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**ANNUAL REPORT 2008**

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**Financial highlights**  
 (\$ thousands except per unit and percentage amounts)

Twelve months ended  
 December 31

	2008	2007
<b>OPERATING RESULTS</b>		
Net income	<b>29,533</b>	1,585
Per unit	<b>2.099</b>	0.115
Normalized income (1)	<b>16,363</b>	17,968
Per unit	<b>1.163</b>	1.298
Spread income (2)	<b>21,280</b>	23,070
Spread percentage	<b>3.10%</b>	3.49%
Distributions per unit	<b>1.02</b>	1.08
Mortgage originations	<b>129,622</b>	127,268
Trailing four quarter origination cost %	<b>9.6%</b>	9.2%
Trailing four quarter administration expense %	<b>0.67%</b>	0.79%
<b>BALANCE SHEET HIGHLIGHTS</b>		
Total assets	<b>999,944</b>	878,267
Mortgage principal plus accrued interest	<b>814,195</b>	707,773
Commercial paper	—	76,788
Medium term debt	<b>804,297</b>	634,062
Subordinated debt	<b>60,407</b>	60,433
<b>PORTFOLIO QUALITY</b>		
Appraised value of underlying properties	<b>2,282,840</b>	1,981,335
Average loan to value	<b>35.7%</b>	35.7%
Non accrual mortgage value	<b>556</b>	291
Portfolio reserves	<b>408</b>	251

(1) Normalized income as discussed on pages 22 and 23 of the MD&A  
 (2) Spread income as discussed on pages 14 and 15 of the MD&A

**CAUTION REGARDING FORWARD-LOOKING STATEMENTS**

Home Equity Income Trust (“HOMEQ” or the “Trust”) from time to time makes written and verbal forward-looking statements about business objectives, operations, performance, and financial condition, including, in particular, the forecast of cash distributions and the likelihood of HOMEQ’s success in developing and expanding its business. These may be included in the Annual Reports, quarterly reports, regulatory filings, reports to unitholders, press releases, Trust presentations and other communications. These forward-looking statements are based upon a number of assumptions and estimates that are inherently subject to significant uncertainties and contingencies, many of which are beyond the control of HOMEQ. Actual results may differ materially from those expressed or implied by such forward-looking statements. HOMEQ does not undertake to update any forward-looking statement, whether written or verbal, that may be made from time to time.



## HOMEQ OVERVIEW

- Home Equity Income Trust (HOMEQ or the Trust) invests in reverse mortgages originated by its wholly owned subsidiary, Canadian Home Income Plan Corporation (CHIP). CHIP has been the main underwriter of reverse mortgages in Canada since pioneering the concept in 1986.
- The main objective of the Trust is to provide unitholders with stable, reliable monthly distributions from a portfolio of reverse mortgages.
- The reverse mortgage portfolio is managed by a team of experienced professionals. HOMEQ's reverse mortgage portfolio is well secured and structured conservatively to generate steady income and minimize risks.
- The Trust's distributions totaled \$1.02 per unit in 2008. The distributions were 87.5% taxable as income and the remainder was a return of capital.
- Standard and Poor's (S&P) has given HOMEQ an 'SR-2' rating, which it assigns to funds or income trusts that have "a very high level of distributable cash flow generation stability relative to other income funds in the Canadian market place."
- HOMEQ's success has earned it the respect of the Canadian financial community. DBRS Limited (DBRS) rates HOMEQ's short-term debt "R1-High" and its senior medium term debt "AAA", the highest ratings issued by DBRS. The Trust's subordinated medium term debt is rated "BBB" by DBRS. .
- CHIP has an enviable reputation of providing a respected financial solution with excellent service to its customer base, Canadian seniors aged 60 and over.
- CHIP is the primary provider of reverse mortgages in Canada with a well-established distribution and referral network. This referral network includes all the major Canadian banks, credit unions, mortgage brokers, investment and financial planning firms.
- As the population of seniors expands rapidly in the years ahead, HOMEQ's mortgage portfolio and cash distributions are also expected to grow.
- The Trust's units are eligible for investment by registered plans, such as RRSPs, RRIFs, and RESPs.

### FINANCIAL HIGHLIGHTS

(\$ thousands, except per unit)

Total Revenue	\$60,433
Net Interest rate spread	3.10%
Operating Margin	\$19,915
Cash distributions per unit	\$1.02
As of December 31, 2008:	
Mortgage Portfolio	\$813,787
Market Capitalization	\$50,233



## Canada's Reverse Mortgage Leader

Home Equity Income Trust, through its subsidiary Canadian Home Income Plan Corporation (CHIP), is Canada's leading provider of reverse mortgages. CHIP is exclusively dedicated to helping Canadian homeowners aged 60 and older turn the equity they have built up in their homes into tax-free cash. Our continued success can be attributed to a number of important factors:

1. Our market opportunity is growing rapidly

Seniors are the fastest growing segment of the Canadian population. According to Statistics Canada, their numbers are forecast to climb to 9.8 million in 2026. A similar demographic trend is being experienced in some of the more established reverse mortgage markets, such as the United States, United Kingdom and Australia, making reverse mortgages an increasingly popular financial solution around the globe.

2. The need is growing

The growing population of seniors will have growing financial needs. They are expected to live longer, so their assets will have to support them longer. They are saving less than their parents did. The average Canadian between 55 and 65 has less than \$125,000 in their RRSP (Statistics Canada, 2005). And 68% of pre-retirees are expecting to carry debt into retirement (The BMO Retirement Trends Study, 2005). In short, seniors are living longer, saving less and spending more, which makes them ideal candidates for a CHIP Home Income Plan.

3. Accessing home equity assists "aging in place"

Proprietary research commissioned by CHIP indicates that 84% of senior homeowners want to stay in their homes, which is a wise decision. Aging in place, as it's called, is believed to have social, emotional and health benefits. But the problem is, senior homeowners in Canada have 77% of their net worth locked up in home equity (Finances in Golden Years, Statistics Canada 2003). With lower savings and higher spending, they will need to turn some of that home equity into cash. For many, a CHIP Home Income Plan will be the best way to get the income they need without having to sell their homes and move.

4. We are broadening the use of our product

CHIP Home Income Plans are increasingly being used in new and interesting ways. With the help of our national network of Business Development Managers (BDMs), financial advisors are discovering how a CHIP Home Income Plan can become a wealth management tool that has a role to play in managing portfolios that include registered and non-registered investments. This type of thinking will become even more common as boomers become seniors. We expect that their comfort with using debt as a financial tool will carry over into retirement and open more doors for CHIP.

5. We have a unique distribution channel

CHIP is the only reverse mortgage offered through Canada's largest banks, as well as credit unions and wealth management advisors. We are also available through mortgage brokers across the country. These exclusive relationships give us a presence in virtually every community in Canada and their impact on our business is growing steadily. Referrals from our partners now represent nearly 60% of our business and are expected to continue growing.



6. We have a proven marketing program

CHIP's two-pronged marketing program speaks directly to seniors as well as to our referral partners. Our television commercials continue to bring significant numbers of prospective clients to our call centre and website and we continue advertising to our referral partners to increase awareness and understanding of the product and help them recognize how CHIP can be an effective solution for their clients. The main focus of our referral marketing program, however, continues to be personal sales calls made by our BDMs. Ongoing sales training and state-of-the-art presentation tools help them build strong relationships with our partners.

7. We have a very strong value proposition

A CHIP Home Income Plan provides extraordinary benefits to seniors who wish to stay in their home while turning some of their equity into cash.

- There are no payments required, principal or interest, until our clients choose to move or sell their homes.
- There are no medical, credit or income qualifications.
- We guarantee that the amount to be repaid will never exceed the fair market value of the home at the time of sale.
- Changes in a client's financial situation or credit rating do not affect their CHIP Home Income Plan, as can be the case with a line of credit or traditional mortgage.

8. We have a robust product solution

We are sensitive and responsive to the needs of our clients and their financial advisors, and have enhanced our product over the years to meet the requirements of a broad spectrum of today's seniors. Currently, no other reverse mortgage anywhere in the world can surpass CHIP's product flexibility. We offer:

- Variable and fixed interest rates and a wide range of fixed rate terms.
- The choice of a lump-sum advance of funds, subsequent advances at various times, or planned advances on a regular schedule.

9. We have over 20 years experience in Canada

No one knows the Canadian reverse mortgage market better. It is difficult for anyone to replicate the depth of experience and talent on our management, finance and sales teams.

- We know Canadian real estate and the behaviour of our clients intimately, allowing us to advance the maximum amount of money with the minimum risk.
- Our highly trained sales people understand the mindset of Canadian seniors, their needs and their concerns.

At CHIP we are focused on a growing market with growing financial needs. The organization has access to an extensive referral network across the country and its marketing, sales and financial expertise is unmatched.



## **The CHIP Promise**

Canadian Home Income Plan Corporation, commonly known as CHIP, has been in business since 1986. From the outset we have committed ourselves to being respectful, open and ethical in all our dealings.

We have reviewed the codes of conduct established by the leading international reverse mortgage associations and developed our own uniquely Canadian CHIP Promise. The CHIP Promise meets or exceeds the standards of professionalism, openness and integrity set for reverse mortgage providers anywhere in the world. In addition, CHIP is a wholly owned subsidiary of Home Equity Income Trust, which is listed on the Toronto Stock Exchange. This means that we are held to the high public company disclosure and reporting standards set by the Securities Commissions across Canada and the Toronto Stock Exchange. Also, as a licensed mortgage broker, CHIP and our sales staff are governed by the various provincial mortgage broker regulatory bodies. To maintain our license we have to meet the mortgage broker industry requirements, which are geared to making sure clients have the information they need to make well-informed financial decisions.

## **This is Our Promise to our clients and to our partners**

- We treat our clients with respect, are consistent in our words and deeds, and act promptly in response to client requests.
- We fully disclose all information about our product, including all obligations and costs, so that our clients can make well-informed decisions. This includes illustrating the potential effect of future house values and interest rates on our clients' home equity and the amount owed.
- We guarantee that the amount owed to CHIP will never exceed the fair market value of the home when it is sold.
- We advise our clients to review all their options with family members and/or other trusted advisors.
- We ensure that all our clients receive independent legal advice before making their final decision.
- We protect our clients' privacy and confidentiality.
- We comply with all applicable laws, rules and regulations established by our governments, government agencies and other authorities.



## TO OUR UNITHOLDERS:

It is once again our pleasure to report to you on the progress of Home Equity Income Trust. Fiscal 2008 can be characterized as a year in which we continued to prove our potential while contending with unprecedented challenges associated with volatile and fragile financial markets. It is at times like this that we see the benefits of our conservative management approach. Despite the challenges faced, we achieved encouraging results and are finishing the year with a larger portfolio of mortgages than ever before.

During 2008 originations grew by 2% to \$130 million and the Trust's total portfolio of reverse mortgages grew by 15% to \$814 million. We occupy a unique position in the Canadian financial services sector and carry out an important social mandate. As we become better known as a viable alternative in retirement planning, seniors are turning to our product in greater numbers. While our clients come from a broad cross-section of society, they share the desire to stay in their homes and experience a comfortable retirement.

Our business is dependant on liquid sources of cost effective capital with which to fund new mortgages and refinance maturing debt. Challenging conditions in the capital markets commencing in the third quarter of 2007 continue to affect the financial services industry in many aspects and our traditional sources of capital remain scarce. While debt transactions carried out in the latter part of 2007 and early 2008 were at higher costs than previously experienced, we made prudent decisions in the past by borrowing for longer terms when funds were available at particularly good rates.

In order to ensure immediate availability of funds to finance new originations, during the year the Trust increased its cash holdings to higher than historical levels. The increased level of cash has had a near term negative impact on profitability as the interest rate earned on the investment of the cash balances is less than the cost of the debt, but from a risk management perspective this has been a crucial action.

In addition, the difference between the Prime Rate and the rate on Government of Canada Treasury Bills, on which our mortgage rates have historically been based, and the rate on Bankers' Acceptances, on which the Trust's debt and hedging instruments are based, have recently deviated significantly from historical norms. This resulted in a reduction of spread percentage during the year. In response, the Trust increased the interest rate charged for new mortgages and changed the interest rate reset methodology. These changes have started to have a positive effect on spread percentage, and will continue to do so as the proportion of the Trust's portfolio priced using the new methodology increases.

As a result of conservative underwriting policies, our portfolio currently has an average loan-to-value ratio of 36%, and less than 1% of the portfolio has a loan-to-value ratio of over 70%, which will mitigate the impact of a predicted drop in residential real estate prices. Over the last several years we have taken a series of prudent steps to reduce risk in the event of future property depreciation, and are constantly assessing residential real estate trends across the country.

As recently disclosed, the Trust intends to apply to the Minister of Finance to convert CHIP to a federally regulated Schedule I bank. The new bank will be called HomEquity Bank in English and Banque HomEquity in French. Subject to the review and approval of its application by the Office of the Superintendent of Financial Institutions (OSFI) and the Minister of Finance, the Trust hopes to be operating HomEquity Bank commencing in the third quarter of 2009.

The objective of obtaining a bank charter is to enable HomEquity Bank to access retail deposits sourced through deposit brokers and directly hold reverse mortgages so as to grow HOMEQ's consolidated reverse mortgage portfolio and increase its spread income. Retail deposits represent a stable and cost effective source of funds that will be used to supplement the wholesale funding strategy HOMEQ has followed since its IPO in 2002. As a result of diversifying its sources of funds, the Trust believes it will again be in the position to be able to return to its proven growth potential and meet the requirements of Canadian seniors. In obtaining a bank charter the Trust will also be in a position to price its product appropriately while maintaining attractive spreads and will benefit from the efficiency of being federally regulated.



Until such time as the Trust is more certain about its access to funds, either by way of bank deposits or traditional sources, it has implemented actions to conserve cash resources. In this regard, the Trust has taken steps to reduce the average mortgage amount for new customers, marketing activity has been scaled back, overhead expenditure is being closely monitored and sales territories have been rationalized. We believe this is a temporary measure but very appropriate at this time for risk management purposes.

We continue to develop our network of referral partners which now encompasses all the major Canadian banks, and also includes foreign and regional banks, wealth management companies and mortgage brokers. These relationships take a long time to establish and require close monitoring and management on an ongoing basis. It is unusual for an entity of our size to have developed business relationships with such a broad and high level array of Canadian businesses, and these relationships are testament to the invaluable service we provide to both our referral partners and our common clients.

The resilience of our business in the face of tough circumstances has been greatly influenced by our operating philosophy and team of highly competent professionals and we have reason to remain optimistic. We have taken steps to reduce our exposure to the impact of the capital markets, we have built up strong brand recognition, our customer segment continues to grow, we have a strong and well secured portfolio and we have momentum on our side. We would like to thank our hard-working and capable employees for their tremendous efforts during the year, and for their dedication to high standards of productivity and customer service. We continue to look forward to future growth and success.

Sincerely,

A handwritten signature in black ink, appearing to read "Lebel".

Pierre Lebel  
Chairman, Board of Trustees

A handwritten signature in black ink, appearing to read "Ranson".

Steven K. Ranson  
President & Chief Executive Officer

March 4, 2009



## MANAGEMENT DISCUSSION AND ANALYSIS

The following management discussion and analysis (“MD&A”) should be read in conjunction with the Consolidated Financial Statements and the accompanying notes of the Trust for the year ending December 31, 2008 as presented on pages 30 to 49 of this Annual Report. These Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and are also available on SEDAR at [www.sedar.com](http://www.sedar.com). All dollar amounts are stated in Canadian dollars. Home Equity Income Trust’s (“HOMEQ” or the “Trust”) Audit Committee reviewed this document, and prior to its release, the Trust’s Board of Trustees approved this document, on the Audit Committee’s recommendation.

The management discussion and analysis is dated March 4, 2009

## CORPORATE OVERVIEW

The objective of Home Equity Income Trust is to generate stable, monthly cash distributions to unitholders by investing in reverse mortgages originated by its wholly owned subsidiary, Canadian Home Income Plan Corporation (“CHIP”).

HOMEQ is publicly traded on the Toronto Stock Exchange (“TSX”) under the symbol HEQ.UN and has various subsidiaries as outlined below:

- CHIP originates reverse mortgages through its advertising and referral network. CHIP also provides mortgage administration services on the reverse mortgage portfolios.
- CHIP Mortgage Trust (“CMT”) finances the reverse mortgages originated by CHIP by issuing short-term and medium-term debt. Senior debt is rated ‘R1-high’ and ‘AAA’ and subordinated debt is rated ‘BBB’ by DBRS Limited (“DBRS”).
- Securitization Partnerships hold portfolios of reverse mortgages originated by CHIP prior to August 2002. These mortgages were originally funded by term debt issued by special purpose trusts and are now funded by CMT.

The discussion of the Trust’s operations in the MD&A and financial statements consolidates the activities of the Trust’s subsidiaries.

Effective January 1, 2008 the Canadian Institute of Chartered Accountants (CICA) new accounting standard, Section 1535, *Capital Disclosures*, was implemented, which requires the disclosure of both qualitative and quantitative information that enables users of financial statements to evaluate the entity’s objectives, policies and processes for managing capital. The new guidance did not have an effect on the financial position or the earnings of the Trust.

Effective January 1, 2008, the accounting and disclosure requirements of the CICA’s two new accounting standards, Section 3862, *Financial Instruments – Disclosures*, and Section 3863, *Financial Instruments – Presentation* were implemented. The new guidance did not have a material effect on the financial position or earnings of the Trust.

## FINANCIAL RESULTS

### Non-GAAP Measures

HOMEQ uses a number of financial measures to assess its performance. Some measures are calculated in accordance with GAAP, such as total revenue and operating margin. Other measures such as distributable cash, normalized income, spread income and spread percentage are non-GAAP measures. These non-GAAP measures do not have standardized meanings under GAAP and may not be comparable to similar measures used by other trusts and companies. The Trust believes that the non-GAAP items provide the reader with additional understanding of how management views the Trust’s performance.



## Financial Overview

The table below provides a summary of the past nine quarters of operations.

(\$ thousands, except per unit amounts)	2006		2007					2008				
	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Total revenue	12,287	43,064	12,224	12,996	13,999	15,339	54,558	15,028	15,216	15,310	14,879	60,433
Operating margin	4,931	17,344	4,713	5,199	5,687	5,026	20,625	4,988	4,881	4,892	5,154	19,915
Income before undernoted items	2,273	6,962	2,077	2,256	2,732	2,041	9,106	1,923	2,277	1,908	2,304	8,412
Per unit	0.166	0.509	0.151	0.163	0.197	0.147	0.658	0.138	0.162	0.135	0.163	0.598
Less:												
Future income tax expense (recovery)	(157)	(52)	(5)	5,780	1,073	145	6,993	3,184	(1,282)	63	4,277	6,242
Recovery of income tax	—	(333)	—	—	(70)	21	(49)	—	2	—	(2)	—
Unrealized (gain) loss on derivative instruments	—	—	959	7,468	(3,423)	(4,427)	577	(14,306)	6,360	(1,671)	(17,746)	(27,363)
Net income (loss)	2,430	7,347	1,123	(10,992)	5,152	6,302	1,585	13,045	(2,803)	3,516	15,775	29,533
Per unit	0.177	0.538	0.082	(0.795)	0.371	0.453	0.115	0.933	(0.199)	0.249	1.116	2.099

Total revenue for 2008 of \$60.4 million was \$5.9 million or 10.8% higher than 2007 due primarily to a 15% growth in the size of the portfolio offset by a drop in the interest yield earned. Furthermore, the Trust earned \$1.3 million additional investment interest income on cash balances that it is carrying to ensure immediate availability of funds to finance new originations. Despite the increase in total revenue, the operating margin decreased by \$0.7 million or 3.4% mainly due to the \$6.6 million higher interest expense on the debt funding the mortgage portfolio and cash balances. For the year, the Trust's spread percentage of 3.10% was lower than the 3.49% in 2007, due to the impact of the continued volatility in the capital markets.

The Trust managed its marketing and overhead expenses to an amount consistent with 2007, which combined with the change in gross margin, resulted in income before undernoted items decreasing by \$0.7 million from 2007 to \$8.4 million. On a per unit basis net income before undernoted items was \$0.598 per unit a 9.1% decrease over 2007. The various elements impacting net income before undernoted items are discussed later in the MD&A.

Under accounting standards introduced in 2007, derivatives are valued at fair market value with changes in fair value recognized in the current period's statement of operations. The Trust's derivative portfolio is substantially weighted to receive fixed rates. Therefore the fair market value of the derivatives will move in an opposite direction than changes in prevailing interest rates. As interest rates decrease, the mark to market of the Trust's derivative portfolio increases. As rates rise, the mark to market will decrease. During 2008, interest rates decreased resulting in a \$27.4 million unrealized gain on the derivative instruments.

The Trust's derivatives are generally neither held for resale nor traded. For derivatives that are not subject to hedge accounting, HOMEQ believes that there is an asymmetry in the recognition methods of derivatives at fair market value, and assets and liabilities at amortized cost which has resulted in net income volatility not indicative of the business. As both derivatives and medium term debt are normally held to maturity, any unrealized gains or losses are timing differences and will be zero at maturity.

The Trust has also recorded a future income tax non-cash expense of \$6.2 million to earnings during 2008, compared to \$7.0 million in 2007, in respect of the temporary differences between the financial reporting and tax basis of the derivatives that are expected to reverse after 2010. The charge will have no impact on the Trust's cash flows or distributions to unitholders.

For Q4 2008, total revenue of \$14.9 million decreased by 3.0% reflecting a lower interest yield offsetting a 16.1% increase in average portfolio value. Despite the decrease in total revenue, operating margin increased by 2.6% and net income before under noted items increased by 12.9% from Q4 2007 reflecting an increase in spread income and a reduction in marketing and overhead expenses in the quarter.



## Portfolio Growth

The Trust intends to grow distributable cash and normalized income by profitably increasing the size of its mortgage portfolio. The mortgage portfolio at the end of 2008 was \$813.9 million, an increase of \$106.4 million or 15.0% over 2007. The following table shows the growth in the mortgage portfolio on a quarterly basis for the past nine quarters.

(\$ millions)	2006	2007				2008			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Opening mortgage balance (1)	593.2	611.9	632.1	654.6	678.3	707.5	737.4	767.2	797.9
Originations	24.8	25.6	33.4	34.4	33.9	28.2	39.0	37.8	24.6
Accrued interest	12.8	13.0	13.6	14.3	15.0	15.2	15.2	15.3	15.2
Repayments of principal	(13.2)	(12.1)	(16.4)	(17.4)	(13.2)	(9.5)	(16.4)	(15.2)	(15.4)
Repayments of accrued interest	(5.7)	(6.3)	(8.1)	(7.6)	(6.5)	(4.0)	(8.0)	(7.2)	(8.4)
Ending mortgage balance (1)	611.9	632.1	654.6	678.3	707.5	737.4	767.2	797.9	813.9
# of origination transactions (2)	319	297	377	380	373	313	400	470	390
Loan to value of originations	31%	30%	30%	30%	32%	31%	32%	30%	27%
Total repayments as % of opening balance	3.2%	3.0%	3.9%	3.8%	2.9%	1.9%	3.3%	2.9%	3.0%
Trailing 4 quarters:									
Originations	104.6	108.8	114.6	118.2	127.3	129.9	135.5	138.9	129.6
# of origination transactions (2)	1,261	1,294	1,340	1,373	1,427	1,443	1,466	1,556	1,573
Average value (\$000's)	83.0	84.1	85.5	86.1	89.2	90.0	92.4	89.3	82.4
Total repayments	(71.4)	(76.3)	(79.0)	(86.8)	(87.6)	(82.7)	(82.6)	(80.0)	(84.1)

(1) Excluding unamortized purchase price premiums, origination fees and commissions, net of portfolio reserves

(2) # of transactions includes new clients and additional borrowing from existing clients

During 2008, the Trust continued its trend of increased originations driven by a growing customer base, improved brand recognition and an expanded product offering. Originations grew to \$129.6 million, 1.9% higher than 2007. In Q4, the Trust further refined its underwriting assumptions to reduce risk in the event of future property depreciation, which reduced the average mortgage amount by between 5% and 15%. Accordingly, the loan to value on new originations in the quarter dropped to 27% from a quarterly average of above 30%, resulting in originations of \$24.6 million in Q4 2008, lower than the record levels of originations recently experienced.

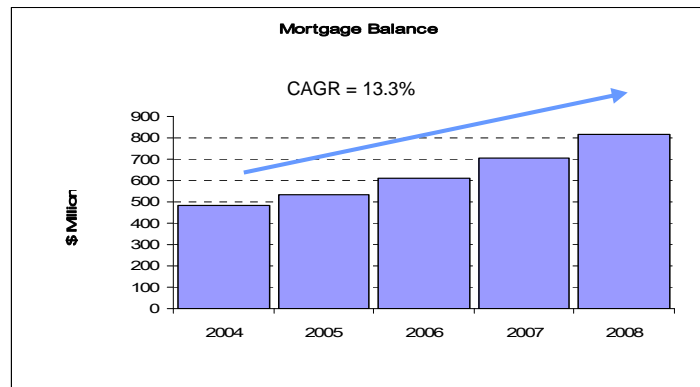
The number of origination transactions in 2008 increased by 10.2% to 1,573 over 2007. The average value per transaction on a trailing four quarters basis decreased 7.6% to \$82,400 primarily due to the changes in underwriting assumptions made in the fourth quarter. In the opinion of the Trust, there was no undue concentration in originations by source, region, age group and property type. The sales force's improved selling techniques, enhanced marketing positioning and positive public relations continue to succeed in educating potential customers of the benefits of a CHIP Home Income Plan and its applicability to their particular needs and circumstances.

Accrued interest for 2008 was \$60.9 million, up 9.0% from \$55.9 million in 2007 mainly due to the 15.0% larger portfolio offset by the yield on the portfolio being 57 basis points lower.

The number of transactions in Q4 was 4.6% higher than Q4 2007. Accrued interest in Q4 2008 was slightly higher than Q4 2007 due to the 16.1% higher average mortgage portfolio, offset by the 119 basis point drop in yield as further discussed in the Spread section of the MD&A.

Total repayments of principal and interest as a percentage of the opening mortgage balance were within the range of historical experience. Short-term fluctuations in the level of originations and repayments will have an impact on the total portfolio balance and the amount of distributable cash in the future.

The compound annual growth rate of the portfolio from 2004 to 2008 was 13.3%.



### Portfolio Quality

The loan-to-value ratio measures the outstanding mortgage balance as a percentage of the appraised value of the home. A lower loan-to-value ratio represents a more conservative investment as there is a higher probability that the proceeds realized on the disposition of the home will be more than sufficient to pay out the outstanding mortgage balance on maturity. Once a reverse mortgage has been originated, typically its loan-to-value ratio increases over time.

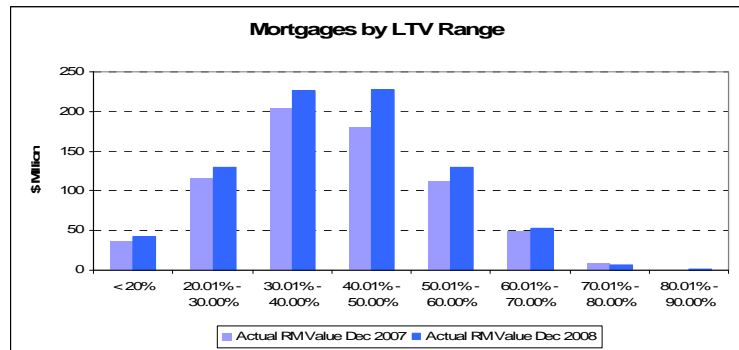
The Trust continually monitors its underwriting policies and procedures, paying close attention to real estate trends and forecasts in all major Canadian markets. In particular, during the underwriting process:

- Every property is appraised by a certified appraiser with particular attention paid to the property type, location and days on market of each comparative property.
- The initial appraised value is subsequently discounted, typically by between 7.5% and 30%.
- A rate of future appreciation of up to 0.5% per annum is assumed for the life of the mortgage, in comparison with the Canadian 20 year average of approximately 3.45%. The average rate of assumed appreciation used in the initial underwriting of the existing mortgage portfolio is 1.63%
- Each mortgage originated is limited in maximum dollar amount and 55% loan-to-value ratio in accordance with internal guidelines.

Following similar steps taken in the past, in the third quarter of 2008 the assumed future property appreciation rates used in determining the client loan amount were lowered from a maximum of 1.50% per annum to 0.50% per annum to reduce the impact of a drop in residential real estate should that occur.

Each property in the Trust's mortgage portfolio is reappraised at least every five years. The loan-to-value ratio of the \$129.6 million of new mortgages originated in 2008 was 32%, two percentage points higher than 2007. For the entire mortgage portfolio, the most recently appraised value of the underlying properties was approximately \$2.3 billion, for a loan-to-value ratio of approximately 36% at the end of 2008, comparable to the end of 2007.

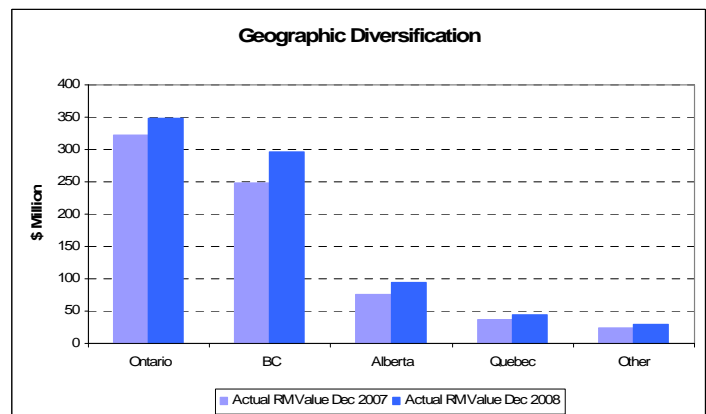
The graph details the mortgage portfolio by loan-to-value range based on the mortgage value at December 31, 2008 and the most recent appraisal on the underlying property. Ninety three percent of the portfolio has a loan-to-value ratio below 60 percent.



HOMEQ's policy is to cease accruing interest income from any mortgage where the loan to value exceeds 83%. To ensure that these loans are reported as accurately as possible, each mortgage with a loan to value in excess of 80% is reappraised at least once per year. At December 31, 2008, six loans had a loan to value greater than 83% having a balance of \$556,100 within the total portfolio of \$813.9 million. The appraised value of the property securing the mortgages is \$670,000.

In addition, a provision exists to compensate for possible future losses on mortgages whose loan-to-value ratios, while currently below 83%, are higher than expected. HOMEQ has evaluated its portfolio, and based on current conditions, has determined its portfolio reserves to be \$407,746 at December 31, 2008, \$156,782 higher than December 31, 2007.

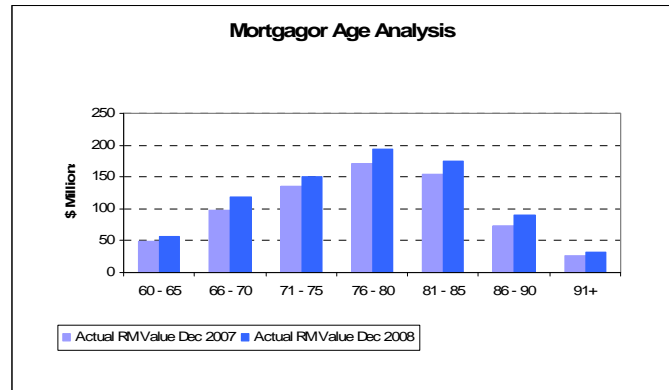
The geographic distribution of the portfolio reflects the population density and real estate value across Canada. At December 31, 2008, 79% of the reverse mortgage portfolio was located in Ontario and British Columbia. The graph shows the geographic distribution of the portfolio based on mortgage balances at December 31, 2008.



Also during the underwriting process, the Trust makes assumptions as to when borrowers will cease occupying their homes (EOT). As of December 31 2008, only 229 customers out of 7,040 have exceeded their original EOT. The average current age of these customers is 90, illustrating the low level of future risk.

The mortgage portfolio at December 31, 2008 has a weighted average yield of 7.48%, compared to 8.52% during 2007, and more than two percent lower than the future interest rates used in the underwriting assumptions. This will result in a slower rate of interest compounding.

Clients in the age group of 71 – 85 represent 64% of the portfolio based on outstanding mortgage balance. The average age for mortgages originated in 2008 was 73. The graph shows the age distribution of individuals within the portfolio based on mortgage balances at December 31, 2008 and reflects the consistent entry age and occupancy term.



### Spread

HOMEQ's operating margin is primarily derived from the spread between the interest earned on the mortgage portfolio, and the interest paid on the 'AAA' rated and investment grade debt used to fund the portfolio. For 2008, aggregate mortgage interest income and investment interest of \$63.6 million was \$6.1 million or 10.7% higher than 2007. The spread percentage in 2008 decreased to 3.10% from 3.49% in 2007.

Interest income earned on the mortgage portfolio in 2008 was \$60.8 million, an increase of \$4.8 million or 8.6% over 2007. The increase results mainly from the 16.5% growth in the average size of the mortgage portfolio, offset by the lower yield earned. The average yield earned on the mortgage portfolio of 7.95% was 57 basis points lower than 2007 due to the lower rates on Government of Canada Treasury Bills ("T-Bills"), on which a majority of the Trust's mortgage rates are based.

The Trust's debt portfolio increased at a faster rate than the portfolio of mortgages because of the Trust's decision to increase its cash holdings. By raising funds in advance of its cash requirements, the Trust has reduced the exposure to short term refinancing risk. The Trust had \$66.0 million of cash and short term investments at December 31, 2008 which will be used to fund new mortgage originations. Net of the cash holdings, the Trust's debt increased 16.7% over 2007, which is in proportion to the 16.5% growth in the average size of the mortgage portfolio referred to above. The increased level of cash, while important from a risk management perspective, is having a negative impact on spread income because of the associated increase in interest expense.

During 2008, as a result of its regular asset and liability matching assessment, the Trust reduced the notional amount of derivative contracts held. The Trust realized \$0.6 million of gains on the transactions, which are netted against interest expense.

Interest expense on the debt portfolio, was \$39.5 million, an increase of \$6.6 million or 20.1% over 2007 due to the higher average debt balance offset by the 18 basis point decrease in the average interest rate on the debt to 4.85%. Net of interest income earned on the higher cash holdings, the Trust's interest expense increased 16.9%.

The Trust's cost of funds reflects the challenging conditions in the capital markets commencing in August 2007 which resulted in a reduction in market liquidity and increased borrowing costs. More specifically, the spread, on a swapped basis, above the corresponding Bankers' Acceptances ("BAs") rate of the \$165.0 million tranche of medium term notes issued in Q2 2008 was approximately 150 basis points higher than the average cost of senior debt outstanding at that time. Inclusive of the \$165.0 million issued in Q2, 2008, the average cost of senior debt was 90 basis points above the corresponding Banker's Acceptance.

Since August 2007, the difference between the rate on T-Bills, on which most of the mortgage rates have historically been based, and the rate on BAs, on which debt and hedging instruments are based, has also risen to levels higher than historical norms. This situation continued throughout 2008 and has contributed to the reduction of spread income and spread percentage. The interest rates of the mortgage and debt portfolios



reset in equal proportions in either of February, May, August or November. The impact of the spread between T-Bills and BAs is largest during these months.

Interest rate risk resulting from timing differences between the interest reset dates on the mortgages and interest reset dates on the Trust's debt is managed through the use of derivative instruments such as interest rate swaps and forward rate agreements. Derivative instruments are entered into with Schedule 1 Canadian chartered banks to reduce counterparty risk. The objective of HOMEQ's hedging practices is to maintain a relatively stable spread between interest earned on the mortgages and interest paid on the highly rated debt used to fund them.

The Trust entered into interest rates swaps, having a notional amount of \$159.0 million, to hedge \$159.0 million of the \$165.0 million fixed rate medium-term debt issued in Q2 2008. The objective of these hedges is to protect against changes in the fair value of the fixed rate medium-term debt due to changes in the underlying benchmark interest rate. The Trust elected under Section 3865 – *Hedges* of GAAP to apply hedge accounting for these interest rates swaps. The hedges are effective at December 31, 2008.

Management has taken steps since August 2007, to offset the ongoing impact on profit margins of higher borrowing costs by raising the interest rate charged for new mortgages. In addition, in Q2 2008 the pricing methodology was changed to a posted rate derived from the Trust's average cost of borrowing as opposed to a mark-up over the T-Bills rate as has previously been the case. This methodology will enable the Trust in the future to change the rates on all mortgages in the portfolio to offset systemic changes in borrowing costs. These changes, however, will take some time to be fully reflected in the Trust's results as mortgage rates on the existing portfolio will continue to reset in accordance with the previous methodology.

Mortgages under the new pricing methodology currently represent approximately 7.2% of the total mortgage portfolio and have an average yield of approximately 8.69% in comparison to the portfolio average of 7.41% earned in the fourth quarter.

For the fourth quarter of 2008, interest income of \$15.0 million was equal to that of Q4 2007. Although the average mortgage portfolio was 16.1% larger than Q4 2007, the average yield earned on the portfolio of 7.41% was 119 basis points lower. Interest expense in Q4 2008 of \$9.5 million was 5.7% lower than Q4 2007 due mainly to the average cost of funds being 97 basis points lower on the average debt balance which was 15.2% higher. The significant basis point decreases in the yield and the cost of funds in Q4 2008 over Q4 2007 reflects the continuing decreases in underlying Treasury Bills and Bankers' Acceptances as explained in the narrative above.

Spread income and spread percentage for the prior nine quarters are shown below.

(\$ thousands)	2006	2007					Full Year	2008					Full Year
	Q4	Q1	Q2	Q3	Q4	Q1		Q2	Q3	Q4			
Mortgage interest income (1)	12,869	12,994	13,559	14,345	15,040	55,938	15,199	15,214	15,302	15,036	60,751		
Average mortgage balance (2)	603,576	620,740	643,532	666,433	693,790	656,282	721,258	752,014	781,435	805,422	764,383		
Average mortgage yield – annualized (%)	8.46%	8.49%	8.45%	8.54%	8.60%	8.52%	8.45%	8.11%	7.77%	7.41%	7.95%		
Interest expense	7,077	7,244	7,515	8,062	10,047	32,868	9,768	10,075	10,154	9,474	39,471		
Average debt balance (3)	578,520	595,736	616,437	651,936	738,094	653,195	755,397	804,337	851,007	850,102	814,247		
Cost of funds	4.86%	4.93%	4.89%	4.92%	5.39%	5.03%	5.19%	5.02%	4.73%	4.42%	4.85%		
Spread (\$)	5,792	5,750	6,044	6,283	4,993	23,070	5,431	5,139	5,148	5,562	21,280		
Spread (%)	3.60%	3.56%	3.56%	3.62%	3.21%	3.49%	3.27%	3.09%	3.04%	2.99%	3.10%		
Investment interest	155	103	72	225	1,096	1,496	707	678	799	616	2,800		

(1) Excluding early repayment fees and amortization of purchase price premiums and commissions

(2) Excluding unamortized purchase price premiums, origination fees and commissions

(3) Reflects the principal portion of debt



### Mortgage Origination Cost

HOMEQ's objective is to maintain mortgage origination costs, which are deferred and amortized in the calculation of net income and normalized income, to no more than 10% of the value of mortgages originated, and to focus on improving sales and marketing efficiencies in order to reduce this percentage over time.

In 2008, the Trust originated \$129.6 million of mortgages, 1.9% higher than 2007, with origination costs of 9.6%, 0.4% higher than the prior year. Total origination costs of \$12.4 million in 2008 increased by \$0.6 million or 5.4% over 2007.

The following table provides the details of the calculation for the past nine quarters. The comparable trailing four-quarter origination cost percentage during this period reflects the consistency in the operational platform.

(\$ thousands)	2006	2007					Full Year	2008				Full Year
	Q4	Q1	Q2	Q3	Q4	Q1		Q2	Q3	Q4		
Mortgage originations	24,857	25,644	33,388	34,442	33,794	127,268	28,235	39,019	37,814	24,554	129,622	
Origination expenses												
Commissions	950	877	964	951	1,669	4,461	1,153	1,278	1,400	1,230	5,061	
Direct origination expenses												
Origination salaries and benefits	159	175	185	172	196	728	198	195	198	189	780	
Marketing	832	808	958	970	1,020	3,756	1,059	865	1,097	774	3,795	
	991	983	1,143	1,142	1,216	4,484	1,257	1,060	1,295	963	4,575	
Origination overhead expenses												
Salaries and benefits	1,086	1,023	1,156	1,136	1,271	4,586	1,055	1,041	1,057	1,233	4,386	
Office	266	249	246	255	263	1,013	308	248	288	266	1,110	
Subtotal	1,352	1,272	1,402	1,391	1,534	5,599	1,363	1,289	1,345	1,499	5,496	
50% inclusion	676	636	701	696	767	2,800	681	645	673	749	2,748	
<b>Total origination cost</b>	<b>2,617</b>	<b>2,496</b>	<b>2,808</b>	<b>2,789</b>	<b>3,652</b>	<b>11,745</b>	<b>3,091</b>	<b>2,983</b>	<b>3,368</b>	<b>2,942</b>	<b>12,384</b>	
Origination cost (%)												
Current quarter	10.5%	9.7%	8.4%	8.1%	10.8%	9.2%	10.9%	7.7%	8.9%	12.0%	9.6%	
Trailing four quarter	9.7%	9.5%	9.3%	9.1%	9.2%	9.2%	9.5%	9.2%	9.4%	9.6%	9.6%	

Commissions of \$5.1 million increased \$0.6 million over 2007. The average commission rate has increased slightly due to the costs of the new sales staff during their start-up period without originating a usual number of mortgages. The Trust expanded its sales force in Q4 2007 by adding business development managers in markets previously serviced over the phone. In Q4, 2008, in expectation of reduced volume from a lower mortgage size, the Trust reduced its sales force in non prime markets.

Offsetting total origination costs, HOMEQ collects a flat fee per mortgage from clients to cover the legal and other costs of completing the transaction. For 2008 the Trust recognized \$0.9 million of revenue, 45.4% higher than 2007 reflecting higher mortgage originations in the year and an increase in the closing fee charged to clients.



## Mortgage Administration Expense

Cost effective administration of its mortgages is an important objective of HOMEQ and an important determinant of normalized income, accordingly management has taken steps to offset the impact of increased cost of funds by actively managing its administrative costs. In 2008, the Trust's administration costs of \$5.1 million were similar to 2007 in comparison with growth in the average mortgage portfolio of \$111.6 million or 16.1%. As a percentage of the average mortgage portfolio, mortgage administration expenses were 0.67% for 2008, a decrease from 0.79% in 2007.

On a quarterly basis, mortgage administration expenses may fluctuate slightly, however, operational efficiencies and economies of scale are reducing administrative expenses as a percentage of the average mortgage portfolio. The following table provides the details of the calculation for the past nine quarters.

(\$ thousands)	2006	2007					2008				
	Q4	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Average mortgage balance	603,576	620,740	643,532	666,433	693,790	656,282	721,296	752,014	781,368	805,422	764,383
Administration expenses											
Mortgage servicing and administration	120	92	95	78	71	336	73	65	66	64	268
Origination overhead expenses	676	636	701	696	767	2,800	681	645	673	749	2,748
Professional services	356	397	443	449	258	1,547	405	276	379	417	1,477
Amortization of capital assets	61	61	64	65	67	257	77	81	76	69	303
Other	55	97	77	80	106	360	161	93	86	93	433
Less:											
Mortgage administration fees	(32)	(26)	(35)	(45)	(39)	(145)	(21)	(37)	(39)	(31)	(128)
Total administration expenses	1,236	1,257	1,345	1,323	1,230	5,155	1,376	1,123	1,241	1,361	5,101
Administration expense (%)											
Annualized	0.82%	0.81%	0.84%	0.79%	0.71%	0.79%	0.75%	0.59%	0.63%	0.67%	0.67%
Trailing four quarters	0.81%	0.79%	0.81%	0.81%	0.79%	0.79%	0.77%	0.71%	0.67%	0.67%	0.67%

## INCOME TAXES

HOMEQ qualifies as a mutual fund trust under the Income Tax Act (Canada). As a mutual fund trust the Trust's taxable income is distributed to the unitholders via the monthly distributions. In 2007, Bill C-52 was passed into law which significantly modifies the income tax rules applicable to publicly traded trusts and partnerships. In particular, certain income of (and distributions made by) these entities will be taxed in a manner similar to income earned by (and distributions made by) a corporation. The Trust recently announced that it will convert to a corporate entity in 2009 subject to the appropriate unitholder vote in order to facilitate obtaining a federally regulated, Schedule I banking license which is described further in the Outlook section.

Future income taxes are accounted for under the asset and liability method. Under this method of tax allocation, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Future income tax assets are recorded in the consolidated financial statements to the extent that realization of such benefits is more likely than not.

In Q4 2008, the Trust's future income tax liabilities increased 4.3 million and the future tax liability at December 31, 2008 was \$13.1 million mainly due to the change in temporary differences on mortgages and unrealized gains on its derivatives expected to reverse after 2010. The Trust has estimated its future income taxes based on its best estimates of results of operations and tax deductible amounts and cash distributions in the future assuming no material change to the Trust's current organizational structure. As currently interpreted, Canadian GAAP does not permit the Trust's estimate of future income taxes to incorporate any assumptions related to a change in organizational structure until such structures are given legal effect.

The Trust's estimate of its future income taxes will vary as do the Trust's assumptions pertaining to the factors described above, and such variations may be material.



## CASH FLOW AND LIQUIDITY

HOMEQ finances its portfolio of mortgages with senior debt, consisting of medium term notes, subordinated debt, and to the extent necessary to maintain the rating of the debt, trust units.

DBRS has issued a AAA rating on the Trust's senior medium term debt and BBB rating on its subordinated debt. As a result of these superior ratings, HOMEQ has historically had access to the capital markets to finance new mortgages on cost-effective terms. Pursuant to the terms of its indenture and with the consent of the rating agency rating its debt, HOMEQ is permitted to operate with a maximum senior debt-to-mortgage ratio of 95% when its senior rated debt consists only of medium term notes. Including senior and subordinated debt, it is permitted to operate with a maximum total debt-to-mortgage ratio of 98%. HOMEQ will also maintain minimum cash on hand equivalent to at least 2% of the CMT mortgage portfolio value. During the year, the Trust operated within these covenants. At December 31, 2008, the senior debt-to-mortgage ratio was 89.0% and the total debt-to-mortgage ratio was 96.3%.

Whereas net accrual of interest on mortgages (accrual of interest on mortgages net of repayments of accrued interest) is deemed an operating activity in accordance with GAAP, it results in growth in the mortgage portfolio, equivalent to new originations, and is effectively an investing activity. The Trust is thus permitted to finance up to 98% of the growth in its mortgage portfolio (net accrual of interest plus originations net of mortgage principal repayments) with debt.

As discussed earlier in the MD&A, the Trust's portfolio of reverse mortgages has a loan to value of 36% and is secured by residential real estate. As a result, the Trust can reasonably expect to recover the full recorded value of each mortgage. The Trust's wholly owned subsidiary, CHIP, has been in business for more than 20 years, and has built a portfolio of over 7,000 reverse mortgages diversified by location, property type, date of origination and age of borrower. As supported by prior experience, on average approximately 3% of the mortgage portfolio is repaid each quarter, providing a predictable source of cash flow.

Historically HOMEQ has used cash flows from operating activities to fund the Trust's operations and distributions, and the excess of those cash flows coupled with borrowings under its debt programs have been used to fund growth in the mortgage portfolio. Due to the current capital market conditions the Trust is carrying substantially higher cash balances than in the past to provide a ready source of funds for new originations. To maintain its leverage within the permitted limits described above as the mortgage portfolio grows, the Trust may be required to issue additional units or subordinated debt which may be difficult or expensive in the current market environment.

### Debt

HOMEQ issues medium term notes utilizing a short-form base shelf prospectus filed with provincial securities commissions on November 23, 2007. This prospectus replaced its initial debt prospectus filed in 2005. The prospectus permits the Trust to offer and issue medium term notes up to a total price of \$750.0 million over a 25-month period.

Total principal amount of outstanding debt at December 31, 2008 of \$849.2 million was \$85.6 million or 11.2% higher than December 31, 2007. Starting in the fourth quarter of 2007, the Trust issued debt in advance of cash requirements due to the liquidity issues in the capital markets.

On May 15, 2008, the Trust issued \$165 million of three-year senior medium-term notes, the proceeds of which were used to retire approximately \$70 million of outstanding short term debt, including commercial paper and bank liquidity line borrowings which, under current capital market conditions, the Trust decided to stop using as a source of funding. The balance of the proceeds, together with existing cash balances and mortgage repayments will be used to finance new originations of reverse mortgages. Concurrent with repayment of the last maturity of commercial paper on May 22, 2008, the Trust terminated its liquidity facility to save the associated costs. The Trust may return to the commercial paper market in the future if conditions improve.

The Trust had \$66.0 million of cash and short term investments as at December 31, 2008 thus reducing its exposure to short term refinancing risk during a period of particularly uncertain times in the capital markets.



The table below summarizes the timing of the expected final payments of the Trust's debt at December 31, 2008.

(\$ thousands)	Less than 1 year	More than 1 year and 2 years or less	More than 2 years and 5 years or less	More than 5 years	December 31, 2008 Total	December 31, 2007 Total
Commercial Paper	—	—	—	—	—	76,788
Medium-Term Debt	150,000	110,000	529,186	—	789,186	626,753
Subordinated Debt	—	—	60,000	—	60,000	60,000
Total	150,000	110,000	589,186	—	849,186	763,541

The expected final payment date of the \$150 million due in less than one year is November 1, 2009. The Trust has a best efforts obligation to refinance the note on that date. If the Trust is unable to refinance the note, the interest will become the one-month Bankers' Acceptance rate plus 2.00% calculated and payable monthly until legal maturity which is November 1, 2032.

### Equity

Periodically, as required, the Trust may issue additional units to manage its leverage as the mortgage portfolio grows. New equity capital was being raised each month through the Trust's Distribution Reinvestment Plan. On July 16, 2008, the Trust announced that it has suspended the distribution reinvestment plan. Prior to the announcement, the Trust issued 139,071 units for \$1.2 million under the distribution reinvestment plan for the year.

The Trust has two long-term incentive plans; a Restricted Unit Plan (RUP) for management and a Deferred Unit Plan (DUP) for Trustees. A unit granted through the RUP entitles the holder to receive, on the vesting date, a Trust unit plus the amount of cash distributions that would have been paid on the unit if it had been issued on the date of grant. Subject to the achievement of performance conditions, if any, restricted units vest equally over three years and the total cost of the grant is recognized over the vesting period.

The DUP allows the Trustees to defer a portion of their compensation and receive the equivalent amount in units of the Trust. On retiring from the Board, a Trustee will receive all deferred units accumulated in the plan. The Trust intends to settle the restricted and deferred units in voting units of the Trust upon vesting and retirement respectively. Until such time, restricted and deferred units do not trade on the TSX, have no voting rights and cannot be sold or liquidated early.

The table below summarizes the Trust's unit activity for the period ended December 31, 2008.

	Voting	Management Restricted Unit Plan	Trustees Deferred Unit Plan	Total number of units
Balance, December 31, 2007	13,805,137	61,980	65,930	13,933,047
Restricted units redeemed	9,384	(9,384)	—	—
Restricted unit grants, net	—	27,100	—	27,100
Deferred units earned	—	—	24,331	24,331
Issued under distribution reinvestment plan	139,071	—	—	139,071
Balance, December 31, 2008	13,953,592	79,696	90,261	14,123,549



## DISTRIBUTABLE CASH AND DISTRIBUTIONS

### Cash available for distribution and portfolio growth

Distributable cash is a non-GAAP measure, and should not be used as a measurement of liquidity or a substitute for comparable metrics prepared in accordance with GAAP. It may differ from similar calculations reported by other entities and should not be compared.

In 2007, the Canadian Securities Administrators issued amended guidance for reporting by income trusts. The policy statement recommends various disclosures and, in particular, describes a new framework for measuring the amount of distributable cash generated by an income trust. The guidance requires the determination of distributable cash to be reconciled to cash generated from operating activities. The Trust has followed the new guidance. The comparative period calculations of distributable cash have been restated to reflect the current period's presentation.

An intricacy of the Trust is the deferred nature of its income streams. The Trust earns and accrues interest on a monthly basis, yet interest income is not received in cash until mortgages are repaid. Whereas net accrual of interest on mortgages (accrual of interest on mortgages net of repayments of accrued interest) is deemed an operating activity in accordance with GAAP, it results in growth in the mortgage portfolio, equivalent to new originations, and is effectively an investing activity. Pursuant to the covenants in its indenture, the Trust is permitted to finance up to 98% of the growth in its mortgage portfolio (net accrual of interest plus originations net of mortgage principal repayments) with debt. In order to reflect the true cash generation of the Trust's operating activities, the net accrual of interest on mortgages is added back in the calculation of distributable cash. Changes in non-cash working capital have also been excluded so as to remove the effects of timing differences in cash receipts and disbursements which generally reverse themselves but can vary significantly across quarters.

On an ongoing basis, distributable cash can be expected to increase in tandem with growth in operating performance as a result of a strengthening operating business. While the Trust's mortgages earn interest over a multi year period, under GAAP, only commissions are deferred and amortized over the period the mortgages are expected to earn interest. Other origination costs such as marketing, origination salaries and benefits and the share of overhead expenses applicable to new mortgage originations are expensed under GAAP in the period incurred. This has the effect of reducing net income, cash flow from operations and distributable cash in the period of origination, but benefiting the Trust in the longer term. During periods of growth, cash flow from operations is normally negatively affected.

The Trust's analysis of mortgage origination costs is presented earlier in the MDA. As noted there, mortgage origination costs are closely monitored and as percentage of originations, have been falling on a consistent basis due to efficiencies resulting from improved selling techniques and enhanced marketing positioning. This will continue to have a positive impact on future operating results.

The table below shows that in 2008, distributable cash increased by \$0.3 million or 2.2% from 2007. As outlined in the Mortgage Origination Cost section earlier in the MDA, the Trust spent \$12.4 million to originate \$129.6 million of new mortgages compared to \$11.7 million to originate \$127.3 million in 2007. Of the origination costs incurred in the quarter, \$7.3 million were expensed in the period similar to 2007. The Trust believes that origination expenditures made in the past are contributing to growth in operating performance and distributable cash and that current period expenditures will have the same result in the future. Distributable cash in Q4 2008 increased \$0.7 million or 20.4% over Q4 2007.

The level of distributions declared is reviewed periodically to take into account the current and future prospective performance of the business and other items considered to be prudent. As a result of current uncertainty in the capital markets, in Q4 2008 the Trust reduced the monthly distribution to reflect the approximate current level of taxable income in order to retain capital in the business to ensure the stability and predictability of the Trust's performance.



The following table provides the details of the calculation of Distributable Cash for the past nine quarters.

	2006	2007						2008					
(\$ thousands, except per unit amounts)	Q4	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year		
<b>DISTRIBUTABLE CASH</b>													
Cashflows from operating activities	(4,138)	(2,875)	(1,335)	(978)	(2,099)	(7,287)	(6,225)	(2,700)	(1,760)	(9,782)	(20,467)		
Add/(deduct)													
Changes in non-cash working capital	938	(234)	(353)	(1,431)	(2,836)	(4,854)	(1,327)	(445)	(2,641)	7,179	2,766		
Net accrual of interest on mortgages	6,789	6,728	5,486	6,653	8,554	27,421	11,119	7,181	8,150	6,889	33,319		
Capital expenditures	(6)	(35)	(63)	(33)	(77)	(208)	(110)	(90)	(10)	-	(210)		
<b>Distributable cash</b>	<b>3,583</b>	<b>3,584</b>	<b>3,735</b>	<b>4,211</b>	<b>3,542</b>	<b>15,072</b>	<b>3,457</b>	<b>3,946</b>	<b>3,739</b>	<b>4,266</b>	<b>15,408</b>		
Total distributions	3,675	3,714	3,700	3,709	3,721	14,844	3,769	3,739	3,765	3,360	14,623		
<b>Excess/(shortfall)</b>	<b>(92)</b>	<b>(130)</b>	<b>35</b>	<b>502</b>	<b>(179)</b>	<b>228</b>	<b>(312)</b>	<b>207</b>	<b>(26)</b>	<b>916</b>	<b>785</b>		
Distributable cash per unit	0.261	0.260	0.270	0.304	0.254	1.088	0.247	0.281	0.265	0.302	1.095		
Distributions per unit	0.270	0.270	0.270	0.270	0.270	1.080	0.270	0.270	0.270	0.210	1.020		
Average number of units outstanding (000's)	13,724	13,773	13,830	13,872	13,918	13,848	13,981	14,061	14,113	14,122	14,069		
Payout ratio	103%	104%	99%	88%	105%	98%	109%	95%	101%	79%	95%		
Trailing four quarter payout ratio	115%	107%	103%	98%	98%	98%	100%	99%	102%	95%	95%		
<b>FINANCING AND INVESTING ACTIVITIES</b>													
Cash from financing activities													
New debt financing, net of issue costs and repayments	16,617	19,379	29,425	45,480	87,581	181,865	(7,214)	95,147	(797)	(1,491)	85,645		
New equity issues, net of issue costs	409	464	442	461	467	1,834	490	504	175	-	1,169		
Cash available for investing activities	17,026	19,843	29,867	45,941	88,048	183,699	(6,724)	95,651	(622)	(1,491)	86,814		
Investing activities													
Net originations	(12,761)	(14,441)	(17,960)	(17,953)	(22,214)	(72,569)	(19,921)	(23,865)	(23,979)	(10,399)	(78,164)		
Increase in short-term investments	-	-	-	-	-	-	-	-	-	(42,465)	(42,465)		
Net accrual of mortgage interest	(6,789)	(6,728)	(5,486)	(6,653)	(8,554)	(27,421)	(11,119)	(7,181)	(8,150)	(6,889)	(33,319)		
<b>Total investing activities</b>	<b>(19,550)</b>	<b>(21,169)</b>	<b>(23,446)</b>	<b>(24,606)</b>	<b>(30,769)</b>	<b>(99,989)</b>	<b>(31,040)</b>	<b>(31,046)</b>	<b>(32,129)</b>	<b>(59,733)</b>	<b>(153,948)</b>		
Excess/(shortfall) distributable cash	(92)	(130)	35	502	(179)	228	(312)	207	(26)	916	785		
Changes in non-cash working capital	(938)	234	353	1,431	2,836	4,854	1,327	445	2,641	(7,179)	(2,766)		
<b>Total</b>	<b>(1,030)</b>	<b>104</b>	<b>388</b>	<b>1,933</b>	<b>2,657</b>	<b>5,082</b>	<b>1,015</b>	<b>652</b>	<b>2,615</b>	<b>(6,263)</b>	<b>(1,981)</b>		
Net increase/(decrease) in cash and cash equivalents	(3,554)	(1,222)	6,809	23,268	59,937	88,792	(36,749)	65,257	(30,136)	(67,487)	(69,115)		



### **Production capacity**

Given the nature of its business, the Trust does not require significant investment in infrastructure, facilities or equipment. Limited capital investment is made on an ongoing basis to upgrade the information technology platform, to maintain the office environment and to provide the sales force with appropriate tools and equipment to carry out their functions. Within the foreseeable future capital expenditure is expected to continue on the basis experienced over the prior years.

The Trust's ability to grow its portfolio is dependant on its access to debt and equity capital markets. The Trust's strategies in this regard are discussed in the Cash Flow and Liquidity section of the MD&A, and associated risks are addressed in the 2008 Annual Financial Statements and Annual Information Form.

### **Normalized income**

Normalized Income is a non-GAAP measure, and should not be used as a substitute for comparable metrics prepared in accordance with GAAP. The Trust's mortgages earn interest over a multi year period while the costs to originate them are generally expensed under GAAP in the period they were incurred. Accordingly, this has the effect of reducing both net income and distributable cash in the current period, but benefiting them in the long term. Additionally, net income of the Trust in a quarter is likely to vary with the level of marketing activity during that quarter. The calculation of normalized income is designed to attempt to match the revenue from the Trust's mortgage portfolio with the corresponding one-time origination expenses by amortizing the origination expenses over an average period that the mortgages earn interest. This metric provides a measure of the consistency of the Trust's operational performance and the profit capabilities from ongoing operations.

Normalized income in 2008 amounted to \$16.4 million or \$1.163 per unit, an 8.9% decrease of \$1.6 million, or 10.4% per unit from 2007. The decrease is mainly due to the compressed spread income earned on the portfolio as discussed in the Net Spread section of the MD&A. Distributions declared were \$14.6 million or \$1.02 per unit, equivalent to 87.7% of normalized income per unit.

Normalized income in Q4 2008 amounted to \$4.1 million or \$0.289 per unit, a 6.1% decrease of \$0.3 million or 7.4% per unit over Q4 2007. Distributions declared in the quarter were \$3.4 million or \$0.21 per unit, equivalent to 72.7% of normalized income.



The following table shows normalized income for the past nine quarters.

(\$ thousands)	2006	2007					2008				
	Q4	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Net income (loss)	2,430	1,123	(10,992)	5,152	6,302	1,585	13,045	(2,803)	3,516	15,775	29,533
Add/(deduct):											
Non-cash items											
Future income tax expense (recovery)	(157)	(5)	5,780	1,073	145	6,993	3,184	(1,282)	63	4,277	6,242
Unrealized (gains) losses on derivative instruments (1)	—	959	7,468	(3,423)	(4,427)	577	(14,306)	6,360	(1,671)	(17,746)	(27,363)
Amortization of purchase premiums and origination fees (2)	950	977	921	945	990	3,833	892	953	939	892	3,676
	3,223	3,054	3,177	3,747	3,010	12,998	2,815	3,228	2,847	3,198	12,088
Direct origination expenses (3)	991	983	1,143	1,142	1,216	4,484	1,257	1,060	1,295	963	4,575
Origination overhead expenses (4)	676	636	701	696	767	2,800	681	645	673	749	2,748
Less:											
Amortization of direct origination expenses and origination overhead expenses (5)	(468)	(503)	(554)	(599)	(648)	(2,304)	(699)	(741)	(779)	(829)	(3,048)
	1,199	1,116	1,290	1,239	1,335	4,980	1,239	964	1,189	883	4,275
<b>Normalized Income</b>	<b>4,422</b>	<b>4,170</b>	<b>4,467</b>	<b>4,986</b>	<b>4,345</b>	<b>17,968</b>	<b>4,054</b>	<b>4,192</b>	<b>4,036</b>	<b>4,081</b>	<b>16,363</b>
Average number of units outstanding	13,724	13,773	13,828	13,872	13,918	13,848	13,981	14,061	14,113	14,124	14,069
Normalized Income per unit Current quarter	0.322	0.303	0.323	0.359	0.312	1.298	0.290	0.298	0.286	0.289	1.163

- (1) Unrealized (gains) losses on derivative instruments are a non cash charge reflecting the change in fair value of derivatives.
- (2) This expense, reflected in the Statement of Cash Flows, relates to fees previously paid in cash and capitalized by the Trust to a third party for the purchase of portfolios of reverse mortgages. The amortized expense is a non-cash expense and it is included in the calculation of Normalized Income in order to reflect profit generating capabilities from ongoing operations
- (3) Direct origination expense relates to expenses paid in cash for mortgages originated in the current period. On the Statement of Operations it comprises "Origination salaries and benefits" and "Marketing". In accordance with GAAP, these expenditure categories are expensed in the period incurred although the mortgages have an expected life of several years. For the Normalized Income calculation, this expense is added back and then amortized (see (5) below) over an average period that the mortgages earn interest.
- (4) Origination overhead expenses relate to overheads incurred during the origination of mortgages. It includes 50% of "Salaries and benefits" and 50% of "Office expenses" as reported on the Statement of Operations. The 50% allocation is based on the Trust's estimate of the allocation of these costs to origination activities. In accordance with GAAP, these expenditure categories are expensed in the period incurred although the mortgages have an expected life of several years. For the Normalized Income calculation, this expense is added back and then amortized (see (5) below) over an average period that the mortgages earn interest
- (5) Amortization of direct origination expenses and origination overhead expenses is the amortization of the previous two items to recognize the expenditure over an average period that the mortgages originated earn interest. This period of amortization is consistent with that used to amortize commissions in accordance with GAAP as reflected in the notes to the financial statements

## FINANCIAL INSTRUMENTS

In the normal course of business, HOMEQ enters into interest rate derivative contracts to hedge the portfolio's interest rate risk. The Trust does not hold or use any derivative contracts for speculative trading purposes. The derivative contracts used are entered into with Schedule 1 Canadian chartered banks to reduce any counterparty risk associated with derivatives.



## **BUSINESS RISKS**

The Trust has specific strategies to manage the primary risks it has identified.

### **Property Risk**

In underwriting new reverse mortgages, the Trust uses a proprietary lending model to predict the date of mortgage repayment based on the age and sex of the borrower. This information, along with information on the type of the property and its location, is used to determine the amount to be lent. The initial mortgage amount is usually between 28% and 33% of the value of the house, substantially less than the 75% ratio commonly applied for a conventional bank mortgage. One of the assumptions made at the time a reverse mortgage is underwritten concerns the rate of future price appreciation for the underlying property. A risk exists that the property might not appreciate in accordance with past experience and the underwriting forecasts. The average rate of assumed appreciation used in the initial underwriting of the existing mortgage portfolio is 1.63% per annum. According to data available from the Canadian Real Estate Association, over the past 20 years, the rate of appreciation for residential real estate in Canada has averaged approximately 3.45% per annum. The Trust currently uses a maximum of 0.5% as the future appreciation rate. In addition, the initial appraised value of every property is discounted, generally by between 7.5% and 30%, depending on the province, location, and property type.

### **Occupancy Risk**

The Trust makes assumptions as to when borrowers will cease occupying their homes. To the extent that borrowers remain in their homes longer than expected, there is a risk that the amount owing on the reverse mortgage at the time the borrower moves or dies will exceed the value of property securing the reverse mortgage, thus resulting in a loss. The EOT for a borrower is determined based on a combination of industry standard mortality data and the Trust's proprietary data on the mobility of its clients at the 75% probability. This formula is closely monitored and is compared to actual experience on an ongoing basis. Calculation of the EOT is fundamental to determining the amount to lend and for predicting cash flows from mortgage repayments.

### **Interest Rate Risk**

An increasing interest rate environment could also result in a mortgage eventually compounding to a value greater than the value of the underlying property. For this reason, when an initial loan amount is determined, interest rates in the future are assumed to be at least 2% higher than the rate at the initial term.

### **Spread Risk**

The Trust's operating margin is primarily derived from the spread between interest earned on the mortgage portfolio, and the interest paid on the debt used to fund the portfolio. Circumstances in the capital markets can result in an increase in the cost of debt used by the Trust to fund the portfolio. In addition, the difference between the Prime Rate and the rate on Government of Canada Treasury Bills, on which most mortgage rates are based, and the rate on Bankers' Acceptances, on which the Trust's debt and hedging instruments are based, can deviate from historical norms. Both of these situations can result in a reduction of spread. In Q2 2008 the pricing methodology was changed to a posted rate derived from the Trust's average cost of borrowing as opposed to a mark-up over the T-Bills rate as has previously been the case. This methodology will enable the Trust in the future to change the rates on all mortgages in the portfolio to offset systemic changes in borrowing costs.

### **Leverage and Refinancing**

The Trust, in its normal course of business, is projected to have significant debt service obligations under its indebtedness. The degree to which The Trust is leveraged could have important consequences, on (i) the Trust's ability to obtain additional financing; (ii) the cost incurred to obtain additional debt or replace maturing debt (iii) the extent of the cash flow from reverse mortgages that will be dedicated to the payment of interest on its indebtedness; (iv) the risk that the cash flow from the Trust's reverse mortgages is not sufficient to repay any indebtedness on maturity, exposing the Trust to refinancing risk. The Trust mitigates these risks by issuing



highly rated debt, by using a syndicate of several dealers to issue debt and by staggering the maturities of its debt obligations. Changes in general market conditions, fluctuations in markets for debt securities and other factors beyond the control of the Trust may affect the Trust's ability to successfully issue debt as and when required.

### **Restrictive Covenants**

The Trust indenture contains covenants that place restrictions on, among other things, the ability of the Trust to incur additional indebtedness, to create liens or other encumbrances, to make cash distributions to unitholders, and to sell or otherwise dispose of significant assets or consolidate with another entity. A failure to comply with the obligations in the Trust indenture could result in an event of default, which if not cured or waived, could permit acceleration of the relevant Indebtedness. If the indebtedness were to be accelerated, there can be no assurance that the assets of the Trust would be sufficient to repay in full that indebtedness.

### **Reliance on Relationships with Financial Institutions**

The Trust has developed an extensive referral network in the broader financial service community, including distribution agreements with the largest Canadian banks. There can be no assurance that this referral network will be maintained. Furthermore, there is no assurance that any new distribution agreements entered into by the Trust will have terms similar to those contained in current arrangements with the banks. The termination or alteration of the referral network and distribution arrangements may adversely affect the Trust's ability to continue originating reverse mortgages, and its growth may be adversely affected as a result.

### **Access to Capital Markets**

Periodically, as required, the Trust may issue additional units to manage its leverage as the mortgage portfolio grows. Changes in general market conditions, fluctuations in markets for equity securities and other factors beyond the control of the Trust may affect the Trust's ability to successfully issue additional units as and when required.

### **Dilution**

The number of units the Trust is authorized to issue is unlimited, and any issuance of units may have a dilutive effect on unitholders' holdings. To prevent significant dilution, additional issuance of units is carefully managed and timed in order to reduce the initial impact.

### **Delays in Distribution**

Payments by CMT to the Trust may be delayed by restrictions imposed by the Trust indenture or the establishment of reserves for expenses. Any such delay could have an adverse effect on the ability of the Trust to pay cash amounts equal to distributable cash.

## **CONTROLS AND PROCEDURES**

### **Disclosure Controls and Procedures**

The Trust maintains appropriate information systems, procedures and controls to ensure that information disclosed externally is complete, reliable and timely. The Trust's President and Chief Executive Officer ("CEO") and the Senior Vice President and Chief Financial Officer ("CFO"), evaluated or caused an evaluation, under their direct supervision and with the participation of management, of the design and operating effectiveness of the Trust's disclosure controls and procedures (as defined in *National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings*, of the Canadian Securities Administrators) as at December 31, 2008. Based on this evaluation, the CEO and the CFO concluded that such disclosure controls and procedures were appropriately designed and were operating effectively.



### **Internal Controls over Financial Reporting**

The Trust also established adequate internal controls over financial reporting to provide reasonable assurance regarding the reliability of the Trust's financial reporting and the preparation of the financial statements for external purposes in accordance with Canadian GAAP. The Trust's CEO and CFO, evaluated or caused an evaluation, under their direct supervision and with the participation of management, of the design and operating effectiveness of the Trust's internal controls over financial reporting (as defined in *National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings*, of the Canadian Securities Administrators) as at December 31, 2008, using the Committee of Sponsoring Organizations Internal Control – Integrated Framework. Based on this evaluation, the CEO and the CFO concluded that such internal controls over financial reporting were appropriately designed and were operating effectively.

It should be noted that a control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Given the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, including instances of fraud, if any have been detected. These inherent limitations include, among other items: (i) that management's assumptions and judgments could ultimately prove to be incorrect under varying conditions and circumstances; (ii) the impact of undetected errors; and (iii) controls may be circumvented by the unauthorized acts of individuals, by collusion of two or more people, or by management override.

The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

### **Changes in Internal Controls over Financial Reporting**

There have been no significant changes in the Trust's internal controls over financial reporting during the year ended December 31, 2008, that have materially affected, or are reasonably likely to materially affect, the Trust's internal control over financial reporting.

## **ACCOUNTING POLICIES AND ESTIMATES**

### **Changes in Significant Accounting Policies**

#### **Capital Disclosures**

Effective January 1, 2008 the CICA's new accounting standard, Section 1535, *Capital Disclosures*, was implemented, which requires the disclosure of both qualitative and quantitative information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital. The new guidance did not have an effect on the financial position or the earnings of the Trust.

#### **Financial Instruments**

Effective January 1, 2008, the accounting and disclosure requirements of the CICA's two new accounting standards, Section 3862, *Financial Instruments – Disclosures*, and Section 3863, *Financial Instruments – Presentation* were implemented. Section 3862 requires the disclosure of the significance of financial instruments for the Trust's financial position, performance and cash flows and the nature and extent of risks arising from financial instruments to which the Trust is exposed during the year and at the balance sheet date, and how the entity manages those risks. Section 3863 carries forward, unchanged, the presentation requirements of Section 3861, *Financial Instruments – Disclosure and Presentation*.

### **Critical Accounting Estimates**

HOMEQ uses estimates to determine the amortization of the commissions, purchase price premiums and origination fees paid on the acquisition of reverse mortgages. The estimates are based on the projected lives of the mortgages for which the premiums and fees were paid. The methodology attempts to match the



amortization of these amounts over the period that the mortgages earn interest income. The projected lives of the mortgages are reassessed on an annual basis.

HOMEQ also uses estimates to establish an appropriate reserve to recognize possible degradations in values of individual mortgages. These estimates are based on underwriting assumptions and place emphasis on mortgages having higher loan-to-value ratios.

There have been no changes to the methodologies used this year.

### **Future Accounting and Reporting Changes**

#### **Credit Risk and the Fair Value of Financial Assets and Financial Liabilities**

Due to mixed practice on whether an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of a derivative instrument, the CICA's Emerging Issues Committee released *EIC-173 Abstract, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities*. The EIC requires the inclusion of credit risk of the counterparty and the Trust in determining the fair value of derivative instruments for periods after January 20, 2009. The EIC requires retrospective adoption without restatement of prior periods. The Trust will adopt the accounting treatment in the first quarter of 2009.

#### **Goodwill, Intangible Assets and Financial Statement Concepts**

The CICA issued a new accounting standard, *Section 3064, Goodwill and Intangible Assets*, which clarifies that costs can be deferred only when they relate to an item that meets the definition of an asset, and as a result, start-up costs must be expensed as incurred. *Section 1000, Financial Statement Concepts*, was also amended to provide consistency with the new standard. These new standards are effective for the Trust beginning on January 1, 2009. The impact of these standards will be that certain items previously included in prepaid expenses which were deferred and amortized, will be expensed as period costs when incurred.

#### **International Financial Reporting Standards**

The Canadian Accounting Standards Board (AcSB) confirmed that International Financial Reporting Standards (IFRS) will replace current Canadian GAAP for publicly accountable enterprises, including HOMEQ, effective for fiscal years beginning on or after January 1, 2011. Accordingly, HOMEQ will report interim and annual financial statements in accordance with IFRS beginning with the quarter ended March 31, 2011.

The Company has commenced the development of an IFRS implementation strategy to prepare for this transition, and is currently in the process of identifying the key accounting policy changes that may be required. Analysis will be required for all current accounting policies, however the initial key areas of assessment include:

- Financial Instruments Presentation & Disclosure
- Financial Instruments Recognition & Measurement
- Impairment of Assets (assessment methodology for Mortgages & Goodwill)
- Share-based payments
- Income Taxes

As the analysis of the each of the key areas progresses, other elements of our IFRS implementation plan will be addressed including the implication of changes to accounting policies, processes or financial statement note disclosures on information technology, internal controls, contractual arrangements and employee training.



The table below summarizes the expected timing of activities related to Home Equity Income Trust's transition to IFRS.

Initial analysis of key areas for which changes to accounting policies may be required.	In progress, expected to be complete during Q1 2009
Detailed analysis of all relevant IFRS requirements and identification of areas requiring accounting policy changes or those with accounting policy alternatives.	Throughout 2009
Assessment of first-time adoption (IFRS 1) requirements and alternatives.	Throughout 2009
Final determination of changes to accounting policies and choices to be made with respect to first-time adoption alternatives	Q4 2009 – Q1 2010
Resolution of the accounting policy change implications on information technology, internal controls and contractual arrangements	Q4 2009 – Q2 2010
Management and employee education and training	Throughout the transition process
Quantification of the Financial Statement impact of changes in accounting policies	Throughout 2010

## OUTLOOK

HOMEQ's goal is to continue to be Canada's leading provider of reverse mortgages. Market awareness of both HOMEQ and its product has increased, and sources of referral cover a widening array of financial institutions. In addition, HOMEQ is benefiting from a preference of seniors to remain in their homes as long as possible, and from the demographic trend of a rising seniors population.

Starting in the third quarter of 2007, volatility in the capital markets resulted in a decrease in availability and a resultant increase in the cost of both commercial paper and medium term notes and, as discussed in Spread, the difference between the rate on T Bills and BAs rose to levels higher than historical norms. In order to ensure immediate availability of funds to finance new originations during this period of volatility, the Trust has increased its cash holdings to higher than historical levels. The increased level of cash, while important from a risk management perspective, is having a negative impact on spread income because of the associated increase in interest expense.

As a result of the increased costs of capital, spread percentage in recent quarters has been lower than the historical range. It is not possible to predict the duration and extent to which current market conditions will continue. Management has taken steps to offset the ongoing impact of these circumstances by changing the pricing methodology to a posted rate derived from the Trust's average cost of borrowing as opposed to a mark-up over the T Bill rate as has previously been the case. These steps, however, will take some time to be fully reflected in the Trust's results as the vast majority of the Trust's existing portfolio has rates set using the old methodology. As a result, spread percentage for the next several quarters will continue to be highly dependant on the difference between rates on T Bills and BAs.

During Q4, the spread percentage of 2.99% was slightly lower than that of Q3, 2008, but at the higher end of the 2.75% to 3.00% range forecast in the Q3 report. In the forthcoming quarter spread percentage is expected to remain at approximately the rate achieved in Q4 2008.

As a result of current uncertainty in the capital markets, the Trust decided to reduce the monthly distribution to reflect the approximate current level of taxable income. Effective November 30<sup>th</sup> the monthly distribution was changed from \$0.09 to \$0.06 per unit.



The Trust recently announced that it intends to apply to the Minister of Finance for CHIP to become a federally regulated Schedule I bank. Subject to unitholder approval, HOMEQ will convert its business structure from an income trust to a taxable corporation prior to HomEquity Bank being continued as a Schedule I bank by the Minister of Finance. The objective of obtaining a bank charter is to enable HomEquity Bank to access retail deposits sourced through deposit brokers and directly hold reverse mortgages so as to grow the Trust's consolidated reverse mortgage portfolio and increase its spread income. Retail deposits represent a stable and cost effective source of funds that will be used to supplement the wholesale funding strategy the Trust has followed since its IPO in 2002.

Subject to the review and approval of its application by the Office of the Superintendent of Financial Institutions (OSFI) and the Minister of Finance, the Trust hopes to be operating HomEquity Bank commencing in the third quarter of 2009. In the interim, the Trust has taken specific actions to conserve its cash resources. Steps have been taken to reduce the average mortgage amount for new customers, marketing activity has been scaled back, overhead expenditure is being closely monitored and sales territories have been rationalized. Until such time as HomEquity Bank becomes fully operational, these actions will result in originations being temporarily reduced. Despite strong demand, the Trust expects that originations during the first quarter will be between 50% and 60% of that in Q1 2008 and marketing costs will be reduced by the same proportion. Based solely on the steps taken to date, existing resources of cash and cash equivalents, and the expectation that mortgage repayments will remain at or near historic levels, the Trust is taking the appropriate actions to ensure that it has sufficient capital to last through 2009 under current circumstances.

#### **ADDITIONAL INFORMATION**

Additional information regarding HOMEQ including the Trust's Annual Information Form is available on SEDAR at [www.sedar.com](http://www.sedar.com).

March 4, 2009



## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The financial statements and other information in this annual report have been prepared by and are the responsibility of the management of the Trust. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles and reflect, where necessary, management's best estimates and judgments.

Management is also responsible for maintaining systems of internal and administrative controls to provide reasonable assurance that the Trust's assets are safeguarded, that transactions are properly executed in accordance with appropriate authorization, and that the accounting systems provide timely, accurate and reliable financial information.

The Board of Trustees is responsible for assuring that management fulfils its responsibility for financial reporting and internal control. The trustees perform this responsibility at meetings where significant accounting, reporting and internal control matters are discussed, and the financial statements, annual and quarterly reports are reviewed and approved.

The financial statements have been audited on behalf of the unitholders by Ernst & Young LLP, Chartered Accountants, in accordance with Canadian generally accepted auditing standards. The Auditors' Report outlines the scope of their examination and their independent professional opinion on the fairness of these financial statements. Ernst & Young LLP has full and open access to the audit committee.

The Board's audit committee, consisting of independent trustees, has reviewed these statements with management and the auditors and has reported the results of this review to the Board of Trustees, which has approved the financial statements.

A handwritten signature in black ink, appearing to read "SKR".

Steven K. Ranson, CA  
President & Chief Executive Officer

A handwritten signature in black ink, appearing to read "GKrikler".

Gary Krikler, CA  
Senior Vice President & Chief Financial Officer



## Auditors' Report

To the Unitholders of  
**Home Equity Income Trust**

We have audited the consolidated balance sheets of Home Equity Income Trust as at December 31, 2008 and 2007, and the consolidated statements of operations and unitholders' equity and cash flows for the years ended December 31, 2008 and 2007. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years ended December 31, 2008 and 2007 in accordance with Canadian generally accepted accounting principles.

A handwritten signature in cursive script that reads "Ernst &amp; Young LLP".

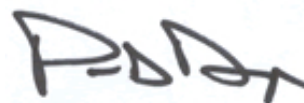
Toronto, Canada,  
February 27, 2009

Chartered Accountants  
Licensed Public Accountants

**HOME EQUITY INCOME TRUST****CONSOLIDATED BALANCE SHEETS**

	As at December 31, 2008	As at December 31, 2007
	\$	\$
<b>ASSETS</b>		
CASH AND CASH EQUIVALENTS (Note 13)	23,569,597	92,685,662
SHORT-TERM INVESTMENTS (Note 4)	42,465,284	—
MORTGAGES (Note 5 and 16)	868,563,225	762,427,629
PREPAID EXPENSES AND OTHER ASSETS	825,013	712,499
FUTURE INCOME TAX ASSETS (Note 6)	76,815	126,275
PROPERTY AND EQUIPMENT, net of accumulated amortization (Note 7)	656,202	748,345
DERIVATIVE INSTRUMENTS (Note 15)	44,679,609	2,457,861
GOODWILL	19,108,636	19,108,636
	<b>999,944,381</b>	<b>878,266,907</b>
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	2,248,250	3,204,028
DISTRIBUTIONS PAYABLE TO UNITHOLDERS	1,228,421	1,518,595
FUTURE INCOME TAX LIABILITIES (Note 6)	13,090,094	6,897,626
COMMERCIAL PAPER (Note 8 and 16)	—	76,788,449
MEDIUM-TERM DEBT (Note 9, 14 and 16)	804,296,950	634,062,030
SUBORDINATED DEBT (Note 10, 14 and 16)	60,406,749	60,432,972
DERIVATIVE INSTRUMENTS (Note 15)	7,949,839	1,451,267
UNITHOLDERS' EQUITY	110,724,078	93,911,940
	<b>999,944,381</b>	<b>878,266,907</b>

On behalf of the Board of Trustees:

Pierre B. Lebel  
TrusteePaul Damp  
Trustee

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

**HOME EQUITY INCOME TRUST****CONSOLIDATED STATEMENTS OF OPERATIONS AND UNITHOLDERS' EQUITY**

	For the years ended December 31,	
	2008	2007
	\$	\$
<b>REVENUES</b>		
Mortgage interest (Note 5)	56,589,194	52,288,230
Mortgage closing fees, net of costs	915,329	629,469
Mortgage administration fees	127,931	144,789
Investment interest and other	2,800,457	1,495,867
	<b>60,432,911</b>	<b>54,558,355</b>
<b>DIRECT COSTS</b>		
Interest expense (Note 11)	39,470,523	32,868,174
Origination salaries and benefits	779,695	728,456
Mortgage servicing and administration	267,767	336,720
	<b>40,517,985</b>	<b>33,933,350</b>
<b>OPERATING MARGIN</b>	<b>19,914,926</b>	<b>20,625,005</b>
<b>MARKETING</b>	<b>3,794,546</b>	<b>3,755,935</b>
<b>OVERHEAD EXPENSES</b>		
Salaries and benefits	4,385,789	4,586,279
Professional services	1,477,006	1,519,243
Office expenses	1,109,693	1,040,458
Amortization of property and equipment	302,675	256,924
Other	433,060	359,680
	<b>7,708,223</b>	<b>7,762,584</b>
<b>INCOME BEFORE UNDER NOTED ITEMS</b>	<b>8,412,157</b>	<b>9,106,486</b>
Unrealized (gains) losses on derivative instruments (Note 15)	(27,362,937)	577,172
Current income tax expense (recovery)	—	(49,061)
Future income tax expense (Note 6)	6,241,928	6,993,204
<b>NET INCOME AND TOTAL COMPREHENSIVE INCOME</b>	<b>29,533,166</b>	<b>1,585,171</b>
<b>UNITHOLDERS' EQUITY</b> , beginning of year	<b>93,911,940</b>	<b>103,399,558</b>
Net proceeds from issuance of Trust units (Note 12)	1,611,851	2,309,605
Distributions declared to unitholders	(14,332,879)	(14,966,160)
Transition adjustment on adoption of financial instrument standards	—	1,583,766
<b>UNITHOLDERS' EQUITY, end of year</b>	<b>110,724,078</b>	<b>93,911,940</b>
<b>AVERAGE NUMBER OF UNITS OUTSTANDING</b>	<b>14,069,259</b>	<b>13,848,058</b>
<b>NET INCOME PER TRUST UNIT (Basic and Diluted)</b>	<b>2.099</b>	<b>0.115</b>

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

## HOME EQUITY INCOME TRUST

### CONSOLIDATED STATEMENTS OF CASH FLOW

	For the years ended December 31,	
	2008	2007
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net income	29,533,166	1,585,171
Adjust for non-cash items		
Amortization		
Amortization of purchase price premiums and origination fees	3,676,271	3,833,392
Amortization of debt issue costs	1,113,496	649,338
Amortization of property and equipment	302,675	256,924
Amortization of deferred commissions	1,514,772	1,011,212
Increase (decrease) in portfolio reserves	156,782	(54,090)
Compensation expense related to long-term incentive plans	442,885	475,897
Future income tax expense	6,241,928	6,993,204
Unrealized (gains) losses on derivative instruments	(27,362,937)	577,172
	15,619,038	15,328,220
Changes in non-cash working capital		
Accrual of interest payable on debt and derivatives	(1,698,017)	3,854,832
Other (Note 13)	(1,068,636)	1,119,812
	(2,766,653)	4,974,644
Accrual of interest on mortgages	(60,908,616)	(55,883,921)
Repayments of accrued interest	27,589,420	28,463,001
Net accrual of interest on mortgages	(33,319,196)	(27,420,920)
Cash used in operating activities	(20,466,811)	(7,118,056)
<b>INVESTING ACTIVITIES</b>		
Mortgages originated	(129,621,861)	(127,267,691)
Mortgage principal repayments	56,519,206	59,161,944
Commissions	(5,061,226)	(4,460,763)
Increase in short-term investments	(42,465,284)	—
Purchase of capital assets	(210,532)	(208,885)
Cash used in investing activities	(120,839,697)	(72,775,395)
<b>FINANCING ACTIVITIES</b>		
(Repayments) proceeds of commercial paper, net	(76,074,732)	32,174,583
Gross proceeds of medium-term debt	165,000,000	296,889,000
Repayment of medium-term debt	(2,566,388)	(136,172)
Gross proceeds of subordinated debt	—	40,000,000
Capitalized debt issue costs	(714,350)	(1,467,736)
Decrease in Securitization trust debt	—	(185,594,190)
Distributions to unitholders	(14,623,053)	(14,844,087)
Proceeds from units issued under distribution reinvestment plan	1,168,966	1,833,708
Cash from financing activities	72,190,443	168,855,106
<b>Net (decrease) increase in cash and cash equivalents during the year</b>	<b>(69,116,065)</b>	<b>88,961,655</b>
Cash and cash equivalents, beginning of year	92,685,662	3,724,007
<b>Cash and cash equivalents, end of year (Note 13)</b>	<b>23,569,597</b>	<b>92,685,662</b>
<b>Supplemental cash flow information:</b>		
Interest paid	39,828,448	28,427,589
Taxes paid	—	21,312

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

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**1. ORGANIZATION AND BASIS OF PRESENTATION**

Home Equity Income Trust (the Trust) is an unincorporated open-end trust created on May 15, 2002 by a Declaration of Trust and governed by the laws of the Province of Ontario. The Trust invests in reverse mortgage portfolios and other permitted investments with the objective of providing stable distributions to unitholders while preserving capital.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The significant accounting policies are summarized as follows:

**Basis of consolidation**

These consolidated financial statements reflect the financial position and results of operations of the Trust, consolidated with the financial position and results of operations of its subsidiaries. The Trust's principal subsidiaries are Canadian Home Income Plan Corporation (CHIP), CHIP Mortgage Trust, Home Equity Mortgage Corporation and the CHIP Limited Partnerships (CHIP Mortgage Limited Partnership, CHIP Four Limited Partnership and CHIP Five Limited Partnership). Transactions and balances between the Trust and its subsidiaries are eliminated on consolidation.

**Financial assets and liabilities**

CICA Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and derivatives. It requires that financial assets and financial liabilities (including derivatives) be recognized on the balance sheet when the Trust becomes a party to a contract. All financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading (based on an intent to sell for short-term profit taking or through an optional irrevocable management election), held-to-maturity, available for sale, loans and receivables or other liabilities. Financial instruments that are designated as held-for-trading must have reliable fair values since they are required to be measured at fair value.

Under these standards, the Trust classifies its mortgages as loans receivable and carries them at amortized cost. The Trust's liabilities continue to be classified as other liabilities. Fair market values of the liabilities, as disclosed in the related notes, are determined using the period end market rates compared to the rates of the liability.

Under the transitional provisions of Section 3855, the Trust has recorded an adjustment to increase opening unitholders' equity by \$1,583,766 on January 1, 2007. The adjustment is related solely to the recognition of the fair value of derivative instruments at January 1, 2007.

**Cash and cash equivalents**

Cash equivalents consist of highly liquid investments readily convertible to known amounts of cash, with less than 90-day maturity from the date of acquisition. Cash and cash equivalents are designated as held for trading, and accordingly, are carried at fair value. Changes to fair value are recorded in the consolidated statement of operations and unitholders' equity. Investment interest is recognized on an accrual basis.

**Short-term investments**

Short-term investments consist of highly liquid investments, which have maturities greater than 90 days from the date of acquisition. Short-term investments are designated as held for trading, and accordingly, are carried at fair value. Changes to fair value are recorded in the consolidated statement of operations and unitholders' equity. Investment interest is recognized on an accrual basis.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Mortgages**

Mortgages are lifetime, interest accruing mortgages that are secured by residential real property. Interest is accrued monthly on all mortgages and is due together with repayment of the principal at the time the property is vacated by the homeowner(s) or when the property is sold, if earlier.

Mortgage loans are stated at amortized cost (including purchase price premiums, origination fees and commissions) plus accrued interest. Purchase price premiums, origination fees and commissions are deferred and expensed over the estimated period that mortgages earn interest. The carrying value of the mortgage loans approximates fair value as the prevailing interest rates reset in accordance with the provisions of the underlying mortgage terms.

A mortgage reserve is taken when, in the opinion of management, there is no longer reasonable assurance of the collection of the full amount of principal and interest. Mortgage reserves are determined based on the mortgage loan outstanding and the most recently appraised value of the underlying property. The Trust's policy is to cease accruing interest income on a mortgage having a loan-to-value ratio greater than 83%. In addition, the remainder of the portfolio is evaluated using specific criteria to establish a portfolio reserve.

Mortgage early repayment fees are recorded as revenue when received.

**Prepaid expenses**

Prepaid expenses are stated at cost and are amortized over the lesser of two years or their expected beneficial life.

**Income taxes**

The Trust qualifies as a mutual fund trust under the Income Tax Act (Canada). The Trust intends to distribute all or substantially all of its taxable income to the unitholders. Income tax obligations relating to the distributions are the obligations of the unitholders and accordingly, no current tax provision for income taxes on the income of the Trust has been made. In June 2007 new legislation was enacted imposing additional income taxes upon publicly traded income trusts, including HOMEQ, effective January 1, 2011. In October 2007, the CICA Emerging Issues Committee issued EIC 167, Future Income Tax Liabilities for Income Trusts and Other Specified Investment Flow-Throughs, dealing with the impact of the enactment of the legislation on the recognition of future income tax assets or liabilities by an income trust. Prior to June 2007, in accordance with CICA Handbook section 3465, the Trust estimated the future income tax on certain temporary differences between amounts recorded on its balance sheet for book and tax purposes at a nil effective tax rate. Under the new legislation, the Trust now estimates the effective tax rate on the reversal of these temporary differences in 2011 to be 29.5% and post 2011 to be 28.0%. Temporary differences reversing before 2011 will still give rise to nil future income taxes.

Future income taxes are determined using the asset and liability method. Under this method of tax allocation, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Future income tax assets are recognized to the extent that realization is considered more likely than not.

**Property and equipment**

Computer hardware and software are recorded at cost and amortized on a straight-line basis over three to four years. Furniture and equipment are stated at cost and are amortized on a straight-line basis over a term of seven years. Leasehold improvements are recorded at cost and are amortized on a straight-line basis over the term of the related lease. The amortization expense is recognized in the consolidated statement of operations and unitholders' equity.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)****Derivative financial instruments**

The Trust uses derivative instruments such as interest rate swaps and forward rate agreements effectively matching the term of its medium-term and subordinated debt to the term of the mortgage portfolio to ensure a relatively stable interest rate spread. Derivatives are classified as held-for-trading and are measured at fair value. Unrealized gains or losses from changes in fair value are recognized in the consolidated statement of operations and unitholders' equity. Fair market values of the derivative instruments are determined using the period end market rates compared to the rates in the derivative contract. Realized amounts receivable or payable on derivatives are accrued and recorded as adjustments to interest expense in the consolidated statement of operations and unitholders' equity.

The Trust does not hold or use any derivative contracts for speculative trading purposes. Derivative instruments used are entered into with Schedule 1 Canadian chartered banks to reduce any counterparty risk associated with derivatives.

**Hedge accounting**

CICA Section 3865, *Hedges* specifies the requirements for the use of hedge accounting. When the Trust applies hedge accounting, at the inception of a hedging relationship, the Trust documents the relationship between the hedging instrument and the hedged item, its risk management objective and its strategy for undertaking the hedge. In order to be deemed effective, the hedging instrument and the hedged item must be highly and inversely correlated such that the changes in fair value of the hedging instrument will substantially offset the effects of the hedged exposure to the Trust throughout the term of the hedging relationship. If a hedge relationship becomes ineffective, it no longer qualifies for hedge accounting and any subsequent change in fair value of the hedging instrument is recognized in earnings.

**Comprehensive income**

CICA Section 1530, *Comprehensive Income*, requires the presentation of a Statement of Comprehensive Income where certain gains and losses that would otherwise be recorded as part of net earnings are presented in other comprehensive income until it is considered appropriate to recognize it in net earnings. The Trust does not have any material income from this source and as such a Statement of Comprehensive Income has not been included in these financial statements.

**Goodwill**

Goodwill reflects the purchase price paid on acquisition of CHIP in excess of the fair market value of net tangible assets and identifiable intangible assets acquired. Goodwill is not amortized but is tested for impairment annually.

**Transaction costs**

Debt issue costs incurred by the Trust are capitalized and are included in medium-term debt, subordinated debt and securitization trust debt. These costs are amortized and included in interest expense in the consolidated statement of operations and unitholders' equity. The Trust does not incur any transaction costs related to financial instruments that are designated as held-for-trading.

**Securitization Trust debt**

Prior to December 31, 2007 special purpose trusts (the Securitization Trusts) raised debt to fund the mortgage portfolios held by the CHIP Limited Partnerships. The Securitization Trusts were limited partners in the CHIP Limited Partnerships. Interest on the Securitization Trusts' debt was recorded on an accrual basis and included in interest expense in the consolidated statement of operations and unitholders' equity. As of December 31, 2007, there was no securitization trust debt outstanding and the Securitization Trusts were no longer limited partners in the CHIP Limited Partnerships.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Fair value of financial instruments**

Except as otherwise indicated in the notes to these consolidated financial statements, the carrying values of the Trust's financial instruments approximate their fair values.

**Long-term incentive plans**

Trustees and senior executives participate in long-term incentive plans under which they are eligible to receive Trust units. The plans consist of a restricted unit plan for senior executives and deferred unit plan for Trustees. The restricted units vest equally over three years. The benefit resulting from the issue of units under this plan is recorded as salaries and benefits expense in the consolidated statement of operations and unitholders' equity, on a straight-line basis over the vesting period, based on the market price of the Trust units on the date of grant. The deferred unit plan allows the Trustees to defer a portion of their compensation until they retire from the Board and receive the equivalent amount in units of the Trust. The amount deferred during the year is recorded as professional services expense in the consolidated statement of operations and unitholders' equity. As the Trust intends to settle its obligations related to these plans by issuing units, the Trust's obligations under these plans are presented within unitholders' equity.

**Net income per Trust unit**

Net income per Trust unit is calculated based on the average number of Trust units outstanding during the year.

**Use of estimates**

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**3. CHANGES IN ACCOUNTING POLICIES**

**Capital Disclosures**

Effective January 1, 2008 the CICA's new accounting standard, Section 1535, *Capital Disclosures*, was implemented, which requires the disclosure of both qualitative and quantitative information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital. The new guidance did not have an effect on the financial position or the earnings of the Trust. See Note 14.

**Financial Instruments**

Effective January 1, 2008, the accounting and disclosure requirements of the CICA's two new accounting standards, Section 3862, *Financial Instruments – Disclosures*, and Section 3863, *Financial Instruments – Presentation* were implemented. Section 3862 requires the disclosure of the significance of financial instruments for the Trust's financial position, performance and cash flows and the nature and extent of risks arising from financial instruments to which the Trust is exposed during the year and at the balance sheet date, and how the entity manages those risks. Section 3863 carries forward, unchanged, the presentation requirements of Section 3861, *Financial Instruments – Disclosure and Presentation*.

The new guidance did not have a material effect on the financial position or earnings of the Trust. The Trust is exposed to a variety of financial risks in the normal course of business. The financial risk management objectives are described in the Management Discussion and Analysis. The new disclosures required under Section 3862 are included in Note 15.

## HOME EQUITY INCOME TRUST

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

#### 4. SHORT-TERM INVESTMENTS

Short-term investments consist of treasury bills, term deposits and corporate notes, which have maturities greater than 90 days from the date of acquisition. The maturity dates of these short-term investments range from February 2009 to May 2009. The yield on these investments ranges between 1.1% and 3.0% with a weighted average rate of 2.0%.

	Due in 1 year or less	Due after 1 year	Carrying value as at December 31,	
			2008	2007
			\$	\$
Treasury bills and term deposits	32,916,602	—	32,916,602	—
Corporate notes	9,548,682	—	9,548,682	—
	42,465,284	—	42,465,284	—

#### 5. MORTGAGES

The following table shows the details of the mortgage balance on the consolidated balance sheet:

	As at December 31,	
	2008	2007
	\$	\$
Mortgage principal plus accrued interest	814,195,059	707,773,208
Mortgage purchase price premiums, net of accumulated amortization	36,839,402	40,282,883
Mortgage origination fees, net of accumulated amortization	2,537,688	2,770,134
Deferred commissions, net of accumulated amortization	15,398,822	11,852,368
Less: portfolio reserves	(407,746)	(250,964)
	868,563,225	762,427,629

Mortgages with a loan-to-value ratio of greater than 83% at December 31, 2008 totaled \$556,100 (December 31, 2007 - \$291,136) and the appraised value of the underlying properties was \$670,000 (December 31, 2007 - \$350,500).

The following table shows the details of mortgage interest on the consolidated statement of operations and unitholders' equity:

	For the years ended December 31,	
	2008	2007
	\$	\$
Interest income	60,908,616	55,883,921
Early repayment fees	1,028,403	1,194,823
(Increase) decrease in portfolio reserves	(156,782)	54,090
Less: Amortization of deferred commissions	(1,514,772)	(1,011,212)
Amortization of purchase price premiums and origination costs	(3,676,271)	(3,833,392)
	56,589,194	52,288,230

## HOME EQUITY INCOME TRUST

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

#### 6. FUTURE INCOME TAXES

The tax effects of temporary differences of the Trust that give rise to the future income tax assets and liabilities are presented below:

Future Income Tax Assets	As at December 31,	
	2008	2007
	\$	\$
Capital assets	38,913	28,352
Non-capital loss carry forwards	37,902	97,923
	<b>76,815</b>	126,275

The future income taxes of the non-capital losses carried forward represents the tax effect of the Trust's subsidiaries' losses from prior years for which it is more likely than not that a future income tax asset will be realized, determined at statutory rates.

As at December 31, 2008, the Trust's subsidiaries had non-capital losses carried forward of \$113,140. The non-capital losses expire as follows: 2010 – \$49,229, 2014 – \$41,638 and 2015 – \$22,273.

Future Income Tax Liabilities	As at December 31,	
	2008	2007
	\$	\$
Mortgages	6,838,635	6,838,635
Derivative instruments	6,251,459	58,991
	<b>13,090,094</b>	6,897,626

In June 2007 the Department of Finance enacted new legislation imposing additional income taxes upon publicly traded income trusts, including HOMEQ, effective January 1, 2011. Prior to June 2007, in accordance with CICA Handbook section 3465, the Trust estimated the future income tax on certain temporary differences between amounts recorded on its balance sheet for book and tax purposes at a nil effective tax rate. Under the new legislation, the Trust now estimates the effective tax rate on the reversal of these temporary differences in 2011 to be 29.5% and post 2011 to be 28.0%. Temporary differences reversing before 2011 will still give rise to nil future income taxes.

While the Trust believes it will be subject to additional tax under the new legislation, the estimated effective tax rate on temporary difference reversals after 2011 may change in future periods.

The Trust's tax provision relates to income earned in the Trust's corporate subsidiaries and the impact of the taxes estimated to be paid by the trust after 2010. The reconciliation of these subsidiaries' statutory and effective rates of tax is as follows:

	As at December 31,	
	2008	2007
Statutory rate	<b>33.5%</b>	35.6%
	\$	\$
Income before taxes	<b>35,775,094</b>	8,529,314
Tax calculated at statutory rate	11,984,656	3,036,436
Increase (decrease) in income taxes resulting from:		
Income distributed to unitholders	(11,984,656)	(2,949,846)
Recovery of taxes	—	(49,061)
Impact of rate change on income trusts	6,192,468	6,897,625
Other	49,460	8,989
Income tax provision recorded during the year	<b>6,241,928</b>	6,944,143

## HOME EQUITY INCOME TRUST

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

#### 7. PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	Cost	Accumulated amortization	As at December 31,	
			2008 Net book value	2007 Net book value
	\$	\$	\$	\$
Computer hardware and software	1,329,509	1,037,720	291,789	359,938
Furniture and equipment	291,242	232,407	58,835	48,939
Leasehold improvements	651,850	346,272	305,578	339,468
			656,202	748,345

#### 8. COMMERCIAL PAPER

On May 22, 2008, the Trust repaid all outstanding commercial paper. The Trust terminated its liquidity loan facility of \$120,000,000 which previously backed its commercial paper program effective May 22, 2008. At December 31, 2007 commercial paper outstanding had a weighted average interest rate of 5.31% and matured on or before May 1, 2008. Included in the commercial paper balance at December 31, 2007 was \$713,716 of accrued interest payable.

#### 9. MEDIUM-TERM DEBT

The following table summarizes the medium-term debt outstanding as at December 31, 2008.

Series	Expected final payment	Interest basis	Interest rate at December 31, 2008	December 31, 2008	Fair Market Value	December 31, 2007
				\$	\$	\$
2007-1	Nov 1, 2009	Fixed rate	5.407%	150,000,000	151,158,750	150,000,000
2005-1	Nov 1, 2010	Fixed rate	4.296%	110,000,000	109,114,445	110,000,000
2007-3	May 2, 2011	Fixed rate	5.613%	125,000,000	126,668,125	125,000,000
2008-1	May 16, 2011	Fixed rate	5.764%	165,000,000	167,424,675	—
2006-3	Aug 1, 2012	Fixed rate	4.542%	115,000,000	111,221,100	115,000,000
2006-1	Feb 1, 2013	Fixed rate	4.637%	105,000,000	100,827,563	105,000,000
2007-2	Jun 15, 2013	Floating rate (1)	3.941%	19,186,440	18,563,648	21,752,828
				789,186,440	784,978,306	626,752,828
Interest payable				8,721,545		7,263,266
Interest payable on derivative instruments				1,250,507		2,501,602
Interest receivable on derivative instruments				(1,053,154)		—
Debt issue costs, net of accumulated amortization				(2,168,627)		(2,455,666)
Adjustment in carrying value of hedged debt (see Note 15)				8,360,239		—
				804,296,950		634,062,030

(1) Rate is reset each May 1<sup>st</sup> and November 1<sup>st</sup> based on the six-month Government of Canada Treasury Bill rate plus 1.283%

The Trust has a best efforts obligation to refinance the series 2006-3, 2007-1, 2007-3 and 2008-1 notes on the respective expected final payment dates. If a note remains outstanding after the expected final date the interest will become the one-month Bankers' Acceptance rate plus the following spreads calculated and payable monthly; 2006-3 – 1.25%, 2007-1 – 2.00%, 2007-3 – 3.00% and 2008-1 – 4.00% until legal maturity. The legal maturity dates of these notes range from August 1, 2031 to May 16, 2033. Fair value of medium-term debt is determined using average quoted market rates provided to the Trust by capital market dealers.

## HOME EQUITY INCOME TRUST

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

#### 10. SUBORDINATED DEBT

The following table summarizes the subordinated debt outstanding as at December 31, 2008.

Series	Expected final payment	Interest basis	Interest rate at December 31, 2008	December 31, 2008	Fair market value	December 31, 2007
				\$	\$	\$
2007-1B	Nov 1, 2012	Fixed rate	6.663%	<b>20,000,000</b>	19,649,500	20,000,000
2007-2B	Jun 15, 2013	Fixed rate	7.582%	<b>20,000,000</b>	21,422,400	20,000,000
2006-2B	Aug 1, 2013	Fixed rate	5.803%	<b>20,000,000</b>	18,940,500	20,000,000
				<b>60,000,000</b>	60,012,400	60,000,000
Interest payable				<b>830,117</b>		904,974
Interest payable on derivative instruments				—		386
Interest receivable on derivative instruments				<b>(70,608)</b>		(7,521)
Debt issue costs, net of accumulated amortization				<b>(352,760)</b>		(464,867)
				<b>60,406,749</b>		60,432,972

The Trust has a best efforts obligation to refinance the series 2006-2B and 2007-1B notes on the respective expected final payment dates. If a note remains outstanding after the expected final date the interest will become the one-month Bankers' Acceptance rate plus the following spreads calculated and payable monthly; 2006-2B – 1.75%, 2007-1B – 3.50% until legal maturity. The legal maturity dates of these notes range from August 1, 2031 to November 1, 2032. The series 2007-2B note is repayable after the 2007-2 Medium Term Note is repaid in full. Fair value of medium-term debt is determined using average quoted market rates provided to the Trust by capital market dealers.

#### 11. INTEREST EXPENSE

The following table summarizes interest expense on the consolidated statement of operations and unitholders' equity:

	For the year ended December 31,	
	2008	2007
	\$	\$
Interest on commercial paper & liquidity line <sup>(1)</sup>	<b>1,154,435</b>	4,248,329
Interest on medium-term notes <sup>(2)</sup>	<b>34,449,453</b>	17,162,881
Interest on subordinated debt <sup>(2)</sup>	<b>2,674,972</b>	1,664,983
Interest on securitization trust debt <sup>(3)</sup>	—	8,907,791
Commercial paper expenses	<b>78,167</b>	234,852
Amortization of debt issue costs	<b>1,113,496</b>	649,338
	<b>39,470,523</b>	32,868,174

(1) On May 22, 2008, the Trust repaid all outstanding commercial paper.

(2) Included in interest on medium-term notes and interest on subordinated debt are realized gains and losses on derivative instruments.

(3) Securitization trust debt of \$140,000,000 matured and was repaid on November 15, 2007. Securitization trust debt of \$45,565,209 was redeemed on December 17, 2007.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

## 12. UNITHOLDERS' EQUITY

An unlimited number of Trust units may be issued by the Trust pursuant to the Declaration of Trust. Each unit represents an equal, undivided beneficial interest in any distributions from the Trust and in the net assets of the Trust. All units are of the same class with equal rights and privileges and are not subject to future calls or assessments. Each unit entitles the holder to one vote at all meetings of unitholders.

	Number of units	Proceeds
Balance, December 31, 2006	13,735,657	\$
Units issued under distribution reinvestment plan	151,973	1,833,708
Units earned and granted under the long-term incentive plans <sup>(1)</sup>	45,417	475,897
	197,390	2,309,605
Balance, December 31, 2007	13,933,047	
Units issued under distribution reinvestment plan	148,456	1,168,966
Units earned and granted under the long-term incentive plans <sup>(1)</sup>	42,046	442,885
	190,502	1,611,851
<b>Balance, December 31, 2008</b>	<b>14,123,549</b>	

(1) Includes vested, non-vested and cancelled units.

The Trust has two long-term incentive plans; a Restricted Unit Plan (RUP) for management and a Deferred Unit Plan (DUP) for Trustees.

A unit granted through the RUP entitles the holder to receive, on the vesting date, a Trust unit plus the amount of cash distributions that would have been paid on the unit if it had been issued on the date of grant. The maximum number of units that may be issued under the RUP is 250,000. Subject to the achievement of performance conditions, if any, restricted units vest equally over three years and the total cost of the grant is recognized over the vesting period. As at December 31, 2008, 136,920 restricted units have been issued since the inception of the plan, 79,696 units remain within the plan of which 28,400 have vested.

The DUP allows the Trustees to defer a portion of their compensation and receive the equivalent amount in units of the Trust. When the Trustee retires from the Board they will receive all deferred units accumulated in the plan. The maximum number of units that may be issued under the DUP is limited to 150,000. As at December 31, 2008, the Trustees have earned 90,261 units under the DUP.

For the year ending December 31, 2008, Trustees fees and executive compensation expense under the long-term incentive plans was \$442,885 (December 31, 2007 - \$475,897).

The Trust intends to settle the restricted and deferred units in real units of the Trust upon vesting and retirement respectively. Until such time, these units do not trade on the Toronto Stock Exchange, have no voting rights and cannot be sold or liquidated early.

The Trust's optional distribution reinvestment plan (DRIP) allows eligible Canadian unitholders to elect to have their cash distributions from the Trust automatically reinvested in additional units. Unitholders who participate in the DRIP will receive a further bonus distribution of units equal in value to 4% of each distribution that was reinvested. The Trust suspended the DRIP on July 16, 2008.

## HOME EQUITY INCOME TRUST

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

#### 13. CONSOLIDATED STATEMENTS OF CASH FLOW

Net change in Other non-cash working capital balances is detailed as follows:

	As at December 31,	
	2008	2007
	\$	\$
Prepaid expenses	(112,514)	4,783
Accounts payable and accrued liabilities	(956,122)	1,185,402
Income taxes payable	—	(70,373)
	<b>(1,068,636)</b>	<b>1,119,812</b>

Cash and cash equivalents at the balance sheet dates are comprised of the following:

	As at December 31,	
	2008	2007
	\$	\$
Cash	<b>6,087,201</b>	13,514,137
Cash equivalents	<b>17,482,396</b>	79,171,525
	<b>23,569,597</b>	<b>92,685,662</b>

#### 14. CAPITAL MANAGEMENT

The main objectives in managing the Trust's capital resources are to have funds available to grow the mortgage portfolio and to be able to generate stable, monthly cash distributions to unitholders. The Trust's capital resources have consisted of cash and cash equivalents, short-term investments, senior debt, consisting of medium-term notes and commercial paper, access to credit facilities, subordinated debt, and issued trust units.

Historically HOMEQ has used cash flows from operating activities to fund the Trust's operations and distributions, and the excess of those cash flows coupled with borrowings under its debt programs have been used to fund growth in the mortgage portfolio. Due to the current capital market conditions the Trust is carrying substantially higher cash balances than in the past to provide a ready source of funds for new originations.

The Trust's borrowings are subject to debt-to-mortgage covenants under its indenture. The covenants are: a maximum senior debt-to-mortgage ratio of 93% when it has commercial paper outstanding, a maximum of 95% when its senior rated debt consists only of medium-term notes and a maximum total debt-to-mortgage ratio of 98%. HOMEQ is also required to maintain minimum cash on hand equivalent to two percent of the CMT mortgage portfolio value. At December 31, 2008, the senior debt-to-mortgage ratio was 89.1%, the total debt-to-mortgage ratio was 96.3% and the Trust held more than the required amount of cash. The Trust closely monitors business performance to evaluate compliance with these covenants. In 2008, the Trust has focused on initiatives and strategies which, despite persistent difficult conditions in the capital markets, have maintained normal operations and growth. The exposure to short-term refinancing risk has for the time being been addressed by raising term debt well in advance of any cash requirements.

Equity capital, in the form of trust units, has been raised each month through the Trust's Distribution Reinvestment Plan up to July 2008. In addition, to manage its leverage as the mortgage portfolio grows, the Trust may issue additional units or subordinated debt in the future.

On May 22, 2008, the Trust repaid all outstanding commercial paper. The Trust terminated its liquidity loan facility of \$120,000,000 which previously backed its commercial paper program effective May 22, 2008.

The total capital managed at December 31, 2008 was approximately \$1.1 billion (December 31, 2007, \$957.9 million).

## HOME EQUITY INCOME TRUST

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

#### 15. DERIVATIVE INSTRUMENTS

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

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

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

#### Fair Values

Fair market values of the interest rate derivatives are determined using the period end market rates compared to the rates in the derivative contract. Changes in fair value resulting in unrealized gains or losses are recorded in the consolidated statement of operations and unitholders' equity.

#### Notional Amounts

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

The following table summarizes the fair values, notional principal and weighted average rates of the derivative instruments outstanding as at December 31, 2008. The floating rate for all instruments is based on the CDOR rate for terms ranging from one to twelve months.

	Weighted average rate		Notional principal		Fair values	
	December 31, 2008	December 31, 2007	December 31, 2008	December 31, 2007	December 31, 2008	December 31, 2007
<b>Interest rate contracts</b>						
Swaps			\$	\$	\$	\$
Receive fixed	4.223%	4.529%	815,000,000	535,000,000	44,510,587	2,053,213
Pay fixed	—	3.862%	—	78,000,000	—	343,361
			<b>815,000,000</b>	<b>613,000,000</b>	<b>44,510,587</b>	<b>2,396,574</b>
Forward Rate Agreements						
Receive fixed	2.764%	4.275%	40,000,000	40,000,000	169,022	23,443
Pay fixed	—	4.460%	—	90,000,000	—	37,844
			<b>40,000,000</b>	<b>130,000,000</b>	<b>169,022</b>	<b>61,287</b>
<b>ASSETS</b>					<b>44,679,609</b>	<b>2,457,861</b>
Swaps						
Receive fixed	—	4.099%	—	130,000,000	—	939,545
Pay fixed	3.904%	4.550%	127,000,000	69,000,000	7,464,842	407,329
			<b>127,000,000</b>	<b>199,000,000</b>	<b>7,464,842</b>	<b>1,346,874</b>
Forward Rate Agreements						
Receive fixed	—	4.563%	—	245,000,000	—	70,605
Pay fixed	2.283%	5.080%	136,000,000	20,000,000	484,997	33,788
			<b>136,000,000</b>	<b>265,000,000</b>	<b>484,997</b>	<b>104,393</b>
<b>LIABILITIES</b>					<b>7,949,839</b>	<b>1,451,267</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

## 15. DERIVATIVE INSTRUMENTS (Continued)

**Maturity Terms**

The following table summarizes the maturity terms of derivative instruments outstanding as at December 31, 2008. Maturity dates range from November 2008 to August 2013.

Notional principal (\$ thousands)	Remaining term to maturity				December 31,	December 31,
	Within 1 year	1 to 3 years	3 to 5 years	Over 5 years	2008 Total	2007 Total
Swaps	170,000	446,000	326,000	—	942,000	812,000
Forward rate agreements	176,000	—	—	—	176,000	395,000

**Fair Value Hedges**

The Trust's fair value hedges principally consist of interest rate swaps that are used to protect against changes in fair value of fixed-rate medium-term debt due to movements in market interest rates. Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded as unrealized (gains) losses on derivative instruments in the consolidated statement of operations and unitholders' equity, along with adjustments to the carrying value of the financial instruments that are attributable to the hedged risk.

**Hedge Accounting Results**

During the year ended December 31, 2008, the Trust entered into interest rates swaps, having a notional amount of \$159 million, to hedge \$159 million of the \$165 million fixed rate medium-term debt issued during the period. The objective of these hedges is to protect against changes in the fair value of the fixed rate medium-term debt due to changes in the underlying benchmark interest rate. The Trust elected under Section 3865 – *Hedges* to apply hedge accounting for these interest rates swaps.

The hedges are effective at December 31, 2008. The fair value of these swaps is positive \$8,300,353 at December 31, 2008 and is recorded as derivative instruments asset on the balance sheet. The Trust has recorded \$8,300,353 of change in fair value of the derivative to unrealized (gain) loss on derivative instruments in the consolidated statement of operations and unitholders' equity. The carrying value of fixed-rate medium-term debt has been adjusted by the same amount with a corresponding debit to unrealized (gain) loss on derivative instruments in the consolidated statement of operations and unitholders equity (See Note 9). A loss of \$59,886 arising from hedge ineffectiveness was recorded for the year ended December 31, 2008.

**Derivative –related risks****Market risk**

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

**Credit risk**

Credit risk on derivative financial instruments is the risk of a financial loss occurring as a result of a default of a counterparty on its obligation to the Trust. Credit risk is limited by dealing only with Schedule 1 Canadian Chartered banks as counterparties. The maximum derivative credit exposure to the Trust is the fair value of derivative contracts presented in the summary table above. The Trust's exposure to risks arising from other financial instruments is disclosed in Note 16.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

## 16. FINANCIAL INSTRUMENTS – FINANCIAL RISKS

**Credit Risk**

Credit risk is the potential for financial loss if a borrower or counterparty in a transaction fails to meet its obligations in accordance with agreed terms. Credit risk on the Trust's Cash and Cash Equivalents is mitigated by maintaining cash balances at Schedule 1 Canadian Chartered banks. Credit risk on the mortgage loans is mitigated by following Board approved underwriting policies. In particular, during the underwriting process every property is appraised by a certified appraiser with particular attention paid to the property type, location and days on market of each comparative property. The initial appraised value is subsequently discounted, typically by between 7.5% and 30%. A rate of future appreciation of up to 0.5% per annum is assumed, in comparison with the Canadian average of approximately over 3.45% for the past 20 years. Each mortgage originated is limited in maximum dollar amount and loan-to-value ratio in accordance with internal guidelines. The Trust also obtains a first charge on the underlying property securing the mortgage. Credit risk is mitigated further by the geographic diversity and the collateralization of the portfolio by mortgages with an appraised value of \$2.3 billion.

The following tables show the composition of the mortgage portfolio by loan-to-value ratio range and geographic distribution.

Mortgage Portfolio – by Loan-to-Value	Dollar Volume As At		Percentage As At	
	December 31, 2008	December 31, 2007	December 31, 2008	December 31, 2007
	\$	\$	%	%
Less than 30.0%	171,280,461	150,895,239	21.0	21.3
30.1% - 40.0%	225,848,888	202,198,370	27.7	28.6
40.1% - 50.0%	226,884,011	179,339,048	27.9	25.3
50.1% - 60.0%	130,055,878	113,650,191	16.0	16.1
60.1% - 70.0%	53,018,395	50,304,123	6.5	7.1
Greater than 70.1%	7,107,426	11,386,237	0.9	1.6
	<b>814,195,059</b>	<b>707,773,208</b>	<b>100.0</b>	<b>100.0</b>

Mortgage Portfolio – by Province	Dollar Volume As At		Percentage As At	
	December 31, 2008	December 31, 2007	December 31, 2008	December 31, 2007
	\$	\$	%	%
Ontario	348,891,247	322,744,475	42.9	45.6
British Columbia	296,757,845	249,060,292	36.4	35.2
Alberta	94,274,395	76,032,421	11.6	10.7
Quebec	44,605,654	36,564,009	5.5	5.2
Other	29,665,918	23,372,011	3.6	3.3
	<b>814,195,059</b>	<b>707,773,208</b>	<b>100.0</b>	<b>100.0</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

## 16. FINANCIAL INSTRUMENTS – FINANCIAL RISKS – (Continued)

## Liquidity Risk

Liquidity risk is the risk that the Trust will not be able to meet its obligations when they are due. The Trust mitigates these risks by issuing only highly rated debt, by using a syndicate of several dealers to issue debt, and by staggering the maturities of its debt obligations. The following table summarizes the expected final payment dates of debt principal:

In \$ thousands	Within 1 year	More than 1 year and 2 years or less	More than 2 years and 5 years or less	More than 5 years	December 31, 2008 Total	December 31, 2007 Total
Interest payable on medium-term debt	8,722	—	—	—	8,722	7,263
Interest payable on subordinated debt	830	—	—	—	830	905
Interest payable on derivative instruments	1,250	—	—	—	1,250	2,502
Debt principal						
Commercial Paper	—	—	—	—	—	76,788
Medium-Term Debt	150,000	110,000	529,186	—	789,186	626,753
Subordinated Debt	—	—	60,000	—	60,000	60,000
<b>Total</b>	<b>160,802</b>	<b>110,000</b>	<b>589,186</b>	<b>—</b>	<b>859,988</b>	<b>774,211</b>

## Interest Rate Risk

The Trust's operating margin is primarily derived from the spread between interest earned on the mortgage portfolio, and the interest paid on the debt used to fund the portfolio. Mortgages have various interest rate reset terms, ranging from variable to five-year. The interest on the majority of the Trust's debt is fixed until maturity. The Trust uses derivative contracts to match the rate reset terms of the debt portfolio to that of the mortgage portfolio, to mitigate any fluctuations that changes to the underlying benchmark rates may have on its operating margin at the time of the mortgage resets.

Interest rates on approximately 93 percent of the mortgage portfolio are based on the Government of Canada Treasury-bill and bond rates whereas interest rates on the debt and derivative instruments are based on the Bankers' Acceptances rates. Historically, changes in interest rates do not impact each benchmark rate equally which may result in a reduction in spread. The following sensitivity analysis shows the annualized impact of a 50 basis point change on each of the underlying benchmark rates individually on the current mortgage and debt portfolios respectively.

	Interest Income	Interest Expense
	\$	\$
50 basis point increase	4,070,927	4,245,934
50 basis point decrease	(4,070,927)	(4,245,934)

These sensitivities are hypothetical and should be used with caution.

## 17. COMMITMENTS

The Trust's annual lease obligations are as follows:	\$
2009	462,263
2010	470,041
2011	478,052
2012	486,303
2013 and thereafter	294,102

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2008

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**18. FUTURE CHANGES IN ACCOUNTING POLICIES**

**Goodwill, Intangible Assets and Financial Statement Concepts**

The CICA issued a new accounting standard, *Section 3064, Goodwill and Intangible Assets*, which clarifies that costs can be deferred only when they relate to an item that meets the definition of an asset, and as a result, start-up costs must be expensed as incurred. *Section 1000, Financial Statement Concepts*, was also amended to provide consistency with the new standard. These new standards are effective for the Trust beginning on January 1, 2009. The impact of these standards will be that certain items previously included in prepaid expenses which were deferred and amortized, will be expensed as period costs when incurred.

**International Financial Reporting Standards**

The CICA will transition Canadian GAAP for publicly accountable entities to International Financial Reporting Standards (IFRS). The Trust's consolidated financial statements will be prepared in accordance with IFRS for the fiscal year commencing January 1, 2011. The impact of the transition to IFRS on the Trust's consolidated financial statements is not yet determinable.

**Credit Risk and the Fair Value of Financial Assets and Financial Liabilities**

Due to mixed practice on whether an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of a derivative instrument, the CICA's Emerging Issues Committee released *EIC-173 Abstract, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities*. The EIC requires the inclusion of credit risk of the counterparty and the Trust in determining the fair value of derivative instruments for periods after January 20, 2009. The EIC requires retrospective adoption without restatement of prior periods. The Trust will adopt the accounting treatment in the first quarter of 2009.

**19. SUBSEQUENT EVENT**

On February 3, 2009 the Trust announced that it will convert its business structure from an income trust to a taxable corporation subject to unitholder approval. HOMEQ plans to call a meeting of unitholders for the last week of April 2009 to approve this conversion. A circular providing information about the conversion will be distributed to unitholders in advance of the meeting.

**20. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS**

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2008 consolidated financial statements.

## **CORPORATE INFORMATION**

### **REGISTRAR AND TRANSFER AGENT**

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100 University Avenue  
Toronto, Ontario M5J 2Y1  
For any inquires please call:  
Toll free: 1-800-663-9097

### **TRUST UNITS**

The units of the Trust are listed on the  
Toronto Stock Exchange under the  
symbol HEQ.UN

For further information, please contact:

#### **Gary Krikler, CA**

Senior Vice President and Chief Financial Officer

or

#### **Scott G. Cameron, CA**

Vice President, Finance



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