Consolidated Financial Statements of

# BLUESHORE FINANCIAL CREDIT UNION

Year ended December 31, 2016

# MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements and all other information contained in the Annual Report are the responsibility of management and have been approved by the Board of Directors. The consolidated financial statements have been prepared by management in accordance with the requirements of the Financial Institutions Act of British Columbia and International Financial Reporting Standards and include amounts based on informed judgments and estimates of the expected effects of events and transactions. Financial information presented elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

In meeting its responsibility for the reliability of financial data, management relies on comprehensive internal accounting, operating and system controls. Controls include an organizational structure providing for effective segregation of responsibilities, delegation of authority and personal accountability, and careful selection and training of personnel, the application of accounting and administrative policies and procedures necessary to ensure adequate internal control transactions, assets and records, as well as a continued program of extensive internal audits. These controls are designed to provide reasonable assurance that financial records are reliable for preparing financial statements and maintaining accountability for assets, and those assets are safeguarded against unauthorized use of disposition.

The Board of Directors has appointed an Audit Committee, comprised of at least three Directors of the Credit Union. The committee meets regularly with management, the internal auditors and the external auditors to review accounting, reporting, auditing, internal control and financial risk matters. The external and internal auditors may access this committee, without management present, to discuss the results of their work if required.

KPMG LLP has been appointed by the membership as independent auditors to examine and report on the consolidated financial statements and their report follows. They have had full and free access to the records of the Credit Union, the internal auditors and the Audit Committee of the Board.

Chris Catliff
*President and Chief Executive Officer*

William H. Keen
*Chief Financial Officer*

February 16, 2017

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# INDEPENDENT AUDITORS' REPORT

To the Members of BlueShore Financial Credit Union

We have audited the accompanying consolidated financial statements of BlueShore Financial Credit Union, which comprise the consolidated statement of financial position as at December 31, 2016, the consolidated statements of income, comprehensive income, changes in members' equity and cash flows for the year 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 audit. We conducted our audit 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 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 BlueShore Financial Credit Union as at December 31, 2016, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.

*Other Matter*

The consolidated financial statements of BlueShore Financial Credit Union as at and for the year ended December 31, 2015 were audited by another auditor who expressed an unmodified opinion on those consolidated financial statements on February 17, 2016.

KPMG LLP

Chartered Professional Accountants

February 16, 2017
Vancouver, Canada

# BLUESHORE FINANCIAL CREDIT UNION

Consolidated Statement of Financial Position
(Expressed in thousands of dollars)

December 31, 2016, with comparative information for 2015

| | Notes | 2016 | 2015 |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | 22 | $ 36,722 | $ 22,994 |
| Interest-bearing deposits with financial institutions | | 297,571 | 272,033 |
| Other financial assets | 6 | 43,043 | 21,267 |
| Derivative financial instruments | 7 | 9,171 | 11,844 |
| Loans and advances to members | 8 | 3,053,550 | 2,712,066 |
| Premises and equipment | 10 | 56,694 | 58,056 |
| Intangible assets | 10 | 7,357 | 8,154 |
| Other assets | 11 | 9,781 | 7,551 |
| Income taxes receivable | | 719 | 232 |
| Deferred income tax | 21 | 2,616 | 3,010 |
| | | $ 3,517,224 | $ 3,117,207 |
| **Liabilities** | | | |
| Members' deposits | 12 | $ 3,071,377 | $ 2,762,030 |
| Derivative financial instruments | 7 | 7,334 | 3,890 |
| Borrowings | 13 | 36,735 | 15,001 |
| Securitized borrowings | 14 | 196,629 | 149,068 |
| Accounts payable and accrued liabilities | | 17,912 | 10,079 |
| Retirement benefit obligation | 15 | 2,452 | 2,197 |
| Income taxes payable | | 1,544 | 543 |
| Deferred income tax | 21 | 3,148 | 4,981 |
| Membership and preferred equity shares | 16 | 1,253 | 1,264 |
| | | 3,338,384 | 2,949,053 |
| **Members' Equity** | | | |
| Equity shares | 16 | 33,883 | 29,852 |
| Retained earnings | | 141,793 | 132,569 |
| Accumulated other comprehensive income | | 3,164 | 5,733 |
| | | 178,840 | 168,154 |
| | | $ 3,517,224 | $ 3,117,207 |

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

Approved on behalf of the Board on February 16, 2017:

______________________ Director ______________________ Director

# BLUESHORE FINANCIAL CREDIT UNION

Consolidated Statement of Income
(Expressed in thousands of dollars)

Year ended December 31, 2016, with comparative information for 2015

| | Notes | 2016 | 2015 |
|---|---|---|---|
| Interest income | 17 | $ 108,430 | $ 98,788 |
| Interest expense | 17 | 47,559 | 44,408 |
| Net interest income | | 60,871 | 54,380 |
| Loan impairment expense | 8 | 1,600 | 1,041 |
| Fee and commission income | 18 | 11,862 | 11,373 |
| Other income | 18 | 1,893 | 1,887 |
| Net interest and other income | | 73,026 | 66,599 |
| Non-interest expenses: | | | |
| Salary and employee benefits | 19 | 34,566 | 31,197 |
| Building and occupancy | 20 | 7,391 | 7,673 |
| General and administrative | 20 | 18,497 | 16,923 |
| | | 60,454 | 55,793 |
| Net operating income | | 12,572 | 10,806 |
| Donations | | 126 | 108 |
| Income before income taxes | | 12,446 | 10,698 |
| Provision for income taxes: | 21 | | |
| Current | | 3,411 | 2,531 |
| Deferred | | (1,439) | (536) |
| | | 1,972 | 1,995 |
| Net income | | $ 10,474 | $ 8,703 |

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

# BLUESHORE FINANCIAL CREDIT UNION

Consolidated Statement of Comprehensive Income
(Expressed in thousands of dollars)

Year ended December 31, 2016, with comparative information for 2015

| | 2016 | 2015 |
|---|---|---|
| Net income | $ 10,474 | $ 8,703 |
| Other comprehensive income - net of tax: | | |
| Net change in unrealized gains on cash flow hedges - net of tax $(1,082) (2015 - $1,082) | (4,831) | 3,520 |
| Net amount transferred to net income on cash flow hedges - net of tax $507 (2015 - nil) | 2,262 | (2) |
| | (2,569) | 3,518 |
| Comprehensive income | $ 7,905 | $ 12,221 |

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

# BLUESHORE FINANCIAL CREDIT UNION

Consolidated Statement of Changes in Members' Equity
(Expressed in thousands of dollars)

Year ended December 31, 2016, with comparative information for 2015

| | 2016 | 2015 |
|---|---|---|
| Equity shares, beginning of year | $ 29,852 | $ 23,962 |
| Shares issued | 4,031 | 5,890 |
| Equity shares, end of year | 33,883 | 29,852 |
| Retained earnings, beginning of year | 132,569 | 124,977 |
| Net income | 10,474 | 8,703 |
| Dividends on equity shares, net of tax | (1,250) | (1,111) |
| Retained earnings, end of year | 141,793 | 132,569 |
| Accumulated other comprehensive income, beginning of year | 5,733 | 2,215 |
| Net change in unrealized gains on cash flow hedges - net of tax $(1,082) (2015 - $1,082) | (4,831) | 3,520 |
| Net amount transferred to net income on cash flow hedges - net of tax $507 (2015 - nil) | 2,262 | (2) |
| Accumulated other comprehensive income, end of year | 3,164 | 5,733 |
| Total members' equity | $ 178,840 | $ 168,154 |

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

# BLUESHORE FINANCIAL CREDIT UNION

Consolidated Statement of Cash Flows
(Expressed in thousands of dollars)

Year ended December 31, 2016, with comparative information for 2015

| | 2016 | 2015 |
|---|---|---|
| Cash provided by (used in): | | |
| Operations: | | |
| Net income for the year | $ 10,474 | $ 8,703 |
| Adjustments for non-cash items: | | |
| Amortization | 5,450 | 5,275 |
| Loan impairment expense | 1,600 | 1,041 |
| Deferred income tax income | (1,439) | (536) |
| Provision for income tax expense | 3,411 | 2,531 |
| Interest income | (108,430) | (97,862) |
| Interest expense | 47,559 | 44,408 |
| | (41,375) | (36,440) |
| Changes in operating assets and liabilities: | | |
| Interest-bearing deposits with financial institutions | (25,538) | (50,554) |
| Other financial assets | (21,821) | (9,664) |
| Derivative financial instruments | 3,549 | (1,997) |
| Loans and advances to members | (342,927) | (421,532) |
| Other assets | (2,702) | 447 |
| Taxes paid | (2,898) | (2,183) |
| Members' deposits | 308,472 | 282,867 |
| Interest paid | (46,658) | (47,519) |
| Interest received | 108,273 | 98,006 |
| Property held for resale | 472 | (1,483) |
| Other liabilities | 8,089 | 1,442 |
| | (55,064) | (188,610) |
| Investments: | | |
| Purchase of premises and equipment | (2,514) | (3,739) |
| Purchase of intangible assets | (777) | (1,635) |
| Dividends received | 44 | 17 |
| | (3,247) | (5,357) |
| Financing: | | |
| Borrowings | 21,708 | (50,000) |
| Receipts from securitized borrowings | 47,561 | 126,792 |
| Dividends paid on equity shares | (1,250) | (1,111) |
| Membership share issuance | 4,031 | 5,890 |
| Redemption of preferred equity shares | (11) | (45) |
| | 72,039 | 81,526 |
| Increase (decrease) in cash and cash equivalents | 13,728 | (112,441) |
| Cash and cash equivalents, beginning of year | 22,994 | 135,435 |
| Cash and cash equivalents, end of year | $ 36,722 | $ 22,994 |

The accompanying notes form an integral part of these financial statements.

## 1. General information:

BlueShore Financial Credit Union (the "Credit Union") is incorporated under the Credit Union Incorporation Act of British Columbia and its operations are subject to the Financial Institutions Act of British Columbia ("the Act"). The Credit Union serves members principally in the Lower Mainland and the Sea to Sky Corridor of British Columbia. The Credit Union is an integrated financial institution that provides a wide range of financial products and services including consumer and commercial lending, deposit taking and wealth management services.

The Credit Union is domiciled in Canada and its registered office is located at 1250 Lonsdale Avenue, North Vancouver, BC, V7M 2H6.

The consolidated financial statements have been approved for issue by the Board of Directors (the "Board") on February 16, 2017.

## 2. Basis of presentation:

(a) Statement of compliance:

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The significant accounting policies applied in the preparation of the consolidated financial statements are set out in note 3. The consolidated financial statements comply with the requirements of IFRS. These requirements have been applied consistently for the years ended December 31, 2016 and 2015.

(b) Basis of measurement:

The consolidated financial statements have been prepared on the historical cost basis, except for available-for-sale financial assets, financial assets and financial liabilities held at fair value through profit or loss and all derivative financial instruments, which are measured at fair value.

(c) Functional and presentation currency:

These consolidated financial statements are presented in Canadian dollars, which is also the Credit Union's functional currency.

(d) Use of judgements and estimates:

The preparation of the consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ materially from those estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised and in any future periods affected.

**2. Basis of presentation (continued):**

(d) Use of judgements and estimates (continued):

Information on significant areas of uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in the consolidated financial statements are described in note 4.

(e) Comparative infomration:

Some of the prior year's information has been restated for comparative purposes and to conform to current year presentation.

**3. Significant accounting policies:**

(a) Consolidation of subsidiaries:

The consolidated financial statements include the assets, liabilities and the results of operations and cash flows of the Credit Union and its wholly owned active subsidiaries:

- BlueShore Capital Corporation
- BlueShore Leasing Ltd.
- BlueShore Strata Finance Ltd.
- BlueShore Transport Finance Ltd.
- BlueShore Wealth Ltd.
- Morningside Properties Ltd.
- 0977916 B.C. Ltd.
- 0976944 B.C. Ltd.
- 0982257 B.C. Ltd.

Subsidiaries are entities controlled by the Credit Union. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The consolidated financial statements have been prepared using uniform accounting policies across all subsidiaries for like transactions and other events in similar circumstances.

The Credit Union has a 50% stake in a joint venture with Capital West Mortgage Inc., which manages Pacifica Mortgage Investment Corporation, and holds 50% of the shares of BlueShore Pacifica Alternative Mortgage Centre Inc.

The primary purpose of the joint venture is to provide management and mortgage services to Pacifica Mortgage Investment Corporation, a British Columbia based company making loans to borrowers on the security of mortgages on real property situated in British Columbia. BlueShore Pacifica Alternative Mortgage Centre Inc. sources mortgages for both Pacifica Mortgage Investment Corporation and BlueShore Financial Credit Union.

**3. Significant accounting policies (continued):**

(a) Consolidation of subsidiaries (continued):

Special purpose entities ("SPEs") are entities that are created to accomplish a narrow and well-defined objective such as the securitization of particular assets, or the execution of a specific borrowing or lending transaction. An SPE is consolidated, if based on an evaluation of the substance of its relationship with the Credit Union, and the SPE's risks and rewards, the Credit Union concludes that it controls the SPE. The Credit Union's activities have not resulted in any entity meeting the circumstances that would require an SPE to be consolidated within these consolidated financial statements.

Intercompany balances, and income and expenses arising from intercompany transactions are eliminated in preparing the consolidated financial statements. Intercompany losses are also eliminated unless the transaction provides evidence of impairment of the asset transferred. The integration of the subsidiaries into the consolidated financial statements is based on consistent accounting and valuation methods for similar transactions and other occurrences under similar circumstances.

(b) Foreign currency translation:

Transactions that are denominated, or that require settlement, in a foreign currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions.

Non-monetary items measured at historical cost denominated in a foreign currency are translated using the exchange rate as at the date of initial recognition. Non-monetary items denominated in a foreign currency that are measured at fair value are translated using the exchange rates at the date when the fair value was determined.

Foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities are recognized immediately in the consolidated statement of income. Such gains and losses are presented net, and are included in fee and commission income.

When a valuation gain or loss is recognized in net income, any related foreign exchange gain or loss is recognized in net income. When a valuation gain or loss is recognized in other comprehensive income, any related foreign exchange gain and loss component is recognized in net income. For non-monetary available-for-sale financial assets, foreign exchange gain and loss related to valuation gain or loss is presented in other comprehensive income, and is included in the available-for-sale fair value reserve in members' equity.

**3. Significant accounting policies (continued):**

(c) Cash and cash equivalents:

Cash and cash equivalents include cash on hand and balances with less than three months maturity from the original date of issuance, including cash on hand, cheques and other items in transit with original maturities of three months or less. Cash and cash equivalents are classified as loans and receivables.

(d) Financial assets:

Management determines the categorization of financial assets at initial recognition. The Credit Union initially recognizes loans and receivables on the date that they are acquired or originated. All other financial assets, including assets designated at fair value through profit or loss ("FVTPL"), are recognized initially on the trade date at which the Credit Union becomes a party to the contractual provisions of the instrument. The Credit Union's financial assets are categorized as one of the following: financial assets at FVTPL, loans and receivables, and financial assets available-for-sale ("AFS").

(*i*) Financial assets at FVTPL:

This category comprises financial assets classified as FVTPL and financial assets designated by the Credit Union at FVTPL upon initial recognition.

A financial asset is required to be classified as FVTPL if it is acquired principally for the purpose of being sold in the near term or if it is a part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking. Derivative financial instruments are also categorized as FVTPL unless they are designated and are effective as hedging instruments in a hedge accounting relationship. Gains and losses on assets classified as FVTPL are recorded in net income.

The Credit Union's financial assets classified as FVTPL consist of derivative financial instruments that are used for economic hedging, but do not qualify for hedge accounting treatment.

(*ii*) Loans and receivables:

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the Credit Union intends to sell immediately or in the short term, which are classified as FVTPL, and those that the Credit Union designates as FVTPL upon initial recognition; (b) those that the Credit Union designates as AFS upon initial recognition; or (c) those for which the holder may not recover substantially all of its initial investment, for reasons other than credit deterioration.

Loans and receivables are recorded at fair value on initial recognition and subsequently at amortized cost using the effective interest method.

**3. Significant accounting policies (continued):**

(d) Financial assets (continued):

(*ii*) Loans and receivables (continued):

The Credit Union's loans and receivables principally consist of loans and advances to members, interest-bearing deposits with financial institutions and accounts receivable.

Leases for which the Credit Union assumes or relinquishes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

(*iii*) Financial assets available-for-sale:

AFS assets are those non-derivative financial assets that are designated as AFS or are not classified as FVTPL, not designated as FVTPL or do not qualify as loans and receivables. AFS assets include shares in Central 1 and other shares. AFS assets are recorded at fair value other than the Credit Union's investment in certain shares whose fair value cannot be reliably measured and are therefore carried at cost. Upon such time that their fair value can be reliably measured, the carrying amount of these financial assets will be adjusted to fair value. Unrealized gains and losses arising from changes in the fair value of AFS financial assets are recognized as accumulated other comprehensive income, until the financial asset is derecognized or impaired, except for foreign currency translation differences on monetary AFS assets which are recognized immediately in the consolidated statement of income. As a result of the derecognition or impairment of an AFS investment, the cumulative gain or loss previously recognized in equity is recognized in the consolidated statement of income.

Interest income on monetary AFS assets is calculated using the effective interest method and is recognized in the consolidated statement of income. Dividends on AFS equity instruments are recognized in the consolidated statement of income when the Credit Union's right to receive payment is established.

(e) Financial liabilities:

Management determines the categorization of its financial liabilities at initial recognition. The Credit Union initially recognizes financial liabilities (including liabilities designated at FVTPL) on the trade date at which the Credit Union becomes a party to the contractual provisions of the instrument. Financial liabilities are categorized as either FVTPL or financial liabilities at amortized cost or hedging derivatives. Financial liabilities are derecognized when extinguished.

**3. Significant accounting policies (continued):**

(e) Financial liabilities (continued):

($i$) Financial liabilities at FVTPL:

Financial liabilities are designated by the Credit Union as FVTPL upon initial recognition.

A financial liability is required to be classified as FVTPL if it is incurred principally for the purpose of redeeming it in the near term or if it is part of a portfolio of identified financial liabilities that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking. Derivatives are also categorized as FVTPL unless they are designated and are effective hedging instruments in a hedge accounting relationship. Gains and losses on financial liabilities are recorded in net income.

The Credit Union's financial liabilities classified as FVTPL consist of derivative financial instruments that are used for economic hedging, but do not qualify for hedge accounting treatment.

($ii$) Financial liabilities at amortized cost:

Financial liabilities that are not classified as FVTPL fall into this category and are measured at amortized cost. Financial liabilities consist of amounts drawn on lines of credit, accounts payable and accrued liabilities, members' deposits, secured borrowings, mortgage-backed security debt liability and certain membership shares. These are measured at fair value on initial recognition and subsequently at amortized cost using the effective interest method.

(f) Determination of fair value:

The determination of fair values of financial assets and financial liabilities is based on quoted market prices or dealer price quotations wherever possible. This includes listed equity securities and quoted debt instruments. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

For all other financial instruments, fair value is determined using valuation techniques. Fair values are estimated using models to estimate the present value of expected future cash flows, or by using other valuation techniques.

In some cases, some of the inputs to these models may not be market observable and are therefore estimated based on assumptions. The impact on net income from financial instrument valuations reflecting non-market observable inputs (level 3 valuations) is disclosed in note 5(g).

**3. Significant accounting policies (continued):**

(f) Determination of fair value (continued):

The output of a model is always an estimate or approximation of a value that cannot be determined with certainty, and valuation techniques employed may not fully reflect all factors relevant to Credit Union's financial instruments. In cases when the fair value of unlisted equity instruments cannot be determined reliably, the instruments are carried at cost less impairment.

(g) Impairment of financial assets:

(*i*) Loans and receivables:

At each reporting date, the Credit Union assesses whether there is objective evidence that a loan or receivable is impaired. The asset (or group of assets) is considered impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a loss event) and that loss event (or events) has an impact on the estimated future cash flows that can be reliably estimated.

The criteria that the Credit Union uses to determine that there is objective evidence of an impairment loss include:

- Notice or other indications of bankruptcy of the borrower.
- Default, payment delinquency and other deterioration in the relationship with the borrower.
- Decline in the fair market value of the security for the loan or lease receivable.

The Credit Union first assesses whether objective evidence of impairment exists individually for assets that are individually significant.

For a loan or receivable with a fixed interest rate, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the asset's original effective interest rate.

If the loan or receivable has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

As a practical expedient, the Credit Union may measure impairment on the basis of an instrument's fair value using third party published rates or other sources.

The calculation of the present value of the estimated future cash flows of a loan or receivable reflects the cash flows that may result from repossession or foreclosure, less costs for obtaining and selling the collateral, whether or not repossession or foreclosure is probable.

**3. Significant accounting policies (continued):**

(g) Impairment of financial assets (continued):

(*i*) Loans and receivables (continued):

If the Credit Union determines that no objective evidence of impairment exists for an individually assessed loan or lease receivable, it includes the asset in a group of assets with similar credit risk characteristics and collectively assesses the group for impairment. Loans or receivable that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

For the purposes of a collective evaluation of impairment, financial assets are categorized on the basis of similar credit risk characteristics. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the counterparties' ability to pay all amounts due according to the contractual terms of the assets being evaluated. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group.

The Credit Union adjusts the inputs to its collective allowance methodology on an ongoing basis, taking into account factors such as historical loss experience and adjusting for current observable data that did not impact the period which the historical loss experience was based on. Estimates of changes in future cash flows for groups of assets reflect and are directionally consistent with changes in related observable data from period to period (for example, real estate prices, payment status, or other factors indicative of changes in the probability and magnitude of losses by the Credit Union).

The methodology and assumptions used by the Credit Union for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

For impaired loans and receivables, the carrying amount of the assets is reduced through the use of an allowance account and the amount of the estimated loss is recognized in the consolidated statement of income. When such an asset is uncollectible, it is written off against the related allowance.

If in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognized in the consolidated statement of income.

Impairment losses and subsequent reversals are classified in impairment losses on loans and receivable in the consolidated statement of income.

**3. Significant accounting policies (continued):**

(g) Impairment of financial assets (continued):

($i$) Loans and receivables (continued):

For collateralized financial assets deemed uncollectable and where collateral has been seized, the seized asset is classified in accordance with its nature, and any subsequent impairment to that asset is charged to the consolidated statement of income under impairment losses on other assets.

($ii$) Assets classified as available-for-sale:

At each consolidated financial reporting date, the Credit Union assesses if there is objective evidence that an AFS financial asset or a group of AFS financial assets may be impaired. A significant or prolonged decline in the fair value of an AFS equity security below its cost is considered objective evidence in determining whether the asset is impaired. An AFS debt instrument may be identified as impaired due to circumstances which can include actual delinquency in contractual payment of principal or interest and/or significant events which indicate there is doubt as to the collectability of the principal or contractual interest. If any such evidence exists for AFS financial assets, the cumulative loss, measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognized as profit or loss, is reclassified from equity and recognized in the consolidated statement of income.

If, in a subsequent period, the fair value of a debt instrument classified as AFS increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss is reversed through the consolidated statement of income. Impairment losses recognized in the consolidated statement of income on equity instruments are not reversed.

(h) Foreclosed property:

In certain circumstances, the Credit Union may take possession of property held as collateral as a result of foreclosure on loans that are in default. Foreclosed properties are classified as assets held for sale and are measured at the lower of the carrying amount and the fair value less costs to sell.

These repossessed assets are normally sold in a manner that maximizes the benefit to the Credit Union, the member and the member's other creditors and may involve the use of realtors and auctioneers.

**3. Significant accounting policies (continued):**

(i) Derivatives and hedge accounting:

Derivative instruments are financial contracts whose value changes in response to a change in a specified interest rate, exchange rate or other variable, provided in the case of a non-financial variable, the variable is not specific to a party to the contract. Derivative contracts have no initial net investment, or a net investment which would be smaller than a non-derivative contract, and are settled at a future date.

Derivatives are initially recognized at fair value on the date at which a derivative contract is entered into. They are subsequently re-measured at fair value and reported as assets where they have a positive fair value or as liabilities where they have a negative fair value.

Derivatives may also be embedded in other financial instruments and are treated as separate derivatives when i) their economic characteristics and risks are not closely related to those of the host contract ii) a separate instrument with the same terms would meet the definition of a derivative instrument and iii) the host contract is not designated as FVTPL or classified as FVTPL. Changes in fair value on derivative instruments not qualifying for hedge accounting are recognized in interest income or expense as appropriate in the consolidated statement of income.

The Credit Union designates derivatives as either hedges of highly probable future cash flows attributable to a recognized asset or liability, or a forecasted transaction (cash flow hedge), or FVTPL derivatives in instances where the derivative does not qualify or has not been designated as a hedge in a hedge accounting relationship. The Credit Union periodically uses derivatives for economic hedging purposes to mitigate an identified financial instrument risk.

Certain derivatives embedded in other financial instruments, such as the embedded option in a market linked term deposit product, are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are separately accounted for at fair value, with changes in fair value recognized in profit or loss.

(j) Cash flow hedges:

The Credit Union uses hedge accounting for derivatives designated as cash flow hedges provided that certain criteria are met. The Credit Union documents, at the inception of the relationship, the relationship between hedged items and hedging instruments, as well as identifying the risk being hedged and its risk management objective and strategy for undertaking various hedge transactions. The Credit Union also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of the cash flows of the hedged items that are attributable to the risk being hedged.

**3. Significant accounting policies (continued):**

(j) Cash flow hedges (continued):

The effective portion of changes in the fair value of a derivative that is designated and qualifies as a cash flow hedge is recognized in other comprehensive income ("OCI"). The gain or loss relating to the ineffective portion is recognized immediately in interest income or expense as appropriate. Amounts accumulated in OCI are reclassified to the consolidated statement of income in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, hedge accounting ceases and any cumulative gain or loss existing in OCI at that time remains in OCI and is recognized when the hedged forecast transaction is ultimately recognized in the consolidated statement of income. However, when a forecast transaction is no longer expected to occur, or when the hedged item expires or is sold, the cumulative gain or loss that was deferred in OCI is recognized immediately in the consolidated statement of income.

(k) Fair value hedges:

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the consolidated statement of income, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortized to profit or loss over the period to maturity and recorded as net interest income. The adjustment to the carrying amount of the hedged item security is included in the consolidated statement of income when the hedged item is disposed of as part of the gain or loss on the sale.

(l) Securitization and derecognition of financial instruments:

In the normal course of its operations, the Credit Union securitizes financial assets, specifically residential mortgages. Asset securitization programs provide the Credit Union an immediate cash payment from an investor, in exchange for the future payment stream from the securitized assets.

After a securitization transaction, the Credit Union assesses the extent to which it has retained the risks and rewards of ownership of the transferred assets. If substantially all the risks and rewards have been retained, the assets remain on the consolidated statement of financial position. If substantially all the risks and rewards have been transferred, the assets are derecognized. If substantially all the risks and rewards have been neither retained nor transferred, the credit union assesses whether or not it has retained control of the assets. If it has not retained control, the assets are derecognized.

**3. Significant accounting policies (continued):**

(l) Securitization and derecognition of financial instruments (continued):

When the assets remain on the consolidated statement of financial position, the Credit Union recognizes the consideration received as a financial liability, classified as a mortgage-backed security debt liability on the consolidated statement of financial position. This liability is retired over time as payments are made to the investor. The difference between the yield on the underlying securitized assets and the interest cost paid to the investor is recorded as income as it is earned.

When the assets are derecognized, they are removed from the consolidated statement of financial position, the securitization is accounted for as a sale and the Credit Union records a gain or loss based on the present value of the net benefit derived from the transaction. The Credit Union has disclosed further information relating to securitization transactions in note 14.

(m) Offsetting financial instruments:

Financial assets and liabilities are offset and the net amount is reported in the consolidated statement of financial position when there is a legally enforceable right to offset the recognized amounts with the same counterparty and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously.

(n) Interest income and interest expense:

Interest income and interest expense for all interest-bearing financial instruments is recognized within interest income and interest expense in the consolidated statement of income using the effective interest method.

The effective interest method is a method of calculating the amortized amount of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument. When calculating the effective interest rate, the Credit Union estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all transaction costs, all fees paid or received between parties to the contract that are an integral part of the effective interest rate, and all other premiums or discounts. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

**3. Significant accounting policies (continued):**

(o) Fee and commission income:

The accounting treatment for loan fees varies depending on the transaction. Fees that are considered to be adjustments to loan yield are recognized using the effective interest method. Loan origination, restructuring and renegotiation fees for commercial and business loans are recorded as fee and commission income over the expected term of the loan using the effective interest method. Commitment fees are recorded over the expected term of the loan, unless the loan commitment will not be used. Loan discharge and administration fees are recorded directly to income when the loan transaction is complete.

(p) Non-financial assets:

(*i*) Premises and equipment:

Premises and equipment are recorded at cost less accumulated depreciation. Land is recognized at cost and is not depreciated.

Depreciation is calculated using the straight-line method to allocate cost to residual values over estimated useful lives, as follows:

| | |
|---|---|
| Buildings | Up to 40 years |
| Leasehold improvements | Term of the lease period |
| Furniture fixtures and other assets | 3 to 20 years |

Premises and equipment are reviewed annually for impairment, or more frequently where events or changes in circumstances indicate that the carrying amount may not be recoverable.

For the purposes of assessing impairment, assets are grouped into cash-generating units reflecting the Credit Union's operating divisions, which is the lowest level for which there are separately identifiable cash-flows associated with the assets in question. The impairment test also can be performed on a single asset when the fair value less cost to sell or the value in use can be determined reliably.

An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell, and its value in use.

Premises and equipment that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

## 3. Significant accounting policies (continued):

(p) Non-financial assets (continued):

(*ii*) Intangible assets:

The banking system and other computer software is capitalized when the future economic benefit is expected to exceed a period of one year. Otherwise, software costs are expensed when incurred. Capitalized software costs are initially recognized at cost and amortized using the straight-line method over the expected useful life. The expected useful life ranges from 3 to 15 years. Depreciation expense is recognized in the consolidated statement of income as part of non-interest expenses.

(q) Income tax:

Income tax expense comprises current and deferred tax. Income tax is recognized in the consolidated statement of income except to the extent that it relates to items recognized directly in equity or in other comprehensive income.

(*i*) Current income tax:

Current income tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

(*ii*) Deferred income tax:

Deferred income tax is recognized in respect to temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred income tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities against current tax assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

**3. Significant accounting policies (continued):**

(r) Employee benefits:

The Credit Union has both defined benefit and defined contribution plans.

(*i*) Defined benefit plan:

A defined benefit plan is a pension or other post-employment plan that defines an amount of benefit that an employee will receive on retirement, dependent on one or more factors, such as age, years of service and compensation.

The liability recognized in the Credit Union's consolidated statement of financial position in respect of its defined benefit plan is the present value of the defined benefit obligation at the date of the consolidated statement of financial position less the fair value of plan assets, together with adjustments for past service costs. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using investments and indices denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating the terms of the related liability.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognized in the consolidated statement of comprehensive income. Past-service costs are recognized immediately in the consolidated statement of income, unless the changes to the plan are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past-service costs are amortized on a straight-line basis over the vesting period.

(*ii*) Participation in multi-employer defined benefit plan:

The Credit Union provides defined retirement benefits to certain employees through a multi-employer plan administered by Central 1 Credit Union ("Central 1"). The current funding requirement for employers participating under this plan is based on the assessment of the pooled assets and liabilities and which is predicated on the collective membership profile of the plan. For this reason the assets and liabilities have not been tracked and administered separately by employer. Although the actuaries may be able to determine a breakdown of the benefit obligations based on each employer's individual demographic profile, there is insufficient information to determine the accumulated assets of each employer group. Accordingly, the Credit Union's participation in the plan is accounted for as a defined contribution plan with contributions recognized in salary and benefits expense in the consolidated income statement.

**3. Significant accounting policies (continued):**

(r) Employee benefits (continued):

(*iii*) Defined contribution plan:

The Credit Union provides defined contribution ("DC") pension arrangements to certain employees. Contributions to the plan are recognized as an expense in the consolidated statement of income. The Credit Union bears no further liability to employees beyond the initial contributions. The Credit Union has two DC plans, one of which has been grandfathered and no new employees are eligible to join. Contribution rates to the grandfathered plan vary from 5% to 7% depending on the employee's age. The open DC plan has a contribution rate of 4% plus 50% of employee's contribution up to a maximum of 6%.

(s) Equity and non-equity shares:

The capital of the Credit Union is divided into several classes of shares designated as equity and one class designated as non-equity. Equity shares are entitled to the residual interest in the equity of the Credit Union. With certain exceptions, all members of the Credit Union are required to own a minimum of 25 Class A membership equity shares. Equity shares are redeemable upon the occurrence of certain events and are transferable between members at the discretion of the Board. The Credit Union redeems, transfers or purchases equity shares, at a par value of one dollar, together with any dividends declared but unpaid. The directors may limit the number of equity shares redeemed in any one year to 10% of the total outstanding, and redemptions would be restricted if they would reduce the Credit Union's capital below required levels.

Dividends on equity shares presented as members' equity are recorded in the consolidated statement of changes in members' equity, net of tax when approved. Dividends on equity shares presented as liabilities are recorded on the statement of financial position when approved.

(t) Provisions:

A provision is recognized if, as a result of a past event, the Credit Union has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate the risks specific to the liability.

A provision for onerous contracts is recognized when the expected benefits to be derived by the Credit Union from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract. Before a provision is established, the Credit Union recognizes any impairment loss on the assets associated with the contract.

**3. Significant accounting policies (continued):**

(u) Standards and interpretations issued but not yet effective:

A number of standards and interpretations, and amendments thereto, have been issued by the IASB, which are not effective for these consolidated financial statements. Those which are expected to have an effect on the Credit Union's consolidated financial statements are discussed below:

(*i*) IFRS 9, *Financial instruments*:

IFRS 9, *Financial instruments*, addresses the classification, measurement and recognition of financial assets and financial liabilities. The complete version of IFRS 9 was issued in July 2014. It replaces the guidance in IAS 39 that relates to the classification and measurement of financial instruments. IFRS 9 retains establishes three primary measurement categories for financial assets: amortized cost, fair value through OCI and fair value through P&L. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset. Investments in equity instruments are required to be measured at fair value through profit or loss with the irrevocable option to recognize changes in fair value with no recycling of gains or loss to the income statement. IFRS 9 requires credit losses to be recognized on an expected loss basis rather than using an incurred loss model. For financial liabilities there were no changes to classification and measurement except for the recognition of changes in own credit risk in other comprehensive income, for liabilities designated at fair value through profit or loss. IFRS 9 relaxes the requirements for hedge effectiveness by replacing the current effectiveness tests. It requires an economic relationship between the hedged item and hedging instrument and for the 'hedged ratio' to be the same as the one management actually use for risk management purposes. Contemporaneous documentation is still required but is different to that currently prepared under IAS 39. The standard is effective for accounting periods beginning on or after January 1, 2018. The Credit Union is in the process of assessing the impact of IFRS 9.

(*ii*) IFRS 15, *Revenue from contracts with customers:*

In May 2014, the IASB issued IFRS 15 which establishes principles for reporting about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. The standard provides a single, principles based five-step model for revenue recognition to be applied to contracts with customers except for revenue arising from items such as financial instruments, insurance contracts and leases. The standard replaces IAS 18 'Revenue' and related interpretations. In September 2015, the IASB amended IFRS 15 by deferring its effective date by one year. IFRS 15 will be effective for the Credit Union on January 1, 2018. The Credit Union is in the process of assessing the impact of IFRS 15.

**3. Significant accounting policies (continued):**

(u) Standards and interpretations issued but not yet effective (continued):

(*iii*) IFRS 16, *Leases*:

IFRS 16, *Leases*, was released in January 2016 and replaces current guidance in IAS 17. Under IAS 17, lessees are required to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet). IFRS 16 requires lessees to recognize a lease liability reflecting future lease payments and a 'right-of-use asset' for virtually all contracts. For lessors the accounting is similar to IAS 17. The standard is effective for accounting periods beginning on or after January 1, 2019. The Credit Union is in the process of assessing the impact of IFRS 16.

**4. Use of estimates and judgements:**

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Credit Union’s accounting policies. Changes in assumptions may have a significant impact on the financial statements in the period the assumptions changed. The principal areas involving a higher degree of judgment or complexity and/or areas which require significant estimates are described below:

(a) Impairment losses on loans and advances:

The Credit Union regularly reviews its loan portfolio to assess for impairment. In determining whether an impairment loss should be recorded in the consolidated statement of income, the Credit Union makes judgments as to whether there is any observable data indicating an impairment trigger followed by a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of members in a group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. Refer to note 8.

(b) Fair value of financial instruments:

The fair values of financial instruments where no active market exists or where quoted prices are not otherwise available are determined by using specific valuation techniques. In these cases, the fair values are estimated from observable data in respect of similar financial instruments or by using models. Where market observable inputs are not available, they are estimated based on appropriate assumptions. Where valuation techniques are used to determine fair values, they are validated and periodically reviewed by management. To the extent practical, models use only market observable data. Where fair value cannot be reliably measured, these investments are recorded at cost. Refer to note 5(g).

**4. Use of estimates and judgements (continued):**

(c) Securitizations and derecognition of transferred financial instruments:

Depending on the contractual arrangements, the Credit Union may not derecognize securitized residential mortgages and may instead recognize a secured borrowing, recognize only a portion of the assets up to the Credit Union’s remaining involvement in those assets; or may derecognize the assets and recognize, as separate assets or liabilities, any rights and obligations constituted or retained in the transfer. In assessing the derecognition criteria, management is often required to make judgments as to the extent to which cash flows are transferred and any continuing exposure to risks and rewards of the transferred receivables exist. The Credit Union has disclosed further information relating to securitization transactions in note 14.

(d) Retirement benefits:

The present value of retirement benefit obligations depends on a number of factors that are determined on an actuarial basis using a number of assumptions. Any changes in these assumptions will impact the carrying amount of the benefit obligation.

The assumptions used in determining the net cost for the retirement benefit plan includes the discount rate. The Credit Union determines the appropriate discount rate at the end of each year. This is the interest rate that should be used to determine the present value of estimated future cash outflows expected to be required to settle the benefit obligations. In determining the appropriate discount rate, the Credit Union considers the interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid and that have terms to maturity approximating the terms of the related benefit liability. Other key assumptions for benefit obligations are based in part on current market conditions. Refer to note 15.

(e) Income taxes:

The Credit Union computes an effective tax rate which includes an evaluation of the current and future availability of the credit union deduction under the Canadian Income Tax Act and the small business income tax rate under the British Columbia Income Tax Act. The credit union deduction and the B.C. small business income tax rate apply to credit unions on taxable income of the credit union until such time 4/3 of 5% of the amounts owing to members (including deposits, members shares and other borrowings) ("the maximum cumulative reserve") exceeds the cumulative taxable income that was previously subject to the credit union deduction (the "preferred rate amount") of the credit union. An estimate of future deposit, member borrowing, share and income growth is based on the modeling of the Credit Union's business plan, inclusive of economic indicators, and provides the basis in determining the availability of the credit union deduction and the credit union small business income tax rate.

**4. Use of estimates and judgements (continued):**

(e) Income taxes (continued):

In 2013, the Canadian Income Tax Act (the Act) was amended to phase out the credit union deduction available to credit unions over five years. The preferential provincial treatment will be reduced to 60% for 2017, 40% for 2018, 20% for 2019 and 0% for 2020 and later years.

The credit union deduction and the B.C. small business income tax rate is taken into account to determine the effective tax rate used in computing the income tax provision. However, the actual amounts of income tax expense do not become known until the filing with and assessment of the income tax return by the relevant tax authorities, which occurs subsequent to the issuance of the consolidated financial statements. To the extent that estimates differ from the final tax returns, net income would be affected in the subsequent year.

**5. Financial risk management:**

(a) Credit risk:

Credit risk is the risk of financial loss to the Credit Union if a member or counterparty of a financial instrument fails to meet its contractual obligations. Credit risk arises primarily from the Credit Union's commercial and consumer loans and advances, and loan commitments arising from such lending activities.

The Credit Union is also exposed to other credit risks arising from derivatives and settlement balances with market counterparties. Credit risk is the single largest risk for the Credit Union's business. Management therefore carefully manages and controls its exposure to credit risk, and regularly reports to the Investment & Loan Committee ("ILC").

The estimation of credit exposure is complex and requires the use of financial models, as the value of a product varies with changes in market variables, expected cash flows and the passage of time. The Credit Union has developed financial models to support the quantification of the credit risk, which are used for all key credit portfolios and form the basis for measuring default risk.

Credit risk valuation adjustments ("CVA") are applied to cover over-the-counter derivatives and other debt based financial instruments, where the initial valuation discounts expected cash flows using a risk-free interest rate curve. As not all counterparties have the same credit risk as that implied by the risk-free curve, a CVA is necessary in order to incorporate the Credit Union's view of both counterparty credit risk and the Credit Union's own credit risk in the valuation of derivatives with a positive and negative fair value respectively.

**5. Financial risk management (continued):**

(a) Credit risk (continued):

The Credit Union's CVA calculation incorporates collateral and any master netting arrangements that the Credit Union considers to be enforceable as inputs into the CVA calculation. The Credit Union's entity level credit risk is measured using an appropriate market proxy. The CVA is calculated based upon the current market risk exposure to a counterparty or entity level credit risk for financial assets and liabilities measured or disclosed at fair value and is calculated as an adjustment to the fair values of the respective financial instruments as at the reporting date.

As a result of the geographical nature of the Credit Union's activities, the Credit Union has a concentration of credit risk as its principal lending activities are carried out within the Lower Mainland and Sea-to-Sky Corridor of British Columbia. The Credit Union's loan and lease portfolio has a geographic concentration of 99.58% (2015 - 99.71%) in British Columbia. To reduce the impact of the geographic credit risk, the Credit Union has insured approximately 4.1% (2015 - 5.06%) of its residential mortgages.

The Credit Union manages, limits and controls concentrations of credit risk, where identified, to individual counterparties and industries. The Board, through the ILC, places limits on the amount of credit risk accepted in relation to one member and/or sector. Overall risks are subject to periodic review where considered necessary. Limits on the Credit Union's overall credit risk tolerance are reviewed by the Board and ILC on an annual basis.

The Board has delegated responsibility for the governance of credit risk to the ILC to oversee credit risk through the following:

- Formulating and recommending credit policies in consultation with business units. These policies provide guidance over collateral requirements, credit assessment, risk ratings assessments for commercial mortgages and business lending as well as a framework for reporting, and ensuring that appropriate legal documentation is completed. The policies ensure that the lending processes are compliant with regulatory and statutory requirements. These policies are reviewed at least annually.
- Establishing authorization limits for the approval and renewal of credit facilities. Authorization limits are assigned to business and retail unit credit officers for commercial mortgages, business lending and retail. Large credit facilities require the approval or review by the Management Credit Committee ("MCC") or the ILC or the Board as directed by policy.
- Reviewing and assessing credit risk. The credit department assesses all credit exposures in excess of designated limits prior to approving the facilities. Renewals and reviews of facilities are subject to a similar process for commercial mortgages and business lending.

**5. Financial risk management (continued):**

(a) Credit risk (continued):

- Establishing limits on the exposure to counterparties for derivatives and securities, concentration in certain geographic areas and industries (for loan advances), as well as limits by issuer, credit rating band, market liquidity and country (for securities). The Credit Union has collateral for many of its loans, which may include mortgages over residential properties, charges over business assets, and charges over financial instruments such as debt securities and equities. Longer term finance and lending to corporate entities or residential mortgages are generally secured forms of lending. Revolving credit facilities are both real estate and non-real estate secured.

- Ensuring that the Credit Union has master netting agreements in place with derivative counterparties with which it has a significant number of transactions. Master netting arrangements may result in a reduction of credit risk, as in the event of a default, all amounts with the counterparty are often terminated and settled on a net basis, therefore reducing the potential exposure of positive balances in the event of a counterparty default.

- Ensuring the Credit Union's risk rating process is developed and maintained appropriately in order to categorize risk according to the degree of financial loss faced and to focus management on these risks. The risk rating system is used in determining where impairment provisions may be required. The current risk rating framework consists of five grades reflecting varying degrees of risk of default and the availability of collateral or other credit risk mitigation. Risk grades are aligned with Financial Institutions Commission of British Columbia ("FICOM") requirements.

- The credit department is required to implement credit policies and procedures, with credit approval authorities delegated from the ILC. The credit department reports on all credit related matters to management and the MCC for monitoring and controlling all credit risks in its portfolios.

- Regular audits of business units and the credit department processes are undertaken by Internal Audit.

- Commitments to extend credit represent unused portions of authorizations to extend credit in the form of loans or letters of credit. With respect to credit risk on commitments to extend credit, the Credit Union is potentially exposed to loss in an equal amount to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most commitments to extend credit are conditional on the member satisfying specific financial covenants or are otherwise conditional in nature, for example, of limited duration.

(Expressed in thousands of dollars)

## 5. Financial risk management (continued):

(b) Credit risk exposure:

At December 31, 2016, the maximum credit risk exposure of the Credit Union approximates the carrying value of all assets except for undrawn lines of credit. The classes of financial instruments for which the Credit Union has credit risk exposure are as follows:

| | 2016 | 2015 |
|---|---|---|
| On balance sheet asset exposure: | | |
| Cash and cash equivalents | $ 36,722 | $ 22,994 |
| Interest-bearing deposits with financial institutions | 297,571 | 272,033 |
| Financial assets: | | |
| Available-for-sale | 43,043 | 21,267 |
| Derivative financial instruments | 9,171 | 11,844 |
| Loans: | | |
| Residential mortgages | 1,948,556 | 1,735,822 |
| Commercial loans | 1,087,160 | 958,431 |
| Consumer loans | 16,727 | 16,893 |
| Accrued interest | 3,811 | 3,653 |
| Accounts receivable | 4,044 | 1,822 |
| | 3,446,805 | 3,044,759 |
| Off balance sheet exposure: | | |
| Credit instruments: | | |
| Commitments to extend credit | | |
| Term to maturity less than one year | 54,282 | 67,992 |
| Term to maturity more than one year | 73,062 | 73,942 |
| Unconditionally cancellable commitments to extend credit relating to lines of credit | 316,851 | 264,230 |
| | 444,195 | 406,164 |
| | $ 3,891,000 | $ 3,450,923 |

For on-balance sheet, the amounts reported are based on the net carrying amounts in the consolidated statement of financial position.

Management has categorized the portfolio with respect to net potential credit risk exposure as follows:

- Residential mortgages, which represent the largest potential credit exposure, are mitigated by secured collateral.
- 99.53% (2015 - 99.33%) of the commercial loans are categorized in the top three grades of the Credit Union's internal rating system and are secured against collateral.

(Expressed in thousands of dollars)

**5. Financial risk management (continued):**

(b) Credit risk exposure (continued):

Cash, cash equivalents and interest-bearing deposits with financial institutions have a low credit risk exposure as the majority of these assets are high quality investments with low risk counterparties. For the retail loan portfolio (residential and consumer loans), the Credit Union's underwriting methodologies and risk modeling is member based rather than product based. The Credit Union reviews the member's capacity to repay the loan rather than relying exclusively on the collateral, although the collateral is an important mitigant when assessing credit risk. Decisions on consumer loans are based on an overall assessment of credit risk utilizing a scoring model that takes into account factors such as Beacon scores and total-debt-service levels relative to income.

The non-retail portfolio (business and commercial loans) utilizes an assessment process that measures credit risk, taking into consideration a number of factors such as the borrower's management, current and projected financial results, industry statistics, and economic trends that cumulate into a risk rating. This risk rating categorizes risk according to the degree of financial loss faced and forces management to focus on these risks and helps determine where impairment provisions may be required. The current risk rating grades are aligned with FICOM requirements, where RR1 is the characteristic of a fully secured loan and RR5 is the characteristic of a loan with poor risk rating. The leasing portfolio has been assessed to have a RR3 risk rating.

The credit quality of the Credit Union's business and commercial portfolio, expressed in terms of the internal risk ratings discussed above, is shown in the table below:

| Risk ratings | 2016 | 2015 |
|---|---|---|
| RR1 | $ 32 | $ 66 |
| RR2 | 235 | 213 |
| RR3 | 1,081,811 | 951,752 |
| RR4 | 4,333 | 4,354 |
| RR5 | 749 | 2,046 |
| | $ 1,087,160 | $ 958,431 |

No RR4 or RR5 loans are underwritten by the Credit Union and any balance is a result of a subsequent downgrade of a loan.

**5. Financial risk management (continued):**

(c) Liquidity risk:

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. Liquidity risk is inherent in any financial institution and could result from entity level circumstances and/or market events.

Accordingly, the Credit Union has policies and procedures in place to manage its liquidity position to comply with both regulatory requirements and sound business practices.

(*i*) Management of liquidity risk:

The Credit Union's approach to managing liquidity is to ensure that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Credit Union's reputation.

The Credit Union's liquidity risk is subject to extensive risk management controls and is managed within the framework, policies and limits approved by the Board. On an annual basis, the Board, through the ILC, reviews the liquidity operating plan presented by management to ensure adherence to regulatory requirements. The Asset Liability Committee ("ALCO") oversees the operational adherence to the liquidity operating plan. The ALCO approves liquidity management processes and strategies presented by the treasury department in addition to overseeing adherence to minimum liquidity limits, funding diversification, deposit concentration and diversification limits. Liquidity ratios based on Basel III requirements and regular stress testing results are reported monthly to ALCO.

The daily management of the Credit Union's liquidity is the responsibility of the treasury department under the direction of the Vice President, Treasurer and Chief Financial Officer. The Vice President, Treasurer reports on a monthly basis to the ALCO. Treasury manages liquidity by monitoring expected daily cash inflows and outflows versus actual inflows and outflows, projecting long-term cash requirements on a monthly basis and by developing channels to diversify funding risk. The Credit Union's primary sources of funding are retail and wholesale deposits, securitization and wholesale borrowings.

Contingency plans exist for liquidity to satisfy funding requirements in the case of a general market disruption or adverse economic conditions. Proper execution of the contingency plan is the responsibility of the treasury department and ALCO. The liquidity contingency plan outlines the appropriate steps to follow and the stakeholders to notify.

(Expressed in thousands of dollars)

## 5. Financial risk management (continued):

(c) Liquidity risk (continued):

(*ii*) Exposure to liquidity risk:

The key measure used by the Credit Union for managing liquidity risk is the ratio of liquid assets to members' deposits and borrowings. For this purpose, liquid assets may comprise the total market value of cash and cash equivalents, interest-bearing deposits held at financial institutions, financial assets at fair value through profit or loss and financial assets available-for-sale, Central 1 shares and other investments.

| | 2016 | 2015 |
|---|---|---|
| Cash and cash equivalents | $ 36,722 | $ 22,994 |
| Interest-bearing deposits held at financial institutions | 297,571 | 272,033 |
| Financial assets available-for-sale | 43,043 | 21,267 |
| | $ 377,336 | $ 316,294 |

The Credit Union is required to maintain a minimum of 8% (2015 - 8%) liquidity at all times, based on total members' deposits and borrowings. At December 31, 2016, the Credit Union's liquidity was 10.07% (2015 - 10.08%).

Cash flows payable under financial liabilities by remaining contractual maturities are as follows:

| | Less than 1 year | 1 to 3 years | 4 to 5 Years | Over 5 Years | Total 2016 |
|---|---|---|---|---|---|
| Members' deposits | $ 2,089,922 | $ 564,130 | $ 167,167 | $ 250,158 | $ 3,071,377 |
| Secured borrowings | 21,735 | - | - | 15,000 | 36,735 |
| Mortgage-backed security debt liability | 23,507 | - | 173,122 | - | 196,629 |
| Preferred equity shares | 41 | 1 | - | 1,211 | 1,253 |
| Other liabilities | 32,390 | - | - | - | 32,390 |
| | $ 2,167,595 | $ 564,131 | $ 340,289 | $ 266,369 | $ 3,338,384 |

| | Less than 1 year | 1 to 3 years | 4 to 5 years | Over 5 years | Total 2015 |
|---|---|---|---|---|---|
| Members' deposits | $ 1,871,710 | $ 559,999 | $ 119,421 | $ 213,962 | $ 2,765,092 |
| Secured borrowings | 1 | - | - | 15,000 | 15,001 |
| Mortgage-backed security debt liability | 17,428 | 9,586 | 122,054 | - | 149,068 |
| Preferred equity shares | 20 | 1 | - | 1,209 | 1,230 |
| Other liabilities | 18,662 | - | - | - | 18,662 |
| | $ 1,907,821 | $ 569,586 | $ 241,475 | $ 230,171 | $ 2,949,053 |

**5. Financial risk management (continued):**

(d) Market risk:

In the normal course of its operations, the Credit Union engages in transactions that give rise to market risk. Market risk is the risk that changes in market prices, such as interest rates, foreign exchange rates and credit spreads, will affect the Credit Union's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimizing the risk based return.

*Management of market risks*

The Board, through the ILC, sets risk tolerance levels for the Credit Union. Within these boundaries, the ALCO measures, monitors and manages the Credit Union's market risk profile. The policies for market risk management are reviewed annually by the ILC, and approved by the Board.

The Credit Union has various policy and procedure statements that specify roles and responsibilities for senior management, treasury, and finance. Many of these policies fall under the responsibility of the ILC.

(*i*) Interest rate risk:

Interest rate risk, inclusive of credit spread risk, is the risk of loss to the Credit Union due to the following: changes in the level, slope and curvature of the yield curve; the volatility of interest rates; the maturity profile of assets and liabilities; mortgage prepayment rates; changes in the market price of credit; and the creditworthiness of a particular issuer. For the Credit Union, mismatches in the balance of assets, liabilities and off-balance sheet financial instruments that mature and re-price in varying reporting periods generate interest rate risk. These mismatches will arise through the ordinary course of business as the Credit Union manages member portfolios of loans and deposits with changing term preferences and through the strategic positioning of the Credit Union to enhance profitability.

*Interest rate risk policies and processes:*

The Credit Union meets its objectives for interest rate risk management by structuring the balance sheet to take advantage of the yield curve and mismatch opportunities while limiting risk exposure to approved levels to ensure that net interest income and net market values are not significantly impacted when there is an adverse change in interest rates.

The treasury department, under the direction of the ALCO, is responsible for managing interest rate risk. The ALCO monitors the Credit Union's compliance with policy through monthly meetings by reviewing the interest rate risk profile of the Credit Union and by reviewing and approving strategies recommended by the treasury department.

**5. Financial risk management (continued):**

(d) Market risk (continued):

(*i*) Interest rate risk (continued):

*Interest rate risk measurement techniques:*

The Credit Union uses a number of techniques to manage interest rate risk. In order to manage the repricing of assets and liabilities, the Credit Union will alter the product mix through the marketing of particular products, pricing initiatives, and the use of derivative instruments. Decisions on determining the appropriate mix of assets, liabilities and derivative instruments, including interest rate swaps and forward rate agreements, are based on economic conditions, member behavior, capital levels, liquidity levels and policies that limit exposure by instrument and counterparty.

Note 7 discloses details of derivatives used for asset/liability management.

The Credit Union also uses several comprehensive analytical techniques to measure interest rate risk. Interest rate risk is measured primarily by simulation models that employ both current interest income and interest expense, and use market values to incorporate an economic perspective. Static gap, duration analysis, and rate shock analyses are also used as supplementary measurement, control and management tools.

*Simulation models:*

Simulation models enable the Credit Union to analyze interest rate risk in a dynamic environment. The models incorporate assumptions about pricing strategies, growth, volume and mix of new business, changes in the level, slope and curvature of the yield curve, interest rates and other related factors. The assumptions used in the model are monitored monthly and updated as required to reflect changing market conditions.

Simulation models can also be run to measure the impact on net interest income and market values of potential asset and liability management strategies in different economic environments to analyze risk and return tradeoffs.

Simulation models are also used to measure the potential impact of interest rate movements. The following table provides the potential before-tax impact of an immediate and sustained 1% increase or decrease in interest rates on net interest income, assuming that no further hedging is undertaken. It further assumes that the prime rate cannot go below zero. These measures are based upon assumptions made by management. All interest rate risk measures are based upon interest rate exposures at a specific time and continuously change as a result of business activities and the Credit Union's risk management initiatives.

**5. Financial risk management (continued):**

(d) Market risk (continued):

(*i*) Interest rate risk (continued):

*Simulation models (continued):*

| | Net income 2016 | Net income 2015 |
|---|---|---|
| 1% increase in interest rates | $ 1,953 | $ 1,906 |
| 1% decrease in interest rates | 3,373 | 1,413 |

The market value risk technique gauges the impact on the market value of both financial assets and financial liabilities as well as off balance sheet instruments from a movement in interest rates. Market value risk is the present value of potential change in the financial margin over all future periods. It is an economic measure of a leading indicator of the potential impact on future income of an adverse movement in interest rates.

*Interest rate risk analysis:*

Gap analysis is a technique used by the Credit Union for asset liability management to assess interest rate risk. It comprises aggregating cash flows into repricing periods and then assessing whether the cash flows in each of the periods net to zero. The repricing periods are time horizons, based on either repricing dates or maturity dates of the assets and liabilities. An interest rate gap is a positive or negative net cash flow for one of the periods. Gap analysis does not take into consideration the credit risk of assets and liabilities. Note 5(e) discloses the Credit Union's gap position.

Duration analysis is a measure of interest rate exposure and provides an indication of when, on average, the present value of any financial instrument will be received. The Credit Union uses duration analysis to measure the sensitivity of asset and liability market values to a change in interest rates and provides an indication of long-term interest rate exposure.

Earnings at Risk analysis measures the volatility of the forecasted financial margin over the following 12 month period. The Credit Union uses Earnings at Risk to measure the variability of the financial margin based upon changes in the level, slope and curvature of the yield curve and the impact it may have on the book value of capital.

**5. Financial risk management (continued):**

(e) Interest rate sensitivity:

Interest rate sensitivity is a measure of how sensitive the Credit Union’s financial position is to movements in interest rates. To manage interest rate risk, the Credit Union uses swaps and other derivative instruments. The determination of interest rate sensitivity or gap position encompasses numerous assumptions. It is based on the earlier of the repricing date or the maturity date of assets, liabilities and derivative instruments used to manage interest rate risk.

The gap position presented is as at December 31 of each year. It represents the position outstanding at the close of the business day and may change significantly in subsequent periods based on member behaviour and the application of the Credit Union’s asset and liability management policies.

The assumptions for the years ended December 31, 2016 and 2015 were as follows:

(*i*) Assets:

Fixed term assets, such as residential mortgage loans and consumer loans, are reported based on scheduled repayments and estimated prepayments that reflect expected borrower behaviour.

Variable rate assets that are related to the Credit Union’s prime rate or other short term market rates are reported in the three months category.

Fixed rate and non-interest bearing assets with defined maturity are reported based on expected account balance behaviour.

(*ii*) Liabilities:

Fixed rate liabilities, such as term deposits, are reported at scheduled maturity with estimated redemptions that reflect expected depositor behaviour.

Interest-bearing deposits on which the member interest rate changes with prime or other short term market rates are reported within the three months category.

Fixed rate and non-interest bearing liabilities with no defined maturity are reported based upon expected account balance behaviour.

(Expressed in thousands of dollars)

## 5. Financial risk management (continued):

### (e) Interest rate sensitivity (continued):

| | Up to 3 months | 3 to 12 Months | 1 to 2 Years | 2 to 3 Years | 3 to 4 Years | Over 4 4 years | Non-interest sensitive | 2016 Total |
|---|---|---|---|---|---|---|---|---|
| **Assets:** | | | | | | | | |
| Cash and cash equivalents | $ 24,710 | $ - | $ - | $ - | $ - | $ - | $ 12,012 | $ 36,722 |
| Loans and advances to members | 1,373,707 | 422,974 | 307,364 | 267,855 | 327,914 | 352,629 | 1,107 | 3,053,550 |
| Other assets and investments | 4,268 | 24,842 | 79,716 | 40,880 | 100,874 | 47,013 | 129,359 | 426,952 |
| Total assets | $ 1,402,685 | $ 447,816 | $ 387,080 | $ 308,735 | $ 428,788 | $ 399,642 | $ 142,478 | $ 3,517,224 |
| **Liabilities** | | | | | | | | |
| Members' deposits | $ 550,769 | $ 1,411,910 | $ 340,417 | $ 100,600 | $ 50,960 | $ 50,387 | $ 566,334 | $ 3,071,377 |
| Other liabilities | 14,159 | 9,349 | - | - | 121,665 | 51,062 | 32,784 | 229,019 |
| Secured borrowing | 21,708 | - | - | - | - | 15,000 | 27 | 36,735 |
| Preferred equity shares | - | - | - | - | - | - | 1,253 | 1,253 |
| Members' equity | - | - | - | - | - | - | 178,840 | 178,840 |
| Total liabilities | $ 586,636 | $ 1,421,259 | $ 340,417 | $ 100,600 | $ 172,625 | $ 116,449 | $ 779,238 | $ 3,517,224 |
| On-balance sheet gap | $ 816,049 | $ (973,443) | $ 46,663 | $ 208,135 | $ 256,163 | $ 283,193 | $ (636,760) | $ - |
| Derivatives | (210,000) | - | (60,000) | (50,000) | 195,000 | 125,000 | - | - |
| Total interest rate sensitivity gap | $ 606,049 | $ (973,443) | $ (13,337) | $ 158,135 | $ 451,163 | $ 408,193 | $ (636,760) | $ - |
| Cumulative gap | $ 606,049 | $ (367,394) | $ (380,731) | $ (222,596) | $ 228,567 | $ 636,760 | $ - | $ - |

| | Up to 3 months | 3 to 12 months | 1 to 2 years | 2 to 3 years | 3 to 4 years | Over 4 4 years | Non-interest sensitive | 2015 Total |
|---|---|---|---|---|---|---|---|---|
| **Assets:** | | | | | | | | |
| Cash and cash equivalents | $ 7,416 | $ - | $ - | $ - | $ - | $ - | $ 15,578 | $ 22,994 |
| Loans and advances to members | 1,243,670 | 382,580 | 305,667 | 241,521 | 211,147 | 326,561 | 920 | 2,712,066 |
| Other assets and investments | 8,277 | 24,916 | 27,887 | 81,365 | 41,131 | 94,090 | 104,481 | 382,147 |
| Total assets | $ 1,259,363 | $ 407,496 | $ 333,554 | $ 322,886 | $ 252,278 | $ 420,651 | $ 120,979 | $ 3,117,207 |
| **Liabilities** | | | | | | | | |
| Members' deposits | $ 634,401 | $ 1,107,475 | $ 354,248 | $ 89,758 | $ 33,426 | $ 22,335 | $ 523,449 | $ 2,765,092 |
| Other liabilities | 16,458 | 893 | 9,479 | 108 | 88 | 121,863 | 18,841 | 167,730 |
| Secured borrowing | 15,000 | - | - | - | - | - | 1 | 15,001 |
| Preferred equity shares | - | - | - | - | - | - | 1,230 | 1,230 |
| Members' equity | - | - | - | - | - | - | 168,154 | 168,154 |
| Total liabilities | $ 665,859 | $ 1,108,368 | $ 363,727 | $ 89,866 | $ 33,514 | $ 144,198 | $ 711,675 | $ 3,117,207 |
| On-balance sheet gap | $ 593,504 | $ (700,872) | $ (30,173) | $ 233,020 | $ 218,764 | $ 276,453 | $ (590,696) | $ - |
| Derivatives | (185,000) | - | - | (60,000) | 50,000 | 195,000 | - | - |
| Total interest rate sensitivity gap | $ 408,504 | $ (700,872) | $ (30,173) | $ 173,020 | $ 268,764 | $ 471,453 | $ (590,696) | $ - |
| Cumulative gap | $ 408,504 | $ (292,368) | $ (322,541) | $ (149,521) | $ 119,243 | $ 590,696 | $ - | $ - |

**5. Financial risk management (continued):**

(f) Foreign currency risk:

Foreign currency risk is the risk that movement in foreign exchange rates will have an adverse effect on the financial condition of the Credit Union. Foreign currency risk arises in the ordinary course of business as the Credit Union meets member demands for foreign currency banking activities.

The Credit Union is exposed to foreign currency risk each time it buys and sells foreign currency products to a member or to another financial institution. The Credit Union holds a foreign currency position that is exposed to the risk of exchange rate movements in the spot market. This exposure has the potential of having a negative effect on income. The Credit Union is exposed to this risk unless the foreign currency position is economically hedged, either naturally or synthetically. The impact of foreign currency risk will be influenced by the volatility of exchange rate changes, the mix of foreign currency assets and liabilities, and the exposure to each currency market.

*Foreign currency risk policies and procedures:*

Foreign currency risk is managed daily by the treasury department under the direction of the Chief Financial Officer. The treasury department develops and implements management policies and processes with the approval of the ALCO. The Credit Union buys foreign currency investment to diminish foreign currency risk. The Credit Union's foreign currency risk is insignificant.

(g) Fair value of financial instruments:

The Credit Union has estimated fair values taking into account changes in interest rates and credit risk that have occurred since the assets and liabilities were acquired. These calculations represent management's best estimates based on a range of methods and assumptions; since they involve uncertainties, the fair values may not be realized in an actual sale or immediate settlement of the instruments. Interest rate changes are the main cause of changes in the fair value of the Credit Union's financial instruments. The carrying value is a reasonable approximation of the fair value of the Credit Union's cash resources, demand deposits, and certain other financial assets and liabilities, due to their short-term nature.

The fair values of financial instruments are as follows:

(*i*) Loans:

In determining the fair value of loans, the Credit Union incorporates the following assumptions:

(A) For fixed rate and floating rate performing loans, fair values are determined by discounting remaining contractual cash flows at current market interest rates offered for loans with similar terms, adjusting for estimated prepayments expected.

**5. Financial risk management (continued):**

(g) Fair value of financial instruments (continued):

(*i*) Loans (continued):

(B) The total value of loans determined using the above assumption is reduced by the allowance for credit losses to determine the fair value of the Credit Union's loan portfolio.

(*ii*) Financial assets:

The fair value of available-for-sale financial assets is determined by using quoted market values when available. For financial assets where market quotes are not available, the Credit Union uses estimation techniques to determine fair value. These estimation techniques include discounted cash flows, internal models that utilize observable market data or comparisons with other financial assets that are substantially the same. Where there is no observable market data, management uses estimates they believed to be reasonable.

(*iii*) Derivative instruments:

The fair value of derivative instruments is determined by using quoted market benchmark rates from an independent source. The Credit Union uses a valuation method that includes discounted cash flows on the remaining contractual life of a derivative instrument, and valuation models that use observable market data.

(*iv*) Deposits:

In determining the fair value of deposits, the Credit Union incorporates the following assumptions:

(A) For fixed rate, fixed maturity deposits, the Credit Union discounts the remaining contractual cash flows, adjusted for expected redemptions, at market interest rates offered for deposits with similar terms and risks.

(B) For floating rate deposits, changes in interest rates have minimal impact on the fair value since deposits re-price to market frequently. On that basis, fair value is assumed to equal carrying value.

(*v*) Funds held in trust:

The Credit Union holds funds in segregated accounts for members investing in self-directed registered retirement savings plans, treasury bills and mutual funds. The market value of the investments, including publicly traded securities, mutual funds units and treasury bills, is determined using the quoted market amounts. The value of mortgages, private company shares and Canada Savings Bonds is determined using the original cost amount. These funds are off-balance sheet and are not included in the consolidated statement of financial position and amount to $902,919 (2015 - $788,741).

(Expressed in thousands of dollars)

## 5. Financial risk management (continued):

(g) Fair value of financial instruments (continued):

The table below sets out the fair values of financial instruments, including derivatives, using the valuation methods and assumptions referred to above. The table does not include assets and liabilities that do not meet the definitions of financial instruments.

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | Carrying value | Fair value | Carrying value | Fair value |
| Assets carried at fair value: | | | | |
| Cash and cash equivalents | $ 7,744 | $ 7,744 | $ 15,439 | $ 15,439 |
| Financial assets* | 43,043 | 43,043 | 21,267 | 21,267 |
| Derivative financial instruments | 9,171 | 9,171 | 11,844 | 11,844 |
| Assets carried at amortized cost: | | | | |
| Cash and cash equivalents (with maturity up to 3 months) | 28,978 | 28,978 | 7,555 | 7,555 |
| Loans and advances to members (net of allowance) | 3,053,550 | 3,063,248 | 2,712,066 | 2,722,571 |
| Interest-bearing deposits with financial institutions** | 297,571 | 299,254 | 272,033 | 277,161 |
| Other assets | 13,116 | 13,116 | 10,793 | 10,793 |
| | $ 3,453,173 | $ 3,464,554 | $ 3,050,997 | $ 3,066,630 |
| Liabilities carried at fair value: | | | | |
| Derivative financial instruments | $ 7,334 | $ 7,334 | $ 3,890 | $ 3,890 |
| Liabilities carried at amortized cost: | | | | |
| Members' deposits | 3,071,377 | 3,076,236 | 2,762,030 | 2,768,104 |
| Secured borrowings | 36,735 | 36,736 | 15,001 | 15,001 |
| Mortgage-backed security debt liability | 196,629 | 193,091 | 149,068 | 147,201 |
| Accounts payable and accrued liabilities (including retirement benefit obligation and current income taxes) | 25,056 | 25,056 | 17,800 | 17,800 |
| Membership and preferred equity shares | 1,253 | 1,253 | 1,264 | 1,264 |
| | $ 3,338,384 | $ 3,339,706 | $ 2,949,053 | $ 2,953,260 |

* Includes certain investments in Central 1 shares and other investments in the amount of $13,492 (2015 - $11,845) which fair value cannot be reliably measured, therefore recorded at cost.

| | | | | |
|---|---|---|---|---|
| ** Current portion | $ 29,110 | $ 29,228 | $ 33,194 | $ 25,078 |

(Expressed in thousands of dollars)

## 5. Financial risk management (continued):

(g) Fair value of financial instruments (continued):

The following tables summarize the valuation methods used to measure the fair value of financial instruments which are accounted for at fair value in the Credit Union's consolidated statement of financial position. Fair value measurements are analyzed according to a fair value hierarchy of three levels, as outlined below. Observable inputs represent instances where market data is obtained from independent sources. Unobservable inputs are based on the Credit Union's own internal assumptions.

Level 1: Unadjusted quoted market prices in active markets for identical financial assets and financial liabilities.

Level 2: Inputs, other than quoted prices included within Level 1, are observable for the financial asset or financial liability either directly or indirectly.

Level 3: Entity level inputs which are not based upon market observable data.

The level in the fair value hierarchy within which the fair value is categorized shall be determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety.

During the years ended December 31, 2016 and 2015, there were no transfers between Level 1, Level 2 and Level 3.

The following table illustrates the classification of the Credit Union's financial instruments within the fair value hierarchy:

| December 31, 2016 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|
| Financial assets: | | | |
| Fair value through profit or loss | $ - | $ 16,915 | $ - |
| Available-for-sale | - | 29,552 | 13,491 |
| Amortized cost | - | 3,404,596 | - |
| | $ - | $ 3,451,063 | $ 13,491 |
| Financial liabilities: | | | |
| Fair value through profit or loss | $ - | $ 7,334 | $ - |
| Amortized cost | - | 3,332,372 | - |
| | $ - | $ 3,339,706 | $ - |

(Expressed in thousands of dollars)

**5. Financial risk management (continued):**

(g) Fair value of financial instruments (continued):

| December 31, 2015 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|
| Financial assets: | | | |
| Fair value through profit or loss | $ - | $ 27,283 | $ - |
| Available-for-sale | - | 9,421 | 11,845 |
| Amortized cost | - | 3,018,081 | - |
| | $ - | $ 3,054,785 | $ 11,845 |
| Financial liabilities: | | | |
| Fair value through profit or loss | $ - | $ 3,890 | $ - |
| Amortized cost | - | 2,949,370 | - |
| | $ - | $ 2,953,260 | $ - |

The following table reconciles the Credit Union's Level 3 fair value instruments:

| | 2016 | 2015 |
|---|---|---|
| Balance at beginning of year | $ 11,845 | $ 10,033 |
| Purchases | 1,647 | 1,812 |
| Balance at end of year | $ 13,492 | $ 11,845 |

A 10% change in the value of Level 3 financial instruments would result in a $1,349 (2015 - $1,185) impact.

(h) Regulatory and capital management:

Capital is managed in accordance with the Credit Union's capital management policy as established by the Board through the ILC, and appropriate management committees. As an integral part of the Credit Union's strategy is to maintain a strong capital base, all elements of capital are monitored throughout the year. Capital plans are updated on an annual basis as a part of the Credit Union's normal budgeting cycle and are forecast over a three to five-year period to ensure an appropriate level of capital is maintained to sustain operations. Capital levels of the Credit Union are reviewed monthly and reported to the ILC. The Credit Union makes annual dividend payments on eligible shares, within the context of its overall Capital Management Plan.

(Expressed in thousands of dollars)

**5. Financial risk management (continued):**

(h) Regulatory and capital management (continued):

The Financial Institutions Act ("FIA") requires the Credit Union to maintain, at all times, a capital base which is adequate in relation to its business. Capital levels for credit unions in British Columbia are regulated pursuant to capital regulations stated by FICOM. Minimum capital standards are based on a total capital to risk weighted assets ("RWA") ratio of 8%, along with a requirement that at least 35% of the capital base consists of retained earnings.

The Internal Capital Target guideline issued by FICOM sets a Supervisory level of 10% for Credit Unions' internal capital targets.

Regulatory capital is allocated to two tiers: Primary ("Tier 1") and Secondary ("Tier 2"). Tier 1 comprises the more permanent components of capital and consists primarily of share capital and retained earnings adjusted for deferred income taxes. Tier 2 capital consists of preferred equity shares, subordinated debt and 50% of the Credit Union's portion of retained earnings in the Credit Union Deposit Insurance Corporation ("CUDIC"), Central 1, and Stabilization Central Credit Union ("SCCU"). Total regulatory capital is defined as the total of Tier 1 and Tier 2 capitals less deductions as prescribed by FICOM.

The capital ratio is calculated by dividing the capital base by RWA, which are the assets weighted according to relative risk (0% to 200%) as determined by FICOM's prescribed rules relating to on-balance sheet and off-balance sheet exposures.

At December 31, 2016 and 2015 including during the year, the Credit Union's capital ratio was greater than both the minimum regulatory and supervisory requirements.

| | 2016 | 2015 |
|---|---|---|
| Capital: | | |
| Tier 1 capital: | | |
| Equity shares | $ 33,883 | $ 29,852 |
| Retained earnings (unconsolidated) | 141,793 | 133,008 |
| Deferred income tax liabilities | 532 | 1,971 |
| Total Tier 1 capital | 176,208 | 164,831 |
| Tier 2 capital: | | |
| 50% of proportion of retained earnings in CUDIC, Central 1, and SCCU | 24,657 | 21,855 |
| Preferred equity shares | 1,253 | 1,230 |
| Subordinated debt | 15,000 | 15,000 |
| Total Tier 2 capital | 40,910 | 38,085 |
| Total capital | 217,118 | 202,916 |
| Deductions from capital | (7,658) | (8,454) |
| Total capital less deductions (capital base) | $ 209,460 | $ 194,462 |

(Expressed in thousands of dollars)

## 6. Other financial assets:

An analysis of available-for-sale assets by remaining term to maturity is as follows:

| December 31, 2016 | Effective yield | Within 1 year | 1 to 5 years | Over 5 years | 2016 |
|---|---|---|---|---|---|
| Available-for-sale: | | | | | |
| Central 1 shares | 3.20% | $ - | $ - | $ 12,256 | $ 12,256 |
| Other financial assets | 0.60% | 29,431 | - | 1,029 | 30,460 |
| Accrued interest and dividends | | 121 | - | 206 | 327 |
| | | $ 29,552 | $ - | $ 13,491 | $ 43,043 |

| December 31, 2015 | Effective yield | Within 1 year | 1 to 5 years | Over 5 years | 2015 |
|---|---|---|---|---|---|
| Available-for-sale: | | | | | |
| Central 1 shares | 4.18% | $ - | $ - | $ 10,440 | $ 10,440 |
| Other financial assets | 2.87% | 9,420 | - | 1,030 | 10,450 |
| Accrued interest and dividends | | 2 | - | 375 | 377 |
| | | $ 9,422 | $ - | $ 11,845 | $ 21,267 |

Certain investments in Central 1 and other shares are recorded at cost as the fair value cannot be reliably measured. There is no separately quoted market value for the shares, and the timing of redemption of the shares cannot be determined.

Included in the above AFS investments are reinvestment assets relating to the Canada Mortgage Bonds (“CMB”) program of $25,419 (2015 - $9,420). These assets form part of the security for the mortgage-backed security debt liability of $196,629 (2015 - $149,068) as described in note 14.

## 7. Derivative financial instruments:

| | Notional amounts Maturities of derivatives | | | | Fair value | |
|---|---|---|---|---|---|---|
| | Within 1 year | 1 to 5 years | 2016 | 2015 | 2016 | 2015 |
| **Derivatives used to manage interest rate risks:** | | | | | | |
| Receive fixed interest swaps | $ - | $ 295,000 | $ 295,000 | $ 270,000 | $ 1,214 | $ 7,884 |
| Receive fixed interest forward starting swaps | - | 125,000 | 125,000 | 125,000 | 841 | 922 |
| Pay fixed interest swaps | - | 85,000 | 85,000 | 135,000 | (234) | (862) |
| Derivatives hedging market linked term deposits | 6,734 | 59,737 | 66,471 | 47,323 | 5,500 | 3,038 |
| Derivatives issued in connection with market linked term deposits | (6,684) | (59,604) | (66,288) | (47,209) | (5,484) | (3,028) |
| Total derivative contracts | $ 50 | $ 505,133 | $ 505,183 | $ 530,114 | $ 1,837 | 7,954 |

The above table includes accrued interest on derivative financial instruments.

Notional amounts are the contract amounts used to calculate the cash flows to be exchanged. They do not represent credit or market risk exposure.

(Expressed in thousands of dollars)

**7. Derivative financial instruments (continued):**

Fair values based on quoted market prices are not available for the Credit Union's derivative instruments. Consequently, fair values are derived using present value and other valuation techniques and may not be indicative of the net realizable values.

The following is a summary of the nature of derivative instruments utilized:

Interest rate swaps are transactions in which two parties exchange interest flows on a specified notional amount for a predetermined period, based on agreed upon fixed and floating rates. Notional amounts are not exchanged.

The Credit Union hedges a portion of the interest rate risk that arises on variable interest cash flows on prime rate mortgages through interest rate derivatives. Interest income and expense reported in the consolidated statement of income include the reclassification of the effective portion of interest rate derivatives designated as hedging items in cash flow hedges from accumulated other comprehensive income in order to match the timing of the hedged interest cash flows recognized in the consolidated statement of income. Any ineffectiveness in the hedging relationship is recorded directly in the consolidated statement of income.

The credit risk amount of derivatives, which represents the current replacement cost of all outstanding over the counter derivative contracts in a gain position, without factoring in the impact of master netting agreements, totaled $9,171 as at December 31, 2016 (2015 - $11,844). The Credit Union manages this credit risk by dealing with counterparties that meet or exceed a minimum credit rating. As at December 31, 2016, the Credit Union has master netting agreements in place with its derivative counterparties.

The following table presents the recognized financial instruments that are subject to enforceable master netting arrangements but not offset, as at December 31, 2016 and 2015, and shows in the 'Net' column the result if all set-off rights were exercised.

| | Amounts offset | | | Amounts not offset | | Net |
|---|---|---|---|---|---|---|
| | Gross liabilities | Gross assets offset | Net amounts presented | Financial instruments | Cash collateral pledge/ received | |
| **December 31, 2016** | | | | | | |
| **Financial liabilities:** | | | | | | |
| Derivative assets | $ - | $ - | $ - | $ 9,171 | $ - | $ 1,837 |
| Derivative liabilities | - | - | - | 7,334 | - | - |
| **December 31, 2015** | | | | | | |
| **Financial liabilities:** | | | | | | |
| Derivative assets | $ - | $ - | $ - | $ 11,844 | $ - | $ 7,954 |
| Derivative liabilities | - | - | - | 3,890 | - | - |

**7. Derivative financial instruments (continued):**

The Credit Union is subject to enforceable master netting arrangements in the form of International Swap and Derivatives Association (ISDA) agreements with derivative counterparties. Under the terms of these agreements, offsetting of derivative contracts is permitted only in the event of bankruptcy or default of either party to the agreements. As at December 31, 2016, if all set-off rights were exercised, the net impact on the Credit Union's consolidated statement of financial position would be to decrease derivative financial instrument assets by $1,850 (2015 - $862) and to decrease derivative financial liabilities by $1,850 (2015 - $862).

Interest income and expense include the release from accumulated other comprehensive income of gains or losses relating to the effective portion of qualifying hedging derivatives designated as cash flow hedges either (i) as the hedged item is recorded in interest income (expense) or (ii) the forecasted cash flows of the hedged item are no longer probable. The amount released is reported as a reclassification from accumulated other comprehensive income.

From time to time, the Credit Union enters into derivative transactions to economically hedge certain business strategies that do not otherwise qualify for hedge accounting, or where hedge accounting is not considered economically feasible to implement. During the year ended December 31, 2016 $461 (2015 – $86) was recorded in net interest expense as unrealized net income in fair value of these derivatives. In addition, net interest expense contains income of $27 (2015 - $2) in net realized gains on derivatives.

The Credit Union has $66,288 (2015 - $47,209) of market linked term deposit products outstanding to its members. These term deposits have maturities of up to five years and pay interest to the depositors, at the end of the term, based on the performance of baskets of securities. The Credit Union has purchased market linked options with a derivative counterparty to offset the exposure to the securities associated with these products. The Credit Union pays a fixed rate based on the notional amount at the inception of the market linked option contract. At the end of the term the Credit Union receives from the derivative counterparty payments equal to the amount that will be paid to the depositors based on the performance of the respective securities.

The purpose of the market linked options is to provide an economic hedge against market fluctuations and have fair values that vary based on changes in the values of the underlying baskets of securities. The fair value of these contracts amounted to $5,500 as at December 31, 2016 (2015 - $3,038) and is included as part of derivative financial instruments. The fair value of the embedded written option in the market linked term deposits amounted to ($5,484) at December 31, 2016 (2015 - ($3,028)) and is included as part of derivative financial instruments. Although hedge accounting is not applied, these agreements continue to be effective as economic hedges. Gains/losses from interest rate and market linked derivative instruments are included in profit or loss as part of interest expense on deposits (note 17).

(Expressed in thousands of dollars)

## 8. Loans and advances to members:

(a) Loan maturities and rate sensitivities:

| | Maturity term | | | | Rate sensitivity | | |
|---|---|---|---|---|---|---|---|
| December 31, 2016 | Under 1 year | 1 to 5 Years | Over 5 Years | Total | Floating | Fixed rate | Total |
| Residential mortgages | $ 1,219,654 | $ 728,688 | $ 214 | $ 1,948,556 | $ 950,552 | $ 998,004 | $ 1,948,556 |
| Commercial loans and finance leases receivable | 561,402 | 505,078 | 20,680 | 1,087,160 | 286,420 | 800,740 | 1,087,160 |
| Consumer loans | 15,625 | 1,098 | 4 | 16,727 | 14,713 | 2,014 | 16,727 |
| Accrued interest | 3,811 | - | - | 3,811 | 3,811 | - | 3,811 |
| Total loans | 1,800,492 | 1,134,864 | 20,898 | 3,056,254 | 1,255,496 | 1,800,758 | 3,056,254 |
| Allowance for credit losses | | | | (4,601) | | | (4,601) |
| Deferred broker expenses | | | | 5,017 | | | 5,017 |
| Deferred mortgage commitment fees | | | | (3,120) | | | (3,120) |
| Total loans - net of allowance for credit losses | | | | $ 3,053,550 | | | $ 3,053,550 |

| | Maturity term | | | | Rate sensitivity | | |
|---|---|---|---|---|---|---|---|
| December 31, 2015 | Under 1 year | 1 to 5 years | Over 5 years | Total | Floating | Fixed rate | Total |
| Residential mortgages | $ 1,095,222 | $ 640,326 | $ 274 | $ 1,735,822 | $ 857,480 | $ 878,342 | $ 1,735,822 |
| Commercial loans and finance leases receivable | 515,656 | 425,001 | 17,774 | 958,431 | 250,418 | 708,013 | 958,431 |
| Consumer loans | 15,372 | 1,519 | 2 | 16,893 | 14,183 | 2,710 | 16,893 |
| Accrued interest | 3,653 | - | - | 3,653 | 3,653 | - | 3,653 |
| Total loans | 1,629,903 | 1,066,846 | 18,050 | 2,714,799 | 1,125,734 | 1,589,065 | 2,714,799 |
| Allowance for credit losses | | | | (4,533) | | | (4,533) |
| Deferred broker expenses | | | | 4,699 | | | 4,699 |
| Deferred mortgage commitment fees | | | | (2,899) | | | (2,899) |
| Total loans - net of allowance for credit losses | | | | $ 2,712,066 | $ | $ | $ 2,712,066 |

(Expressed in thousands of dollars)

## 8. Loans and advances to members (continued):

(b) Reconciliation of allowance for credit losses:

| | Residential | Commercial and leasing | Consumer | Total 2016 | Total 2015 |
|---|---|---|---|---|---|
| Balance, beginning of year | $ 35 | $ 4,244 | $ 254 | $ 4,533 | $ 4,314 |
| Allowance for credit losses | 1,046 | 428 | 126 | 1,600 | 1,041 |
| Loans written off | - | (919) | (203) | (1,122) | (507) |
| Leases written off | - | (510) | - | (510) | (479) |
| Recoveries of loans written off | - | 62 | 38 | 100 | 164 |
| Balance, end of year | 1,081 | 3,305 | 215 | 4,601 | 4,533 |
| Individual allowances | - | 1,440 | 204 | 1,644 | 3,438 |
| Collective allowances | 1,081 | 1,865 | 11 | 2,957 | 1,095 |
| Total loan allowances | $ 1,081 | $ 3,305 | $ 215 | $ 4,601 | $ 4,533 |

(c) Loans and advances individually impaired:

| | 2016 | 2015 |
|---|---|---|
| Impaired loans with individual allowances: | | |
| Residential mortgages | $ - | $ 747 |
| Commercial loans and leases receivable | 2,480 | 9,159 |
| Consumer loans | 51 | 71 |
| Individual allowances | (1,644) | (3,438) |
| | $ 887 | $ 6,539 |

The fair value of the collateral held by the Credit Union as security for the above loans was $1,150 (2015 - $16,900). The Credit Union has estimated the fair value of collateral based on an updated assessment of the security appraisal undertaken at the original funding assessment and management's knowledge of local real estate market conditions.

The collateral and other credit enhancements held by the Credit Union as security for loans include: (*i*) insurance, mortgages over residential lots and properties, (*ii*) recourse to business assets such as real estate and equipment, (*iii*) recourse to the commercial real estate properties being financed, and (*iv*) recourse to liquid assets, guarantees and securities.

Valuations of the collateral are updated periodically depending on the nature of the collateral. The Credit Union has policies in place to monitor the existence of undesirable concentration in the collateral supporting its credit exposure.

(Expressed in thousands of dollars)

## 8. Loans and advances to members (continued):

(d) Loans past due but not impaired:

A loan is considered past due when a payment has not been received by the contractual due date. The following table presents the carrying value of loans that are past due but not classified as impaired because they are either (*i*) less than 90 days past due unless there is information to the contrary that an impairment event has occurred or (*ii*) fully secured and collection efforts are reasonably expected to result in repayment.

Loans that are past due but not impaired as at December 31, 2016 and 2015 are as follows:

| December 31, 2016 | 30 to 59 days | 60 to 89 days | 90 days | Total |
|---|---|---|---|---|
| Residential mortgages | $ - | $ 216 | $ - | $ 216 |
| Commercial loans and leases receivable | 64 | - | - | 64 |
| Consumer loans | 7 | 9 | - | 16 |
| | $ 71 | $ 225 | $ - | $ 296 |

| December 31, 2015 | 30 to 59 days | 60 to 89 days | 90 days | Total |
|---|---|---|---|---|
| Residential mortgages | $ 155 | $ - | $ 747 | $ 902 |
| Commercial loans and leases receivable | 118 | 740 | 185 | 1,043 |
| Consumer loans | 43 | 9 | 4 | 56 |
| | $ 316 | $ 749 | $ 936 | $ 2,001 |

(e) Foreclosed collateral:

There were no new assets acquired in respect of delinquent loans in 2016. Assets acquired in 2015 ($1,483) are included in other assets (note 11).

(Expressed in thousands of dollars)

## 8. Loans and advances to members (continued):

(f) Leases receivable:

The investment in leases receivable and the present value of minimum lease payments receivable at the end of the reporting period are detailed below.

| | 2016 | 2015 |
|---|---|---|
| Gross investment in leases receivable: | | |
| Less than 1 year | $ 3,296 | $ 2,624 |
| Between 1 year and 5 years | 74,014 | 71,030 |
| Later than 5 years | 6,717 | 6,527 |
| | 84,027 | 80,181 |
| Unearned finance income on finance leases | (7,382) | (7,705) |
| Present value of minimum lease payments receivable | $ 76,645 | $ 72,476 |
| Present value of minimum lease payments receivable: | | |
| Less than 1 year | $ 3,218 | $ 2,528 |
| Between 1 year and 5 years | 67,845 | 64,570 |
| Later than 5 years | 5,582 | 5,378 |
| | $ 76,645 | $ 72,476 |

## 9. Assets pledged as collateral:

In the normal course of business, the Credit Union pledges mortgage assets and readily marketable securities to secure credit and clearing facilities. Asset pledging transactions are conducted under terms that are common and customary to standard derivative and other financing activities. Standard risk management controls are applied with respect to asset pledging.

(Expressed in thousands of dollars)

## 9. Assets pledged as collateral (continued):

Assets which are pledged as collateral are related to proceeds from securitizations and other borrowings. The nature and carrying amounts of the assets pledged as collateral are as follows:

| | 2016 | 2015 |
|---|---|---|
| Securitized loans | $ 196,629 | $ 149,068 |
| Mortgages | 53,119 | 53,164 |
| Assets with a general charge | 335,000 | 297,000 |
| Total assets pledged | $ 584,748 | $ 499,232 |
| Assets pledged to, or charged against by: | | |
| Central 1 Credit Union | $ 175,000 | $ 137,000 |
| Other financial institutions | 213,119 | 213,164 |
| Securitized borrowings | 196,629 | 149,068 |
| | $ 584,748 | $ 499,232 |

## 10. Premises and equipment and intangible assets:

(a) Premises and equipment:

| | Land | Buildings | Leasehold improvements | Furniture fixtures and other other assets | 2016 Total |
|---|---|---|---|---|---|
| Cost: | | | | | |
| Balance at January 1, 2016 | $ 10,320 | $ 45,139 | $ 4,236 | $ 11,655 | $ 71,350 |
| Acquisitions | - | 1,077 | 137 | 1,300 | 2,514 |
| Disposals | - | (51) | (1,637) | (1,233) | (2,921) |
| Balance at December 31, 2016 | $ 10,320 | $ 46,165 | $ 2,736 | $ 11,722 | $ 70,943 |
| Accumulated depreciation: | | | | | |
| Balance at January 1, 2016 | $ - | $ 5,882 | $ 2,367 | $ 5,045 | $ 13,294 |
| Disposals | - | (51) | (1,637) | (1,233) | (2,921) |
| Depreciation | - | 1,559 | 274 | 2,043 | 3,876 |
| Balance at December 31, 2016 | $ - | $ 7,390 | $ 1,004 | $ 5,855 | $ 14,249 |

(Expressed in thousands of dollars)

**10. Premises and equipment and intangible assets (continued):**

(a) Premises and equipment (continued):

| | Land | Buildings | Leasehold improvements | Furniture fixtures and other other assets | 2015 Total |
|---|---|---|---|---|---|
| Cost: | | | | | |
| Balance at January 1, 2015 | $ 10,320 | $ 44,458 | $ 3,379 | $ 11,673 | $ 69,830 |
| Acquisitions | - | 696 | 1,182 | 1,861 | 3,739 |
| Disposals | - | (15) | (325) | (1,879) | (2,219) |
| Balance at December 31, 2015 | $ 10,320 | $ 45,139 | $ 4,236 | $ 11,655 | $ 71,350 |
| Accumulated depreciation: | | | | | |
| Balance at January 1, 2015 | $ - | $ 4,382 | $ 2,375 | $ 4,883 | $ 11,640 |
| Disposals | - | (15) | (325) | (1,879) | (2,219) |
| Depreciation | - | 1,515 | 318 | 2,040 | 3,873 |
| Balance at December 31, 2015 | $ - | $ 5,882 | $ 2,367 | $ 5,045 | $ 13,294 |
| Balance at December 31, 2015 | $ 10,320 | $ 39,257 | $ 1,868 | $ 6,611 | $ 58,056 |
| Balance at December 31, 2016 | 10,320 | 38,775 | 1,732 | 5,867 | 56,694 |

(b) Intangible assets:

| | Banking system | Other software | Total 2016 |
|---|---|---|---|
| Cost: | | | |
| Balance at January 1, 2016 | $ 8,159 | $ 4,910 | $ 13,069 |
| Acquisitions | - | 777 | 777 |
| Disposals | - | (456) | (456) |
| Balance at December 31, 2016 | $ 8,159 | $ 5,231 | $ 13,390 |
| Accumulated depreciation: | | | |
| Balance at January 1, 2016 | $ 3,238 | $ 1,677 | $ 4,915 |
| Disposals | - | (456) | (456) |
| Depreciation | 661 | 913 | 1,574 |
| Balance at December 31, 2016 | $ 3,899 | $ 2,134 | $ 6,033 |

(Expressed in thousands of dollars)

### 10. Premises and equipment and intangible assets (continued):

(b) Intangible assets (continued):

| | Banking system | Other software | Total 2015 |
|---|---|---|---|
| Cost: | | | |
| Balance at January 1, 2015 | $ 8,036 | $ 4,812 | $ 12,848 |
| Acquisitions | 123 | 1,513 | 1,635 |
| Disposals | - | (1,415) | (1,415) |
| Balance at December 31, 2015 | $ 8,159 | $ 4,910 | $ 13,069 |
| Accumulated depreciation: | | | |
| Balance at January 1, 2015 | $ 2,585 | $ 2,342 | $ 4,927 |
| Disposals | - | (1,415) | (1,415) |
| Depreciation | 653 | 749 | 1,403 |
| Balance at December 31, 2015 | $ 3,238 | $ 1,677 | $ 4,915 |
| Carrying amounts: | | | |
| Balance at December 31, 2015 | $ 4,921 | $ 3,233 | $ 8,154 |
| Balance at December 31, 2016 | 4,260 | 3,097 | 7,357 |

### 11. Other assets:

| | 2016 | 2015 |
|---|---|---|
| Assets held for sale | $ 2,029 | $ 2,501 |
| Prepaid expenses and deposits | 3,708 | 3,228 |
| Accounts receivable | 4,044 | 1,822 |
| | 9,781 | 7,551 |
| Current | 6,384 | 3,916 |
| Non-current | $ 3,397 | $ 3,635 |

The assets held for sale consist of foreclosed property and land for sale, measured at the lower of carrying value and fair value less costs to sell.

(Expressed in thousands of dollars)

## 12. Members' deposits:

| | 2016 | 2015 |
|---|---|---|
| Demand deposits | $ 691,124 | $ 648,018 |
| Term deposits | 2,040,259 | 1,804,230 |
| Registered deposits | 319,854 | 290,518 |
| Accrued interest and dividends payable | 20,140 | 19,265 |
| | 3,071,377 | 2,762,030 |
| Current | 2,513,769 | 2,248,790 |
| Non-current | $ 557,608 | $ 513,240 |

The Credit Union holds an amount of $2,060 (2015 - $1,214) in deferred principal guarantees that relate to embedded derivatives with respect to the yield on market linked term deposits. Market linked term deposits are performance based with settlement at maturity. The Credit Union has an agreement with a derivative counterparty that locks in the costs to the Credit Union.

Term deposits include equity market linked deposits as described in note 7.

## 13. Borrowings:

| | 2016 | 2015 |
|---|---|---|
| Subordinated Debt | $ 15,000 | $ 15,000 |
| Central 1 | 21,708 | - |
| Accrued interest payable | 27 | 1 |
| | 36,735 | 15,001 |
| Current | 21,735 | 1 |
| Non-current | $ 15,000 | $ 15,000 |

The Credit Union has granted a general security interest in its present and after acquired personal property as security for the revolving line of credit facility with Central 1 of $175,000 (2015 - $137,000). A specific assignment of mortgage loans has been pledged as security for the revolving lines of credit facilities with counterparties of $130,000 (2015 - $130,000). Subordinated debt has an original term to maturity of 10 years maturing on December 13, 2023 with a right to repay after 5 years at the Credit Union's option. The subordinated debt qualifies as Tier 2 secondary capital for regulatory capital purposes and an interest rate of 5.68% (2015 - 5.61%).

(Expressed in thousands of dollars)

**14. Securitized borrowings:**

The Credit Union periodically enters into asset transfer agreements with Central 1 and other third parties which may include securitization of residential mortgages.

The Credit Union reviews transfer agreements in order to determine whether the transfers of financial assets should result in all or a portion of the transferred mortgages being derecognized from its consolidated statement of financial position. The derecognition requirements include an assessment of whether the Credit Union’s rights to contractual cash flows have expired or have been transferred or whether an obligation has been undertaken by the Credit Union to pay the cash flows collected on the underlying transferred assets over to a third party. The derecognition standards also include an assessment of whether substantially all the risks and rewards of ownership have been transferred.

The table below sets out the carrying amounts of financial assets for CMB and mortgage-backed security debt liability.

| | 2016 | 2015 |
|---|---|---|
| Mortgages receivable | $ 193,565 | $ 120,037 |
| Principal and interest reinvestment accounts | 29,552 | 9,421 |
| | $ 223,117 | $ 129,458 |
| CMB program obligations | $ 196,506 | $ 148,992 |
| Accrued interest | 123 | 76 |
| | $ 196,629 | $ 149,068 |

The Credit Union has $196,629 (2015 - $149,068) of residential mortgages categorized as loans held as security for the secured borrowing. As a result of the transaction, the Credit Union receives the net differential between the monthly interest receipts of the mortgages and the interest expense on the borrowings. The exposure to variability of future interest income and expense has been incorporated into the Credit Union’s interest rate sensitivity calculations in notes 5(d) and 5(e).

**15. Retirement benefit obligations:**

The Credit Union provides pension and other post-retirement benefits to employees through defined benefit, defined contribution and multi-employer defined benefit plans.

The Credit Union funds the multi-employer defined benefit plan based on actuarially prescribed amounts. The defined benefit and defined contribution plans are paid directly by the Credit Union at the time of entitlement.

(Expressed in thousands of dollars)

**15. Retirement benefit obligations (continued):**

(a) Defined benefit plans:

The accrued benefit obligation was actuarially measured for accounting purposes as of December 31, 2016.

(*i*) Retirement benefit liability:

| | | 2016 | | 2015 | | 2014 | | 2013 | | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|
| Unfunded benefit obligation | $ | 2,614 | $ | 2,248 | $ | 1,907 | $ | 1,678 | $ | 1,409 |
| Actuarial adjustment | | (162) | | (51) | | 24 | | 19 | | 15 |
| Retirement benefit obligation recognized | | 2,452 | | 2,197 | | 1,931 | | 1,697 | | 1,424 |
| Current portion | | - | | - | | - | | - | | - |
| Non-current portion | $ | 2,452 | $ | 2,197 | $ | 1,931 | $ | 1,697 | $ | 1,424 |

The movement in the unfunded benefit obligation is as follows:

| | | 2016 | | 2015 |
|---|---|---|---|---|
| Unfunded benefit obligation at January 1 | $ | 2,197 | $ | 1,931 |
| Current service cost - net of employee contributions | | 138 | | 166 |
| Interest cost | | 139 | | 94 |
| Employee contributions | | - | | - |
| Other | | 22 | | 50 |
| Benefit payments | | (44) | | (44) |
| Unfunded benefit obligation at December 31 | $ | 2,452 | $ | 2,197 |

The amounts recognized in the consolidated statement of income were as follows:

| | | 2016 | | 2015 |
|---|---|---|---|---|
| Current service cost | $ | 138 | $ | 166 |
| Interest cost | | 139 | | 94 |
| Expected return on plan assets | | - | | - |
| Past service cost | | 69 | | - |
| Other | | (10) | | 50 |
| Total included in employee benefits expense (note 19) | $ | 336 | $ | 310 |

(Expressed in thousands of dollars)

### 15. Retirement benefit obligations (continued):

(a) Defined benefit plans (continued)

The principal actuarial assumptions used were as follows:

| | 2016 | 2015 |
|---|---:|---:|
| Discount rate | 4.00% | 4.00% |
| Inflation rate | 2.00% | 2.00% |
| Future salary increases | 3.00% | 3.00% |
| Future pension increases | 3.00% | 3.00% |

Risks associated with the Defined benefit plans:

The different plans expose the Credit Union to different risks such as:

(*i*) Interest rate risk:

A variation in bond rates will affect the value of the plan liabilities.

(*ii*) Longevity risk:

A greater increase in life expectancy than the one predicted by the mortality table used will increase the plan liabilities.

(*iii*) Inflation risk:

The defined benefit obligation is calculated taking into account an increase in level of salary and future cost of living adjustments. If actual inflation is greater than expected, it will result in an increase in the defined benefit obligation.

(b) Multi-employer pension plan:

The Credit Union is one of several employers that participate in the BC Credit Union Employees' Pension Plan (The Plan). The Plan is a multi-employer contributory defined benefit pension plan governed by a 12-member Board of Trustees. The Board of Trustees is responsible for overseeing the management of the Plan, including investment of the assets and administration of the benefits. The Plan, as at December 31, 2015, had approximately 3,200 active employees and 760 retired plan members. Total plan assets at December 31, 2015 are estimated at $561 million.

(Expressed in thousands of dollars)

**15. Retirement benefit obligations (continued):**

(b) Multi-employer pension plan (continued):

Every three years, an actuarial valuation is performed to assess the financial position of the Plan and the adequacy of the funding level. The most recent actuarial valuation, which was conducted as at December 31, 2015, indicated a going concern unfunded liability of $25 million and a solvency deficiency of $123 million. The deficit is targeted to be financed over time through increased contributions, collectively, from participating employers. As approved by the regulator the Plan's solvency deficiency is expected to be funded by the year 2027. The Credit Union paid $2,698 for employer contributions to the plan in fiscal year 2016 (2015 - $2,508).

The next actuarial valuation is scheduled as at December 31, 2018.

**16. Shares:**

The Credit Union has authorized an unlimited number of equity shares, each with a par value of one dollar. Outstanding shares consist of Class A membership shares, Class E Life Insurance Savings Non-equity shares, Class B Transaction Equity shares, Class C Investment Equity shares, Class E Equity shares and Class G to Q Preferred Equity shares.

| | 2016 | 2015 |
|---|---|---|
| Membership and preferred equity shares | $ 1,253 | $ 1,264 |
| Transaction shares | $ 1,048 | $ 1,104 |
| Investment and Class E shares | 32,835 | 28,748 |
| Equity shares | $ 33,883 | $ 29,852 |

Members are required to purchase membership shares and are from time to time allowed to purchase investment shares. Membership shares are redeemable at par only when a membership is withdrawn. Preferred equity shares are redeemable at fixed dates. In previous years, certain members were required to purchase transaction shares related to a loan transaction. Investment shares are specifically structured to provide an opportunity for members to invest in the capital structure of the Credit Union. Dividends on all shares are declared at the discretion of the Board.

(Expressed in thousands of dollars)

## 17. Net interest income:

| | 2016 | 2015 |
|---|---|---|
| Interest income: | | |
| Interest from loans and advances to members | $ 99,913 | $ 91,062 |
| Interest on interest-bearing deposits with financial institutions | 4,959 | 4,697 |
| Central 1 investments | 222 | 458 |
| Net interest income and gains on derivative financial instruments | 2,540 | 1,645 |
| Mortgage commitment fees | 2,995 | 2,681 |
| Mortgage broker fees | (2,199) | (1,755) |
| | 108,430 | 98,788 |
| Interest expense: | | |
| Interest on members' deposits | 42,525 | 41,091 |
| Interest on borrowed funds | 4,732 | 2,718 |
| Deposit agent commissions | 302 | 599 |
| | 47,559 | 44,408 |
| Net interest income | $ 60,871 | $ 54,380 |

## 18. Fee and commission income and other income:

| | 2016 | 2015 |
|---|---|---|
| Fee and commission income: | | |
| Account services fees | $ 1,670 | $ 1,702 |
| Commission | 6,513 | 6,364 |
| Lending fees | 3,679 | 3,307 |
| | $ 11,862 | $ 11,373 |
| Other income: | | |
| Other member income | $ 1,826 | $ 1,401 |
| Miscellaneous income | 67 | 486 |
| | $ 1,893 | $ 1,887 |

(Expressed in thousands of dollars)

## 19. Salary and employee benefits:

| | 2016 | 2015 |
|---|---|---|
| Salaries | $ 28,918 | $ 26,059 |
| Benefits | 2,579 | 2,320 |
| Pension costs: | | |
| Multi-employer plan | 2,698 | 2,493 |
| Other benefit plans | 336 | 310 |
| Defined-contribution plan | 35 | 15 |
| | $ 34,566 | $ 31,197 |

## 20. Building and occupancy and general and administrative expenses:

| | 2016 | 2015 |
|---|---|---|
| Building and occupancy: | | |
| Amortization | $ 3,876 | $ 3,873 |
| Occupancy | 3,515 | 3,800 |
| | 7,391 | 7,673 |
| General and administrative expenses: | | |
| Technology | 4,225 | 4,030 |
| Dues, fees and charges | 4,052 | 3,594 |
| Marketing | 1,844 | 1,881 |
| General business | 1,861 | 992 |
| Office expenses | 1,688 | 1,726 |
| Amortization of intangible assets | 1,574 | 1,402 |
| Bank charges | 1,160 | 1,200 |
| Human resources and training | 667 | 733 |
| Lien and title searches | 518 | 567 |
| Board compensation and expenses | 525 | 469 |
| Equipment rental and maintenance | 383 | 329 |
| | $ 18,497 | $ 16,923 |

(Expressed in thousands of dollars)

**21. Income taxes:**

(a) Income tax expense:

| | | 2016 | | 2015 |
|---|---|---|---|---|
| Current tax expense: | | | | |
| Current year | $ | 3,411 | $ | 2,531 |
| Deferred tax expense: | | | | |
| Origination and reversal of temporary differences | | (1,439) | | (536) |
| Total income tax expense | $ | 1,972 | $ | 1,995 |

(b) Reconciliation of effective tax rate:

Deferred taxes are calculated on all temporary differences under the liability method using an effective tax rate table. The income tax expense differs from the amount that would be computed by applying the combined federal and provincial statutory income tax rates of 26% (2015 - 26.00%) to income before income taxes. The reasons for the differences are as follows:

| | | 2016 | | 2015 |
|---|---|---|---|---|
| Combined federal and provincial statutory tax rate | $ | 3,273 | $ | 2,781 |
| Credit union preferred rate reduction | | (912) | | (1,217) |
| Non-deductible and other items | | (389) | | 431 |
| | $ | 1,972 | $ | 1,995 |

(Expressed in thousands of dollars)

## 21. Income taxes (continued):

(c) Deferred tax assets and liabilities:

| | Balance at December 31, 2015 | Recognized in profit or loss | Reclass | Recognized in OCI | Balance at December 31, 2016 |
|---|---|---|---|---|---|
| Deferred tax assets: | | | | | |
| Leasing assets | $ 3,010 | $ (2,949) | $ | $ | $ 61 |
| Pensions benefits | 619 | (55) | | | 564 |
| Allowance for impairment of loans | 140 | 982 | | | 1,122 |
| Deferred revenue | 4 | (4) | | | - |
| Loss carryforward | 594 | 2,085 | | | 2,679 |
| Other provisions | 42 | (42) | | | - |
| Total | $ 4,409 | $ 17 | $ | $ | $ 4,426 |
| Deferred tax liabilities: | | | | | |
| Premises and equipment | $ 3,051 | $ (184) | $ | $ | $ 2,867 |
| Cash flow hedges | 1,678 | (1,678) | | | - |
| Deferred revenue | - | 1,607 | | | 1,607 |
| Land | 484 | - | | | 484 |
| Deferred expenses | 1,167 | (1,167) | | | - |
| Total | $ 6,380 | $ (1,422) | $ | $ | $ 4,958 |
| Net deferred tax assets | $ 3,010 | | | | $ 2,616 |
| Net deferred tax liabilities | 4,981 | | | | 3,148 |

Deferred taxes of the credit union that are expected to reverse in the future have been measured using a weighted average effective tax rate of 23.0% (2015 - 22.64%). The increase is caused by a change in the federal income tax rate applicable to credit unions. All other entities have used the statutory applicable rate of 26% which is unchanged from the prior year.

(d) Unrecognized deferred tax assets:

At December 31, 2016, deferred tax assets for temporary differences related to investments in subsidiaries were not recognized because the Credit Union controls these assets.

(Expressed in thousands of dollars)

**22. Commitments and contingencies:**

(a) Credit commitments:

The following amounts represent the maximum amount of additional credit that the Credit Union could be obligated to extend. These amounts are not necessarily indicative of credit risk as many of these arrangements may expire or terminate without being utilized. Further the Credit Union has no obligation to advance funds.

| | 2016 | 2015 |
|---|---|---|
| Undrawn lines of credit | $ 316,851 | $ 264,230 |
| Commitments to extend credit | 118,410 | 131,421 |
| Documentary letters of credit | 8,933 | 10,513 |
| | $ 444,194 | $ 406,164 |

(b) Deposit commitments:

Under governing legislation, the Credit Union is required to maintain a portion of its liquidity in the form of deposits held with Central 1. Required liquidity deposits with Central 1 totalled $256,206 (2015 - $226,720) of the total $284,303 (2015 - $230,444) deposited.

(c) Restricted cash:

Included within cash and cash equivalents, the Credit Union has restricted cash of $2,080 (2015 - $4,386) arising from securitization agreements in the ordinary course of business. This restricted cash is due to be paid to the recipient of the transferred receivables, but has not yet been remitted.

(d) Lease commitments:

The Credit Union has leases on certain branch and office premises for terms extending to 2025 with an option to renew after that period. The lease arrangements may include escalation clauses to reflect fair market rental rates. Total lease payments of $1,252 (2015 - $1,373) were expensed during the year ended December 31, 2016, and are recognized in the consolidated statement of income as a part of building and occupancy expenses.

The future minimum lease payments are as follows:

| | 2016 | 2015 |
|---|---|---|
| No later than one year | $ 1,370 | $ 1,098 |
| Later than one year and no later than five years | 6,397 | 4,365 |
| Later than five years | 5,178 | 2,645 |
| | $ 12,945 | $ 8,108 |

(Expressed in thousands of dollars)

**22. Commitments and contingencies (continued):**

(e) Other commitments:

The Credit Union and Capilano University (the University) have an agreement whereby the Credit Union committed $1 million over a 15 year period to the University starting in 2011, which results in the University's performing arts theatre at the North Vancouver campus being named the BlueShore Financial Centre for the Performing Arts.

The Credit Union also has a commitment to pay annual maintenance fees for its banking system and other information systems.

Outstanding commitments are as follows:

| | 2016 | 2015 |
|---|---|---|
| Capilano University | $ 600 | $ 667 |
| Technology | 3,407 | 4,621 |
| | $ 4,007 | $ 5,288 |

(f) Contingencies:

In the ordinary course of business, the Credit Union has legal proceedings brought against it and provisions have been included in liabilities where appropriate. Based on current knowledge, the Credit Union expects that final determination of these claims will not have a material adverse effect on its consolidated statement of financial position or on operating results.

**23. Related parties:**

Related parties of the Credit Union include subsidiaries, associates, joint ventures, senior management, close family members of senior management and entities which are controlled, jointly controlled or significantly influenced, or for which significant voting power is held, by senior management or their close family members.

A number of transactions were entered into with senior management in the normal course of business:

| | 2016 Ending balance | 2016 Activity | 2015 Ending balance |
|---|---|---|---|
| Loans and deposits: | | | |
| Loans | $ 9,644 | $ 778 | $ 8,866 |
| Deposits | 5,603 | (154) | 5,757 |
| | $ 15,247 | $ 624 | $ 14,623 |

(Expressed in thousands of dollars)

**23. Related parties (continued):**

| | 2016 | 2015 |
|---|---|---|
| Key management personnel compensation: | | |
| Salaries and other short-term employee benefits | $ 2,247 | $ 2,334 |
| Total pension and other post-employment benefits | 347 | 372 |
| Other long-term benefits | 499 | 519 |
| | $ 3,093 | $ 3,225 |

The above key management personnel compensation represents the total compensation (base salary, incentives, benefits and pension contributions) that was charged to salaries and employee benefits in the consolidated statement of income for the Chief Executive Officer and the executive management of the Credit Union, who have the authority and responsibility for planning, directing and controlling the activities of the Credit Union.

In addition, members of the Board of Directors, in their capacity as Directors, received remuneration of $330 (2015 - $338) in aggregate.

**24. Subsequent events:**

(a) On December 2, 2016, the Credit Union entered a purchase and sale agreement, whereby it will sell one of its branches located at 1080 Marine Drive North Vancouver, BC. The sale price is $7,600,000 and the transaction is expected to close on March 2, 2017. As a condition of the sale, the Credit union will enter into a 5 year lease with two 5 year options of the property with the purchaser.

(b) On December 23, 2016, the Credit Union entered into a 15 year property lease at 2326 West 41st Avenue, Vancouver, BC. The leased property will be the location of the Credit Union’s newest branch expected to open at the end of 2017. The commencement of lease payments has not yet been agreed upon with the landlord.