equity value, on a fully diluted basis, of approximately $138,000. The Board of Directors of the Company (the Board), based on the recommendation of its Special Committee (the Special Committee) and with the benefit of advice from its financial and legal advisors, had determined that the Arrangement was in the best interests of the Company. The Transaction was carried out by way of a statutory Plan of Arrangement under the Business Corporations Act (Ontario).

Holders of the Company's common shares voted in favour of the arrangement at the annual and special meeting of shareholders on May 28, 2012 in Toronto. A final order from the Ontario Superior Court of Justice approving the arrangement under the Business Corporations Act (Ontario) was obtained on May 30, 2012. On November 8, 2012, Birch Hill received regulatory approval that will enable the completion of the Transaction. It is anticipated that the Arrangement will close on or before November 30, 2012. Following completion of the Arrangement, it is anticipated that the Company's shares will be delisted from the Toronto Stock Exchange and the Company will apply to cease to be a reporting issuer.

The Arrangement Agreement contains customary non-solicitation provisions which restrict the Company from soliciting or entertaining third party acquisition proposals, subject to customary "fiduciary out" provisions that entitle the Company to consider and accept a superior proposal and a matching right in favour of Birch Hill. If the Arrangement Agreement is terminated in certain circumstances, including if the Company enters into an agreement with respect to a superior proposal or if the Board withdraws its recommendation with respect to the Arrangement, Birch Hill is entitled to a termination payment of $5,000. The Company is entitled to a reverse break fee of $7,500 if the Arrangement Agreement is terminated in certain circumstances, and to a reverse break fee of $5,000 in other circumstances.

26. SUBSEQUENT EVENT

On October 9, 2012, the Company repaid all of the series 2007-1B subordinated notes for a cash consideration of $10,323, consisting of principal and accrued interest.

27. COMPARATIVE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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

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