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**ANNUAL MANAGEMENT  
DISCUSSION & ANALYSIS 2009**

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<b>Financial highlights (\$ thousands except per share and percentage amounts)</b>	Three months ended December 31,		Twelve months ended December 31,	
	<b>2009</b>	2008	<b>2009</b>	2008
<b>OPERATING RESULTS</b>				
Net income (loss)	<b>345</b>	15,775	<b>(1,827)</b>	29,533
Per share	<b>0.024</b>	1.117	<b>(0.129)</b>	2.099
Adjusted net income (loss) (1)	<b>1,815</b>	1,544	<b>7,386</b>	5,636
Per share	<b>0.127</b>	0.103	<b>0.520</b>	0.401
Return on equity (annualized)	<b>1.4%</b>	60.5%	<b>(1.7%)</b>	28.9%
Adjusted return on equity (annualized) (2)	<b>8.4%</b>	6.9%	<b>8.4%</b>	6.2%
Spread income (3)	<b>6,627</b>	5,562	<b>23,315</b>	21,280
Spread percentage	<b>3.15%</b>	2.99%	<b>3.12%</b>	3.10%
Dividends per share	<b>0.14</b>	0.21	<b>0.56</b>	1.02
Mortgage originations	<b>43,365</b>	24,554	<b>110,195</b>	129,622
Trailing four quarter origination cost %	<b>9.5%</b>	9.6%	<b>9.5%</b>	9.6%
Trailing four quarter administration expense %	<b>0.69%</b>	0.67%	<b>0.69%</b>	0.67%
<b>BALANCE SHEET HIGHLIGHTS</b>				
Total assets			<b>1,016,563</b>	999,944
Mortgage principal plus accrued interest			<b>865,659</b>	814,359
Medium term debt			<b>792,328</b>	804,297
Subordinated debt			<b>50,335</b>	60,407
<b>PORTFOLIO QUALITY</b>				
Appraised value of underlying properties			<b>2,413,923</b>	2,282,840
Average loan to value			<b>35.9%</b>	35.7%
Non-accrual mortgage value			<b>1,492</b>	556
Allowance for credit losses			<b>2,149</b>	408

(1) Adjusted net income (loss) is explained in the Financial Results section on page 10 of the MD&A

(2) Adjusted return on equity is explained in the Financial Results section on page 10 of the MD&A

(3) Spread income, a non-GAAP measure, as discussed on pages 17 and 18 of the MD&A



## **TO OUR SHAREHOLDERS:**

We are pleased to report significant developments in the evolution of HOMEQ Corporation (HOMEQ) over the past year.

In mid 2008, we assessed that the fallout from the international credit crisis would be prolonged. As a result of the crisis, wholesale funding became scarcer—and more costly. To address this, we sought diversified and reliable funding sources. To ensure a consistent supply of funding we exercised a long-term strategy and applied to become a federally regulated Schedule I Bank.

After 12 months of focused effort, in a climate of rigorous scrutiny by regulators, our subsidiary received its Schedule I status as HomEquity Bank on October 13, 2009. With this designation, HOMEQ accesses funding from retail deposits to supplement its existing wholesale funding strategy.

At the core of HomEquity Bank is a trusted brand, a popular product line, and effective customer and partner relationships. As part of our new mandate, we implemented operating, control and compliance platforms consistent with the requirements for a deposit taking institution. We were entitled to commence deposit taking immediately upon designation as a Bank. Of note, during the last quarter, we raised sufficient deposits to finance our record origination volume.

November 2009 is a milestone for the widespread acceptance of the reverse mortgage option. Although reverse mortgage rates were at an historic low, to attract new customers to our product, we lowered the rates to as low as 3.75%. The positive impact on origination volume was immediate and significant. The record \$43 million origination volume in the fourth quarter of 2009 was an increase of 11% over the previous record in the second quarter of 2008. This growth attests to the transition of a formerly niche product to one with more widespread acceptance.

Reverse mortgages offer seniors greater flexibility in financing their retirement lifestyles. Our competitive pricing structure will turn our products into mainstream ones, grow the size of our mortgage portfolio and raise the barrier-to-entry among competitors.

Although the initial quarters of the year were challenging, in 2009 our mortgage portfolio expanded, spreads improved, and our adjusted net income improved considerably from the year prior. Our portfolio is well secured and our capital structure is strong. As well, during the year, we successfully issued \$150 million of medium-term notes at competitive rates. These proceeds repaid an equivalent amount of medium-term notes that matured on November 1, 2009.

This annual report, including management discussion and analysis, and financial statements are consistent with a financial institution, rather than an income trust. As such, appropriate disclosure and relevant measures are provided according to financial industry standards. The significant changes in the corporate structure from an income trust to a taxable entity, coupled with changes in accounting presentation, result in some inconsistencies in comparisons to prior year periods.

The future looks bright. It's based on an exciting intersection of demographics, product and expertise. Canada's seniors' market is the fastest growing segment of the population and is estimated to grow by 20% in the next six years. Increasingly, seniors will rely on HomEquity Bank for flexible and innovative solutions to meet their retirement needs. Our achievements and milestones over the last two years attest to our business model and its development and implementation by our highly trained professionals.

In the short term, we will capitalize on becoming a Bank and build on our growth potential. We thank our dedicated staff and applaud their efforts in our successful transition. We are excited by our prospects and our opportunities for growth.



Sincerely,

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

Pierre Lebel  
Chairman, Board of Directors

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

Steven K. Ranson  
President & Chief Executive Officer

March 4, 2010



## **MANAGEMENT DISCUSSION AND ANALYSIS**

The following management discussion and analysis ("MD&A") of HOMEQ Corporation ("HOMEQ Corp") reflects the continuation of Home Equity Income Trust (the Trust) subsequent to the court approved plan of arrangement where the Trust converted to a corporation on June 30, 2009 (the "Conversion"). HOMEQ Corp and the Trust are together referred to as "HOMEQ" or the "Company".

Effective June 30, 2009, all of the outstanding trust units of the Trust were exchanged for common shares of HOMEQ Corp on a one-for-one basis. All references to "shares" refer collectively to the common shares subsequent to Conversion and to units prior to the Conversion. All references to "dividends" refer collectively to payments to shareholders subsequent to Conversion and to payments to unitholders prior to the Conversion. Since the Conversion, HOMEQ has ceased reporting on matters specifically relevant to Income Trusts.

HOMEQ Corp has the same financial year end, December 31, as the Trust and continues the business of the Trust. For the financial year ended December 31, 2009, its first financial year after the effective date of the Conversion, HOMEQ Corp presents audited consolidated financial statements, including a comparison to the results of the Trust for the financial year ended December 31, 2008.

On October 13, 2009, HOMEQ's wholly owned operating subsidiary Canadian Home Income Plan Corporation ("CHIP") received its Letters Patent and Order to Commence as a federally regulated Schedule I bank, HomEquity Bank, ("HomEquity") from the Minister of Finance. The continuance as a bank (the "Continuance") is a strategic initiative that will allow access to additional cost-effective and reliable sources of funding as detailed later in the MD&A. Unless indicated otherwise, CHIP and HomEquity Bank are collectively referred to as HomEquity.

The MD&A should be read in conjunction with the Consolidated Financial Statements and the accompanying notes of the Company for the year ending December 31, 2009. 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. HOMEQ's Audit Committee reviewed this document, and prior to its release, the Company's Board of Directors approved this document, on the Audit Committee's recommendation.

The management discussion and analysis is dated March 4, 2010.

## **CAUTION REGARDING FORWARD-LOOKING STATEMENTS**

*HOMEQ Corporation 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 anticipated dividend policy and the likelihood of HOMEQ's success in developing and expanding its business. These may be included in HOMEQ's or its predecessor's Annual Reports, quarterly reports, regulatory filings, reports to shareholders, press releases, 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 including but not limited to risks related to capital markets and additional funding requirements, fluctuating interest rates, asset quality and rates of default as well as those factors discussed under the heading "Business Risks" herein and in HOMEQ's documents filed on SEDAR. HOMEQ does not undertake to update any forward-looking statement, whether written or verbal, that may be made from time to time.*



## **NON-GAAP MEASURES**

HOMEQ uses a number of financial measures to assess its performance. Some measures are calculated in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"), such as net interest income. Other measures are not defined by GAAP and do not have standardized meanings or similar measures used by other companies. HOMEQ believes that the non-GAAP items provide the reader with additional understanding of how management views HOMEQ's performance.

Non-GAAP measures used in the MD&A include the following:

### **Yield**

Yield is a measure that presents interest earned on the mortgage portfolio as a percentage of the mortgage portfolio value.

### **Cost of funds**

Cost of funds is a measure that presents the interest incurred on the debt used to fund the mortgage portfolio as a percentage of the aggregate value of debt.

### **Spread Income**

Spread income is the difference in dollars between interest earned on the mortgage portfolio and interest paid on the debt used to fund the portfolio.

### **Spread Percentage**

Spread percentage is a measure that presents spread income as a percentage calculated as the difference between the yield earned on the mortgage portfolio and the cost of funds of the debt funding the mortgages.

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

The capital ratios provided in this MD&A are those of the Company's wholly owned subsidiary, HomEquity Bank. The calculations are in accordance with the guidelines issued by the Office of the Superintendent of Financial Institutions ("OSFI").

### **Adjusted Net Income**

To arrive at adjusted net income, HOMEQ removes certain items from reported net income which, as described in the MD&A, management believes are not indicative of the underlying business performance.

### **Adjusted Shareholders' Equity**

To arrive at adjusted shareholders' equity, HOMEQ removes certain items from reported equity which Management believes are not indicative of the underlying capital structure.

### **Return on Equity (Annualized) and Adjusted Return on Equity (Annualized)**

Return on equity (annualized) is a measure that presents net income earned in the current quarter multiplied by a factor of four and reflected as a percentage of average shareholders' equity. Adjusted return on equity is calculated as adjusted net income divided by the average adjusted shareholders' equity.

### **Efficiency ratio**

The efficiency ratio is derived by dividing non-interest expenses by the sum of net interest income and non-interest income. In general, a lower efficiency ratio is associated with a more efficient cost structure.

### **Loan-to-Value**

Loan-to-Value or LTV measures the outstanding mortgage balance as a percentage of the appraised value of the property.



## **CORPORATE OVERVIEW AND STRATEGY**

### **Overview of the Business**

HOMEQ through its subsidiary HomEquity provides reverse mortgages to homeowners aged 60 and over, Canada's fastest growing demographic segment. HomEquity originates reverse mortgages under the CHIP Home Income Plan brand. HomEquity has been the main underwriter of reverse mortgages in Canada since its predecessor, Canadian Home Income Plan, pioneered the concept in 1986. The objective of HOMEQ is to generate stable profits and cash flow primarily from the spread between the interest earned on the mortgage portfolio and the interest paid on the debt and deposits used to fund the portfolio.

HOMEQ Corp is publicly traded on the Toronto Stock Exchange (TSX) under the symbol HEQ and has the following direct and indirect subsidiaries:

- HomEquity originates and finances reverse mortgages and provides mortgage administration services on the reverse mortgage portfolio. HomEquity issues Guaranteed Investment Certificate deposits to fund its mortgage portfolio.
- CHIP Mortgage Trust (CMT), a wholly owned subsidiary of HomEquity, finances a segment of the reverse mortgages originated by HomEquity 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).

The discussion of HOMEQ's operations in the MD&A and financial statements consolidates the activities of these subsidiaries.

A reverse mortgage is a type of residential mortgage that permits qualifying homeowners to convert a portion of their home equity into cash on a tax-free basis while remaining in the home. Customers are not required to repay any principal or interest on such mortgage until the loan becomes due.

Each reverse mortgage is secured by a specific residential property, is a registered first mortgage and contains standard contractual mortgage terms, conditions and default remedies. The loan becomes due on the earlier of (i) the time the home is sold, (ii) the time the home is permanently vacated by the mortgagors (as both spouses are typically mortgagors), (iii) 120 days following the death of the last surviving mortgagor, and (iv) demand for repayment after the occurrence of an event of default (including failure to pay property taxes, maintain insurance or keep the house in proper repair).

Homeowners may remain in the home as long as they wish or are able, provided they are not in default. When the loan becomes due, the reverse mortgage is repaid from the proceeds of the sale of the home or the mortgagors' estate and, if the home is sold, any excess value of the home remains with the homeowner or the homeowner's estate. The right of the Company to receive principal and interest when due under the reverse mortgage is limited to the fair market value of the property at such time and HOMEQ has no additional recourse to the mortgagors or their estates.

HOMEQ is the primary provider of reverse mortgages in Canada through its distribution and referral network. The referral network includes all the major Canadian banks as well as credit unions, mortgage brokers, investment and financial planning firms.

HOMEQ finances its portfolio of mortgages with deposits, medium term notes, subordinated debt, and to the extent necessary to maintain its regulatory capital and debt rating, equity. By maintaining a diversified source of financing it is able to mitigate its liquidity risk. The mix of funding in place is based on several factors including cost and availability at any point in time.

### **Strategy**

HOMEQ intends to continue to lead the reverse mortgage market and grow its reverse mortgage business through continuous enhancement of product features to meet consumer need. HOMEQ will focus on flexibility, giving consumers choices on how often to receive funds and interest rate terms. HOMEQ will maintain and expand its distribution, with a referral network that now includes all major national Schedule I



Canadian chartered banks and numerous credit unions, mortgage brokers, wealth management and financial planners. 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.

The target market for HOMEQ's reverse mortgage products, Canadian homeowners 60 years and over, is growing rapidly, and is the fastest growing segment of the Canadian population. According to Statistics Canada, between 2006 and 2036, the number of seniors will increase from 4.3 million to 9.8 million. Approximately 1.71 million homes are owned by this age group, of which 85% are reported by the homeowners to be debt-free.

Moreover, the need for retirement funds is growing. Seniors are expected to live longer, but they are saving less than their parents did. The average Canadian between 55 and 65 has less than \$125,000 in their RRSP, according to a 2005 Statistics Canada report, and that figure may have decreased due to the market volatility experienced in 2008 and 2009.

Management believes that a significant percentage of pre-retirees are expected to carry debt into retirement. As a result, accessing home equity is an appealing solution for seniors who want to stay in their homes, and who have their net worth locked up in home equity.

## **ANNUAL OVERVIEW**

From late in 2007 through the second quarter of 2009, HOMEQ operated in an environment of extreme uncertainty as a result of very volatile capital market conditions. Under these circumstances, commencing in late 2008 steps were taken to reduce the level of new mortgage originations by up to 50% in order to conserve cash until such time as HOMEQ's ongoing financing capability became more predictable.

Strategic actions and initiatives commencing in 2008 and completed in 2009 have resulted in HOMEQ achieving an improved capital structure and access to additional cost-effective and reliable sources of funding. In particular, these actions and initiatives include the following:

- The Conversion of Home Equity Income Trust to HOMEQ on June 30, 2009;
- The Continuance of HomEquity Bank on October 13, 2009;
- The issuance of \$10 million of subordinated debt qualifying as Tier 2B capital in HomEquity Bank on October 23, 2009;
- The refinancing of \$150 million of medium term debt that matured on November 1, 2009.

During 2009, necessary operating, control and compliance platforms were implemented to encompass the additional requirements of a deposit taking institution. Accordingly, HOMEQ was in position to commence taking deposits immediately on receiving notice of the Continuance.

Commencing in late October 2009, HOMEQ began accepting deposits from the public by issuing Guaranteed Investment Certificates ("GICs") with terms up to five years. GICs provide a reliable and stable source of funding that can be matched against anticipated reverse mortgage cash-flows. HOMEQ sources its deposits exclusively through deposit agents including affiliates of large Schedule 1 Banks with whom HOMEQ has had longstanding mortgage origination referral agreements. During Q4 2009, HOMEQ successfully raised GICs in volumes sufficient to meet its cash requirements to fund new mortgages. The interest rates offered on HOMEQ's GICs were competitive in the market.

Following the Continuance, HOMEQ reduced the rates on its mortgages. The significantly lower rates are competitively priced in comparison to other financial products and give seniors more flexibility in how their home equity can be used during retirement. In Q4, 2009 HOMEQ achieved record originations of reverse mortgages, an early indication that the pricing strategy is working and that its reverse mortgage offering is being transformed from a niche product into a mainstream financial solution.



The cost of the Conversion and Continuance incurred in 2009 was \$2.5 million, of which \$1.4 million was capitalized and \$1.1 million was expensed in 2009. Commencing in Q4, 2009 incremental period expenditure as a result of the Conversion, Continuance and ongoing operations of running HomeEquity is anticipated to be approximately \$0.8 million on an annualized basis. This comprises amortization of capitalized costs, software licence and maintenance fees and professional fees. This “step-up” of expenditure will initially have a negative effect on HOMEQ’s profitability but will be offset in the future as the mortgage portfolio and associated spread income continue to grow.

## FINANCIAL HIGHLIGHTS

### Financial Overview

Reverse mortgages are long term assets and earn interest over a multi-year period. Under GAAP, interest income is recognized in the period it is earned despite not being received in cash. Other than sales commissions, which are deferred and amortized over the period the mortgages are expected to earn interest, 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 during periods of growth, but benefiting HOMEQ in the longer term.

The change in HOMEQ’s corporate structure from an income trust to a taxable entity, and the relevant significant change in financial presentation will make comparison to prior year periods somewhat inconsistent this year and for the forthcoming year.

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

(\$ thousands, except per share amounts)	2007		2008					2009				
	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Interest income (1)	15,084	53,726	14,852	14,975	15,096	14,742	59,665	13,081	12,554	11,963	11,217	48,815
Interest expense	10,047	32,868	9,768	10,075	10,154	9,473	39,470	8,492	7,201	6,268	5,694	27,655
Net interest income	5,037	20,858	5,084	4,900	4,942	5,269	20,195	4,589	5,353	5,695	5,523	21,160
Provision for credit losses (1)	50	58	(6)	(30)	(66)	(174)	(276)	23	(40)	(1,784)	(39)	(1,840)
Non interest income	205	774	182	271	279	311	1,043	222	199	255	293	969
Net interest income and other income	5,292	21,690	5,260	5,141	5,155	5,406	20,962	4,834	5,512	4,166	5,777	20,289
Non interest expenses	3,251	12,583	3,337	2,864	3,247	3,102	12,550	3,104	3,086	3,095	3,497	12,782
Income before undernoted items	2,041	9,107	1,923	2,277	1,908	2,304	8,412	1,730	2,426	1,071	2,280	7,507
Less:												
Unrealized (gain) loss on derivative instruments	(4,427)	577	(14,306)	6,360	(1,671)	(17,746)	(27,363)	(2,271)	5,384	1,595	3,819	8,527
Current income tax expense (recovery)	21	(49)	—	2	—	(2)	—	—	—	973	900	1,873
Future income tax expense (recovery)	145	6,994	3,184	(1,282)	63	4,277	6,242	910	2,108	(1,300)	(2,784)	(1,066)
Net income (loss)	6,302	1,585	13,045	(2,803)	3,516	15,775	29,533	3,091	(5,066)	(197)	345	(1,827)
Per share	0.45	0.11	0.93	(0.20)	0.25	1.12	2.10	0.22	(0.36)	(0.01)	0.02	(0.13)
Average number of shares outstanding	13,918	13,848	13,981	14,061	14,113	14,124	14,069	14,153	14,213	14,229	14,239	14,209

(1) For the periods Q3 2009 and prior, specific allowances have been reclassified from interest income to provision for credit losses



### Adjusted Net Income and Adjusted Return on Equity

The table below details the adjustments between net income and adjusted net income for the past nine quarters of operations. In calculating adjusted net income, HOMEQ removes certain items from reported net income as it believes that these items are not indicative of the underlying business performance. In particular, as further discussed under "Derivatives" later in the MD&A, derivatives are normally held to maturity and thus any unrealized gains or losses are timing differences and will be zero at maturity. In addition, costs related to the Conversion, the adjustment to the provision for credit losses in Q3 2009 and changes in future income tax rates are not considered recurring items. HOMEQ has calculated notional taxes for prior quarters when it was an income trust using a tax rate of 33%.

(\$ thousands, except per share amounts)	2007		2008					2009				
	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Net Income (loss) before tax	6,468	8,529	16,229	(4,083)	3,579	20,050	35,775	4,001	(2,958)	(524)	(1,539)	(1,020)
Add (deduct)												
Unrealized (gain) loss on derivatives	(4,427)	577	(14,306)	6,360	(1,671)	(17,746)	(27,363)	(2,271)	5,384	1,595	3,819	8,527
Conversion costs	—	—	—	—	—	—	—	522	524	65	—	1,111
Adjustment to provision for credit losses	—	—	—	—	—	—	—	—	—	1,741	—	1,741
Adjusted net income before tax	2,041	9,106	1,923	2,277	1,908	2,304	8,412	2,252	2,950	2,877	2,280	10,359
Notional taxes	(674)	(3,005)	(635)	(751)	(630)	(760)	(2,776)	(743)	(974)	—	—	(1,717)
Tax provision as reported less tax effect of above items and changes in future income tax rates	—	—	—	—	—	—	—	—	—	(791)	(466)	(1,257)
Adjusted net income	1,367	6,101	1,288	1,526	1,278	1,544	5,636	1,509	1,976	2,086	1,815	7,385
Per share	0.10	0.44	0.09	0.11	0.09	0.11	0.40	0.11	0.14	0.15	0.13	0.52
Average number of shares outstanding	13,918	13,848	13,981	14,061	14,113	14,124	14,069	14,153	14,213	14,229	14,239	14,209

Similarly, management adjusts shareholders' equity for items it believes are not indicative of the underlying capital structure in order to arrive at adjusted shareholders' equity used to determine adjusted return on equity. Adjusted return on equity is calculated as adjusted net income divided by the average adjusted shareholders' equity. The table below details the adjustments between shareholders' equity and adjusted shareholders' equity for the past nine quarters.

(\$ thousands)	2007		2008					2009				
	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Shareholders' equity	93,912	93,912	103,779	97,774	97,798	110,724	110,724	110,890	102,547	102,486	100,982	100,982
Add (deduct)												
Derivative instruments, net	(948)	(948)	(12,085)	(7,044)	(8,630)	(22,119)	(22,119)	(23,231)	(17,344)	(16,271)	(14,101)	(14,101)
Adjusted shareholders' equity	92,964	92,964	91,694	90,730	89,168	88,605	88,605	87,659	85,203	86,215	86,881	86,881
Adjusted return on equity (annualized)	5.9%	6.5%	5.6%	6.7%	5.7%	6.9%	6.2%	6.8%	9.1%	9.7%	8.4%	8.4%

A discussion of various elements impacting net income is included below. Where applicable, further details are discussed later in the MD&A.



### **Net Interest Income**

Net interest income is derived mainly from the spread between the interest earned on the mortgage portfolio and the interest paid on the debt to fund the portfolio. For 2009 net interest income was \$21.2 million, an increase of \$1.0 million or 4.8% over 2008. Spread percentage was 3.12% for the year, two basis points higher than the 3.10% spread earned in 2008. The improvement in spread percentage reflects that the Canadian debt capital markets have recently been more consistent with historic experience than has been the case since Q3 2007. In particular, the difference between the Prime Rate and the rate on T-Bills, on which mortgage rates have in the past been based, and the rate on BAs, on which HOMEQ's debt and hedging instruments are based, have returned to historical norms after deviating significantly over the last two years.

In Q4 2009, net interest income was \$5.5 million, \$0.3 million or 4.8% higher than Q4 2008. Spread percentage in Q4 2009 was 3.15%, 16 basis points higher than Q4 2008 mainly as a result of improved capital market conditions. Spread percentage in Q4 2009 was five basis points lower than Q3 2009 reflective of the refinancing of the \$150.0 million medium term debt at wider credit spreads than the maturing debt.

### **Allowance for Credit Losses**

HOMEQ increased its general allowance for credit losses in Q3 2009, resulting in a non cash-flow reduction in interest income of \$1.7 million following which the general allowance was \$2.1 million, equivalent to 0.25% of the total value of the mortgage portfolio. The increase to the general allowance followed a comprehensive assessment of statistical and qualitative analyses of the underwriting performance of each mortgage as well as changes in the characteristics of the portfolio. The assessment, which is discussed in detail later in the MD&A, included a review of general real estate conditions and trends and their potential impact on the portfolio.

### **Non-Interest Income**

Non-interest income comprised of mortgage closing fees, net of costs and administration fees, was \$1.0 million in 2009, 7.1% lower than 2008 due mainly to the reduced number of mortgages originated while the company waited to receive its bank Charter.

### **Non-Interest Expenses**

In order to conserve cash resources prior to HomeEquity receiving its bank Charter, commencing in Q3 2008, HOMEQ reduced its marketing spend and managed overhead expenses to 2008 levels. For 2009, total non-interest expenses of \$12.8 million were \$0.2 million or 1.8% higher than 2008. The cost of the Conversion and the Continuance was \$2.5 million, of which \$1.4 million has been capitalized and \$1.1 million has been expensed. Excluding Conversion costs of \$1.1 million, \$0.1 million for the bank launch and \$0.3 million of capital tax not previously incurred, non-interest expenses for 2009 were \$11.3 million or 10.1% lower than 2008. Without those costs, the efficiency ratio for 2009 was 51.0% an improvement from 59.1% in 2008.

Non-interest expenses for Q4 2009 of \$3.5 million were \$0.4 million or 12.7% higher than Q4 2008. The increase was due to increased incentive compensation based on 2009 results versus targets. HOMEQ's efficiency ratio for Q4 2009 was 60.1% compared to 55.6% in Q4 2008.

### **Derivatives**

Under GAAP, derivatives are valued at fair market value with changes in fair value recognized in the current period's statement of income. HOMEQ's derivative portfolio is substantially weighted to receive fixed rates. Therefore the fair market value of the derivatives will move in an opposite direction to changes in the underlying interest rates and the yield curve used to value the derivatives. As rates decrease or the yield curve flattens the fair value of the derivative portfolio increases. As the rates increase or the yield curve steepens, the fair value will decrease. In addition, as the derivative contracts approach maturity, the fair value will reduce.



HOMEQ recorded an \$8.5 million unrealized loss on its derivatives in 2009 mainly as a result of a steeper yield curve at December 31, 2009 compared to December 31, 2008. In 2008, a \$27.4 million unrealized gain was recorded as rates and the yield curve significantly decreased during the year.

In Q4 2009 the fair value of the derivatives declined \$3.8 million mainly due to yield curve being steeper at December 31, 2009 compared to September 30, 2009.

HOMEQ'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. This 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.

### **Income Taxes**

With the conversion to a corporate structure on June 30 2009, HOMEQ is now subject to income tax on its taxable income and has recorded a net tax expense of \$0.8 million of current and future taxes in 2009. Prior to the Conversion, HOMEQ distributed all of its taxable income to its unitholders and was not subject to corporate taxes.

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 basis 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.

Included in its tax provision, HOMEQ recorded a future income tax non-cash recovery of \$1.1 million to earnings during 2009. The future tax asset and liability reflect the temporary differences between the financial reporting and tax basis of the derivatives, mortgage reserves and mortgage premiums as of December 31, 2009.

### **Net Income (loss) and Adjusted Net Income**

HOMEQ reported a \$1.8 million net loss for the year, or \$0.13 per share compared to net income of \$29.5 million or \$2.10 per share in 2008. Adjusted net income in 2009 was \$7.4 million or \$0.52 per share, \$1.8 million or \$0.12 per share higher than 2008 as a result of higher net interest income and lower non-interest expenses.

For the fourth quarter of 2009 HOMEQ reported net income of \$0.3 million or \$0.02 per share and adjusted net income of \$1.8 million or \$0.13 per share. Adjusted net income was \$0.3 million or 17.6% higher than Q4 2008 mainly due to the increase in net interest income and a recovery of taxes.

### **Return on Equity and Adjusted Return on Equity**

HOMEQ reported a negative return on equity of 1.7% for 2009 and a positive adjusted return on equity of 8.4% in comparison to positive 28.9% and 6.2% respectively in 2008. The increase in adjusted return on equity in 2009 is as a result of higher net interest income and lower non-interest expenses in the year.

For Q4 2009, return on equity (annualized) was 1.4% compared to 60.5% in Q4 2008. Adjusted return on equity (annualized) was 8.4% in Q4 2009 compared to 6.9% in Q4 2008 primarily due to the increase in net interest income.



## Portfolio Growth

HOMEQ intends to grow the size of its mortgage portfolio thus generating increased profits and cash flow. The mortgage portfolio at the end of 2009 was \$865.4 million, an increase of \$51.2 million or 6.3% over 2008. The following table shows the growth in the mortgage portfolio on a quarterly basis for the past nine quarters.

(\$ millions)	2007	2008				2009			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Opening mortgage balance (1)	678.7	707.8	737.7	767.5	798.2	814.2	825.7	832.9	837.0
Originations	33.9	28.2	39.0	37.8	24.6	14.7	22.7	29.5	43.4
Accrued interest	14.9	15.2	15.2	15.3	15.2	14.1	13.6	12.9	12.4
Repayments of principal	(13.2)	(9.5)	(16.4)	(15.2)	(15.4)	(11.2)	(20.0)	(26.1)	(17.7)
Repayments of accrued interest	(6.5)	(4.0)	(8.0)	(7.2)	(8.4)	(6.1)	(9.1)	(12.2)	(9.7)
Specific allowance (2)	—	—	—	—	—	—	—	—	0.3
Ending mortgage balance (1)	707.8	737.7	767.5	798.2	814.2	825.7	832.9	837.0	865.7
Loan to value of new origination	32%	31%	32%	30%	27%	28%	28%	29%	33%
Total repayments as % of opening balance	2.9%	1.9%	3.3%	2.9%	3.0%	2.1%	3.5%	4.6%	3.3%
Trailing 4 quarters:									
Originations	127.3	129.9	135.5	138.9	129.6	116.1	99.8	91.5	110.2
Total repayments	(87.6)	(82.7)	(82.6)	(80.0)	(84.1)	(87.9)	(92.6)	(108.5)	(112.1)

(1) Excluding unamortized purchase price premiums, origination fees, deferred commissions and allowance for credit losses

(2) For the reporting period December 31, 2009 specific allowances are reported separately from the mortgage balance. The adjustment has been made in Q4 2009 in the above table.

Commencing in Q4, 2008, HOMEQ took specific actions to conserve its cash resources. Steps were taken to reduce the average mortgage amount for new customers, marketing activity was scaled back, overhead expenditure was closely monitored and sales territories were rationalized. As anticipated, these steps caused originations to be reduced by 40% to 50% in late 2008 and early 2009 and resulted in the loan to value on new originations dropping to 29% or below from a quarterly average of above 30%.

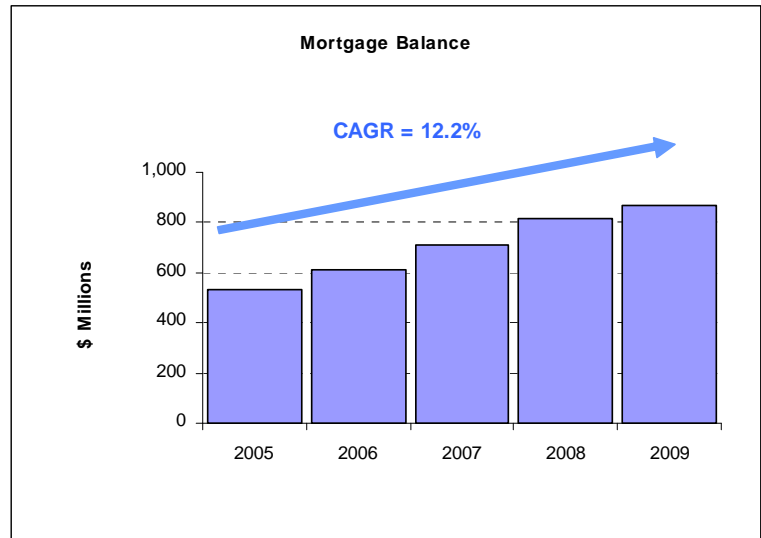
During the year as the Continuance became imminent, interest rates and mortgage closing costs were gradually reduced to allow average mortgage amounts to revert to historic norms. In Q4 2009, following the Continuance, HOMEQ significantly reduced the rates on its mortgages resulting in record quarterly originations of \$43.4 million, \$18.8 million above Q4 2008. For 2009 total originations were \$110.2 million, 15.0% lower than 2008.

Accrued interest in 2009 of \$53.1 million decreased 13.0% from \$61.0 million in 2008 mainly due to the 159 basis point reduction in yield earned on the mortgage portfolio. The impact of the reduction in the yield was partially offset by the 6.3% growth in the mortgage portfolio from 2008. For Q4 2009, accrued interest decreased 18.4% to \$12.4 million due to the 165 basis point reduction in yield from Q4 2008, partially offset by the increase of the portfolio by 6.3%.

Total repayments of principal and interest of \$112.1 million in 2009 were \$28.0 million or 33.3% higher than 2008. Repayments in the middle of the year were higher than historical experience reflecting increased housing market activity. As a percentage of the opening mortgage balance, total repayments were 13.8% which is higher than the expected range of 11.5% to 12.5%. Short-term fluctuations in the level of originations and repayments will have an impact on the total portfolio balance in the future. Repayments in Q4 2009 were 3.3% of the opening mortgage balance.



The compound annual growth rate of the portfolio from 2005 to 2009 was 12.2%.



### Portfolio Quality

The loan-to-value ratio (“LTV”) measures the outstanding mortgage balance as a percentage of the appraised value of the property. A lower LTV together with information on the past performance of the mortgage indicates a probability that the proceeds realized on the disposition of the home will be sufficient to pay out the outstanding mortgage balance on maturity. Once a mortgage has been originated, typically its LTV increases over time. Each property in the mortgage portfolio is reappraised at least every five years.

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, 2009, 13 loans had a loan to value greater than 83% having a balance of \$1.8 million, net of a \$0.3 million specific allowance. The appraised value of the property securing the mortgages is \$1.8 million before disposition costs. There were six mortgages with a loan-to-value greater than 83% at December 31, 2008.

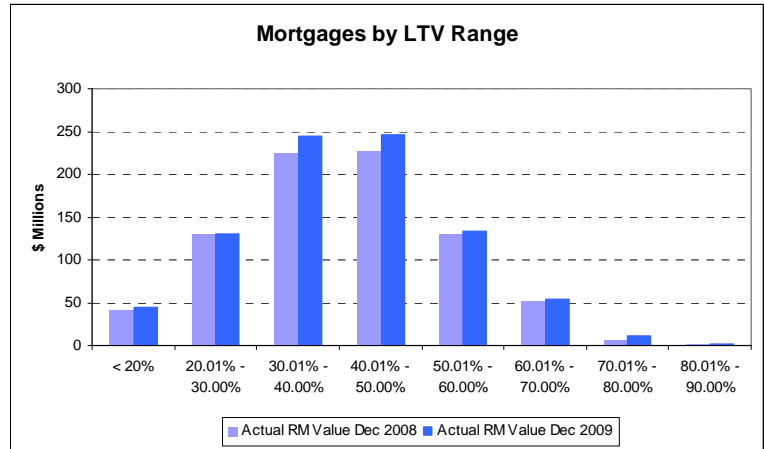
HOMEQ continually monitors and reassesses its underwriting policies, procedures and methodology, paying close attention to, amongst others, real estate trends, interest rate environments and occupancy experience. In particular, during the underwriting process:

- 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 7.5% or more;
- A rate of future property appreciation is assumed for the life of the mortgage in comparison with the Canadian 20 year average. The average rate of assumed appreciation used in the initial underwriting of the mortgages in the portfolio is approximately 1.50%;
- Each mortgage originated is limited in maximum dollar amount and to no more than 55% loan-to-value ratio.

The loan-to-value ratio of the \$43.4 million of new mortgages originated in Q4 2009 was 33% in comparison to 27% in Q4, 2008. 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 December 31, 2009, comparable to that of December 31, 2008.



The graph details the mortgage portfolio by loan-to-value range based on the mortgage value at December 31, 2009 and the most recent appraisal on the underlying property. Ninety two percent of the portfolio has a loan-to-value ratio below 60 percent.

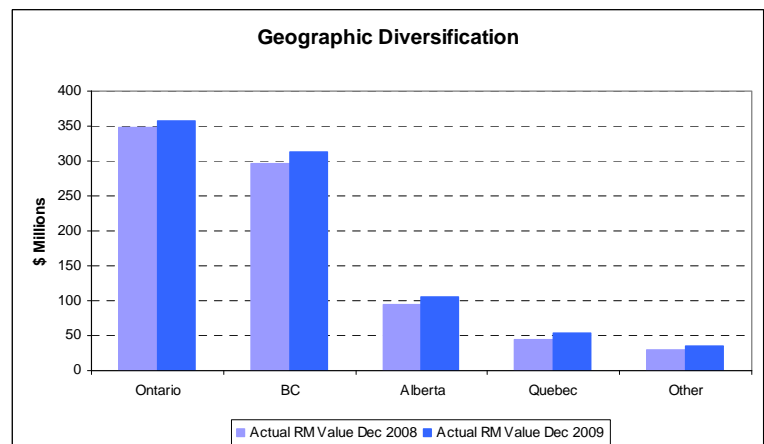


There is an inherent risk that the expected occupancy term (“EOT”), interest rate and property appreciation experienced over the life of a mortgage might vary from the assumed factors used in underwriting the mortgage. In addition, the value of a mortgage may increase unexpectedly as a result of charges being applied to the mortgage during the course of its life. Charges applied to the mortgage can include fire insurance, property taxes, property maintenance and legal fees which the client has not paid. HOMEQ covers these charges in order to retain its registered mortgage in first position.

In recognition of the above, HOMEQ has developed a loan provisioning policy based on a risk management process that:

- Utilizes an anticipatory approach to measuring and reporting risk and the probability of loss;
- Calculates a general allowance that estimates the potential loss within the portfolio in an amount closely approximating the present value of projected future cash flow shortfalls; and
- Adequately discloses general allowances.

The geographic distribution of the portfolio reflects the population density and real estate value across Canada. At December 31, 2009, 77% 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, 2009.





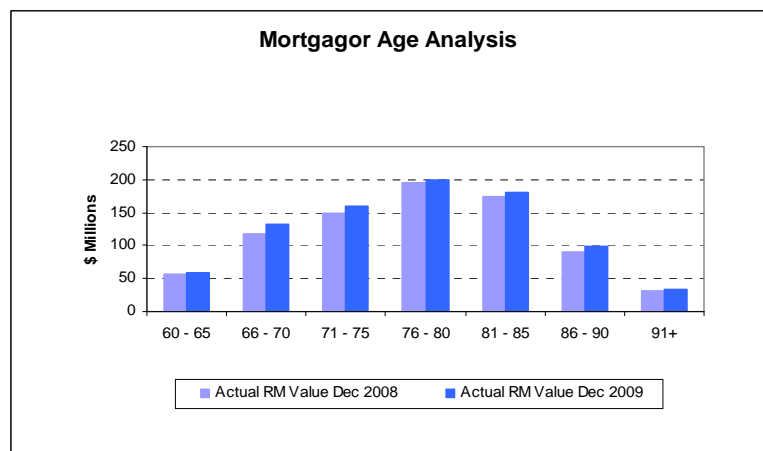
HOMEQ's loan provisioning methodology is reviewed and assessed periodically and is updated to take into account both current circumstances and evolution of the portfolio and business. During 2009 a significant review was undertaken, having last been undertaken comprehensively approximately five years ago. The most recent findings indicate that the portfolio remains strong with a low loan-to-value however, other qualitative aspects are becoming evident as the portfolio matures and have now been addressed.

As a result, HOMEQ's loan provisioning policy has been updated to incorporate allowances required to identify the following:

- Mortgages with a current value greater than the current expected realizable value of the property;
- Mortgages with a LTV that may be inaccurate because;
  - a) The value of a property may have fallen since the last appraisal (up to five years prior) resulting in the expected realizable value of the property becoming less than the value of the mortgage;
  - b) Re-appraisals are conducted on either a desk top or drive-by basis which may not adequately recognize internal and structural damage or regional issues that could have a negative effect on the value of the property.
- Mortgages that have exhibited characteristics indicating a greater likelihood of exceeding the expected realizable value of the relevant property during the expected life of the mortgage. This situation can occur when the interest rates and/or property appreciation and/or charges applied against the mortgage experienced since funding are different from the underwriting assumptions;
- Mortgages that have already exceeded their current EOT and thus are indicating a payment trend significantly different from the EOT expectations.

A general allowance has been established in accordance with the updated loan provisioning methodology referred to above, relating to probable losses in an amount closely approximating the present value of projected future cash flow shortfalls on mortgages whose loan-to-value ratios are still below 83%. The allowance for credit losses has been increased to \$2.1 million from \$0.4 million and equates to 0.25% of the mortgage balance. The large increase in the year is a result of updating the policy and is not expected to recur in the future. The provision has therefore been excluded from adjusted net income.

Clients in the age group of 71 – 85 represent 63% of the portfolio based on outstanding mortgage balance. The average age for mortgages originated in 2009 was 72. The graph shows the age distribution of individuals within the portfolio based on mortgage balances at December 31, 2009 and reflects the consistent entry age and occupancy term.





## Spread

HOMEQ's net interest income is derived from the spread between the interest earned on the mortgage portfolio and the interest paid on the debt to fund the portfolio. The yield on mortgages has historically been based on Prime and Government of Canada Treasury Bills ("T-Bill") rates whereas the cost of debt is primarily based on the rate of Bankers Acceptances ("BAs").

Commencing in August 2007, a reduction in market liquidity resulted in an increase in HOMEQ's marginal borrowing costs. In addition, the difference between the rate on T-Bills and the rate on BAs rose to levels higher than historical norms. This situation continued throughout 2008 and contributed to a reduction of spread income and spread percentage.

Management took steps to offset the ongoing impact on spread income 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 HOMEQ's average cost of borrowing as opposed to a fixed spread above the T-Bill rate as had previously been the case. This methodology will enable HOMEQ in the future to change the rates on all mortgages in the portfolio for strategic purposes to offset systemic changes in borrowing costs.

During 2009, the difference between T-Bills and BAs returned to historical norms, which has helped to restore spread percentage to higher rates. In addition, mortgages under the new pricing methodology have grown to approximately 21% of the total mortgage portfolio at December 31, 2009.

Interest rate risk resulting from timing differences between the interest reset dates on the mortgages and interest reset dates on HOMEQ'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 Bank of Canada benchmark interest rate has declined significantly since the beginning of the credit crisis. The corresponding decreases to the Prime Rate and interest rates on T-Bills and BAs resulted in reductions to HOMEQ's yield and cost of funds. The interest rate resets throughout 2009 were at lower underlying benchmark rates than in 2008 therefore the yield on HOMEQ's mortgages and its cost of funds in 2009 were lower than in 2008.

Interest income earned on the mortgage portfolio in 2009 was \$53.1 million, a decrease of \$7.9 million or 13.0% from 2008 due primarily to the lower interest rate environment. The average yield earned on the mortgage portfolio of 6.36% was 159 basis points lower than 2008. The reduced yield was partially offset by the 9.0% increase in the average mortgage portfolio from December 31, 2008.

Correspondingly, interest expense on the debt portfolio, was \$27.7 million, a decrease of \$11.8 million or 29.9% from 2008 due to a 161 basis point decrease in the average interest rate on the debt to 3.24%.

The spread percentage earned in 2009 of 3.12% was two basis points higher than 2008. The improvement in spread percentage reflects that the Canadian debt capital markets have recently been more consistent with historic experience than has been the case since Q3 2007. In particular, the difference between the Prime Rate and the rate on T-Bills, on which mortgage rates have in the past been based, and the rate on BAs, on which HOMEQ's debt and hedging instruments are based, have returned to historical norms after deviating significantly over the last two years.

For Q4 2009, net interest income was \$5.5 million, \$0.2 million or 4.8% higher than Q4 2008. Spread percentage in Q4 2009 was 3.15%, 16 basis points higher than Q4 2008 mainly as a result of improved capital market conditions. Spread percentage in Q4 2009 was five basis points lower than Q3 2009 reflective of the refinancing of the \$150.0 million medium term debt at wider credit spreads than the maturing debt.

HOMEQ has elected under CICA's Section 3865 – *Hedges* to apply hedge accounting for certain interest rate swaps in its derivative portfolio. During 2009, HOMEQ designated interest rates swaps having a notional



amount of \$10.0 million, to hedge \$10.0 million of deposits issued during the year. The hedges are effective at December 31, 2009.

In 2008, HOMEQ designated interest rate swaps having a notional amount of \$159.0 million to hedge \$159.0 million of the \$165.0 million series 2008-1 fixed rate medium-term debt maturing in May 2011. The hedges are effective at December 31, 2009.

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.

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

(\$ thousands)	2007	2008					Full Year	2009					Full Year
	Q4	Q1	Q2	Q3	Q4	Q1		Q2	Q3	Q4			
Mortgage interest income (1)	15,040	15,199	15,214	15,302	15,036	60,751	14,177	13,595	12,877	12,321	52,970		
Average mortgage balance (2) (4)	693,790	721,258	752,014	781,435	805,422	764,383	820,369	829,548	832,866	848,452	833,025		
Average mortgage yield – annualized (%)	8.60%	8.45%	8.11%	7.77%	7.41%	7.95%	7.01%	6.57%	6.13%	5.76%	6.36%		
Interest expense	10,047	9,768	10,075	10,154	9,474	39,471	8,492	7,201	6,268	5,694	27,655		
Average debt balance (3) (4)	738,094	755,397	804,337	851,007	850,102	814,247	848,448	847,809	846,418	864,221	852,823		
Cost of funds – annualized (%)	5.39%	5.19%	5.02%	4.73%	4.42%	4.85%	4.06%	3.41%	2.94%	2.61%	3.24%		
Spread (\$)	4,993	5,431	5,139	5,148	5,562	21,280	5,685	6,394	6,609	6,627	25,315		
Spread (%)	3.21%	3.27%	3.09%	3.04%	2.99%	3.10%	2.95%	3.17%	3.20%	3.15%	3.12%		

- (1) Net of specific allowances, excludes early repayment fees and amortization of purchase price premiums and deferred commissions
- (2) Excluding unamortized purchase price premiums, origination fees and commissions
- (3) Reflects the principal portion of debt
- (4) Calculated on the average of the month end balances during the period



## Mortgage Origination Cost

HOMEQ's objective is to limit mortgage origination costs 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.

As referred to previously, over the past two years HOMEQ took specific actions to conserve its cash resources resulting in a reduction in the rate of originations. As a result, originations in 2009 of \$110.2 million were 15.0% lower than 2008. Total origination costs in 2009 of \$10.4 million were \$2.0 million or 16.1% lower than 2008. The origination cost percentage of 9.5% was slightly better than 2008.

In Q4 2009, following the Continuance, HOMEQ significantly reduced the rates on its mortgages resulting in record quarterly originations of \$43.4 million \$18.7 million above Q4 2008. Total origination costs of \$3.5 million were \$0.5 million higher than Q4 2008 but resulted in a 4.0% lower origination costs percentage of 8.0%.

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

(\$ thousands)	2007	2008					2009				
	Q4	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Mortgage originations	33,794	28,235	39,019	37,814	24,554	129,622	14,680	22,690	29,460	43,365	110,195
Origination expenses											
Commissions	1,669	1,153	1,278	1,400	1,230	5,061	856	943	1,166	1,681	4,646
Direct origination expenses											
Origination salaries and benefits	196	198	195	198	189	780	201	193	191	197	782
Marketing	1,020	1,059	865	1,097	774	3,795	428	356	581	663	2,028
	1,216	1,257	1,060	1,295	963	4,575	629	549	772	860	2,810
Marginal origination costs	2,885	2,410	2,338	2,695	2,193	9,636	1,485	1,492	1,938	2,541	7,456
Origination overhead expenses											
Salaries and benefits	1,271	1,055	1,041	1,057	1,233	4,386	1,082	1,077	1,106	1,502	4,767
Office	263	308	248	288	266	1,110	264	283	283	353	1,183
Subtotal	1,534	1,363	1,289	1,345	1,499	5,496	1,346	1,360	1,389	1,855	5,950
50% inclusion	767	681	645	673	749	2,748	673	680	695	927	2,975
Total origination cost	3,652	3,091	2,983	3,368	2,942	12,384	2,158	2,172	2,633	3,468	10,431
Origination cost (%)											
Marginal Origination cost											
Current quarter	8.5%	8.5%	6.0%	7.1%	8.9%	7.4%	10.1%	6.6%	6.6%	5.9%	6.8%
Trailing four quarter	7.0%	7.3%	7.2%	7.4%	7.4%	7.4%	7.5%	7.9%	7.8%	6.8%	6.8%
Total Origination cost											
Current quarter	10.8%	10.9%	7.7%	8.9%	12.0%	9.6%	14.7%	9.6%	8.9%	8.0%	9.5%
Trailing four quarter	9.2%	9.5%	9.2%	9.4%	9.6%	9.6%	9.8%	10.6%	10.8%	9.5%	9.5%

Commissions in 2009 of \$4.6 million decreased \$0.4 million or 8.2% over 2008 while mortgage originations decreased 15.0%. The average commission rate was higher than that of 2008 due mainly to the fixed portion of the sales staff compensation during a year of reduced originations. The Company retained most of the sales team during the year to be well positioned to grow originations once becoming a bank. Commissions in Q4 2009 were 36.7% higher than Q4 2008 compared to 76.6% increase in originations reflective of the scalability of originations without additional costs.

In accordance with measures to conserve cash available for mortgage originations, marketing spend was reduced for the year, by \$1.8 million or 46.6% lower than 2008.



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 2009 HOMEQ recognized \$0.8 million of revenue, 12.4% lower than 2008 reflecting the anticipated reduction in number of transactions completed during the year.

### Mortgage Administration Expense

Cost effective administration of its mortgages is an important objective of HOMEQ, and management has taken steps to offset the impact of lower originations and increased cost of funds by actively managing its administrative costs. In 2009, the administration costs, net of \$0.1 million of expenses for the bank launch and \$0.3 million of capital tax expense were \$5.3 million, \$0.2 million or 3.9% higher than 2008 in comparison with growth in the average mortgage portfolio of 9.0%. As a percentage of the average mortgage portfolio, mortgage administration expenses net of those costs were 0.64% in 2009, compared to 0.67% in 2008.

In Q4 2009, administration costs, net \$0.1 million of capital tax expense, were \$1.6 million, \$0.2 million or 19.4% higher than Q4 2008. The average mortgage portfolio increased 5.3%. As a percentage of the average mortgage portfolio, mortgage administration expenses, net of those costs were 0.77% in Q4 2009, compared to 0.68% in Q4 2008.

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)	2007	2008					2009					Full Year
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Full Year		
Average mortgage balance	693,790	721,296	752,014	781,368	805,422	764,383	820,369	829,548	832,866	848,452	833,025	
Administration expenses												
Mortgage servicing and administration	71	73	65	66	64	268	75	67	88	77	307	
Origination overhead expenses	767	681	645	673	749	2,748	673	680	695	927	2,975	
Professional services	258	405	276	379	417	1,477	878	981	502	478	2,839	
Amortization of capital assets	67	77	81	76	69	303	60	64	66	91	281	
Business and capital taxes	-	-	-	-	-	-	-	-	215	45	260	
Other	106	161	93	86	93	433	116	65	63	91	335	
Less:												
Conversion costs	—	—	—	—	—	—	(522)	(524)	(65)	—	(1,111)	
Mortgage administration fees	(39)	(21)	(37)	(39)	(31)	(128)	(25)	(36)	(66)	(39)	(167)	
Total administration expenses	1,230	1,376	1,123	1,241	1,361	5,101	1,255	1,297	1,498	1,670	5,720	
Administration expense (%)												
Annualized	0.71%	0.75%	0.59%	0.63%	0.67%	0.67%	0.61%	0.63%	0.72%	0.79%	0.69%	
Trailing four quarters	0.79%	0.77%	0.71%	0.67%	0.67%	0.67%	0.63%	0.64%	0.66%	0.69%	0.69%	



## CASH FLOW AND LIQUIDITY

The objective of liquidity management is to ensure that the amount of liquidity available is sufficient to meet HOMEQ's financial obligations when they are due in order to support the orderly continuation of operations. Senior management is responsible for managing the various funding sources, and to ensure that adequate funds are available for future growth at an appropriate cost. Liquidity management ensures availability of funds to meet anticipated maturities of existing sources of funds and to finance growth in the asset portfolio. The liquidity management process takes account of operating liquidity, uncertainties surrounding cashflows, the quality of liquid assets and the availability of liquidity lines and funding facilities.

An intricacy of HOMEQ is the deferred nature of its income streams. HOMEQ 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 CMT's trust indenture and the capital treatment of HomeEquity Bank's assets, HOMEQ is able to finance substantially all of the growth in its mortgage portfolio (net accrual of interest plus originations net of mortgage principal repayments) with debt and deposits.

HOMEQ finances its portfolio of mortgages with deposits, medium term notes, subordinated debt, and to the extent necessary to maintain its regulatory capital and debt rating, equity. By maintaining a diversified source of financing it is able to mitigate its liquidity risk. The mix of funding in place is based on several factors including cost and availability at any point in time.

Primary sources of funding are as follows:

1. Deposits – HOMEQ, through its subsidiary HomeEquity, accepts deposits from the public by issuing GICs with terms up to five years. GICs provide a reliable and stable source of funding that can be matched against anticipated reverse mortgage cash-flows.

Payment of principal and interest on HomeEquity's GICs is eligible to be guaranteed to the holder by the Canadian Deposit Insurance Corporation in an amount up to \$100,000. Deposits are sourced exclusively through deposit agents who are members of the Federation of Canadian Independent Deposit Brokers ("FCIDB") or the Investment Industry Regulatory Organization of Canada ("IIROC"). HomeEquity has longstanding relationships with the largest Schedule 1 Banks through the mortgage origination partnership agreements which have been in place for many years. The majority of its deposit requirements come from affiliated deposit agents of some of these banks.

2. Medium Term Notes – HOMEQ, through its subsidiary CMT has the option of raising funds through the issuance of Medium Term Notes.

DBRS has issued a AAA rating on the senior medium term debt and BBB rating on the subordinated debt. As a result of these superior ratings, CMT 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, CMT 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%. CMT must also maintain minimum cash on hand equivalent to at least 2% of the CMT mortgage portfolio value. During the year, CMT operated within these covenants. At December 31, 2009, the senior debt-to-mortgage ratio was 90.4% and the total debt-to-mortgage ratio was 97.5%.

In order to mitigate the refinancing risk of existing Medium Term Notes, approximately 70% of these instruments can be extended from their expected final payment dates to their legal maturities which range from 2031 to 2034. Any Medium Term Notes Issued in the future will also have extended legal maturities.

As discussed earlier in the MD&A, the portfolio of reverse mortgages has a loan to value of 36% and is secured by residential real estate. As a result, HOMEQ can reasonably expect to recover the full recorded



value of most mortgages. HOMEQ's portfolio of approximately 7,100 reverse mortgages is diversified by location, property type, date of origination and age of borrower. As supported by prior experience, between 2% and 5% 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 its operations and dividends, and the excess of those cash flows coupled with borrowings under its debt programs have been used to fund growth in the mortgage portfolio.

### Liquid Assets

HOMEQ holds liquid assets ("Regulatory Liquid Assets" or "RLA") determined in accordance with its liquidity management policy and invested in the form of cash and bank deposits, treasury bills, bankers' acceptances, government bonds and debentures. The credit quality of these assets is such as they are easily marketable and can be readily converted to cash and thus can be used to fulfill cash requirements should the need arise.

The table below summarizes the liquid assets held at December 31

(\$ thousands)	December 31, 2008	December 31, 2009
Cash and non-interest bearing deposits with regulated financial institutions	6,087	8,218
Treasury bills issued or guaranteed by Canada	—	—
Treasury bills issued or guaranteed by Provinces	10,988	6,298
Corporate notes	6,494	—
Cash and cash equivalents	23,569	14,516
Interest bearing deposits with regulated financial institutions	17,963	21,972
Total liquid assets	41,532	36,488

### Medium Term Notes

The total principal amount of outstanding debt at December 31, 2009 of \$845.3 million is \$5.4 million lower than December 31, 2008 due to repayments. The remaining notes have a bullet payment requirement at their respective expected final payment dates.

The table below summarizes the timing of the expected final payments of the debt at December 31, 2009. Approximately 70% of these instruments can be extended from their expected final payment dates to their legal maturities which range from 2031 to 2034.

(\$ thousands)	Within 1 year	2 to 3 years	4 to 5 years	More than 5 years	December 31, 2009	December 31, 2008
Medium-Term Debt	260,000	405,000	119,115	—	784,115	789,186
Subordinated Debt	—	10,000	40,000	—	50,000	60,000
Total	260,000	415,000	159,115	—	834,115	849,186

HOMEQ refinanced \$150 million medium term notes which matured on November 1, 2009 by issuing a one-year floating rate note having a maturity of October 26, 2010. The interest on the new note is the 3-month BA rate plus 140 basis points.

The \$260 million medium term notes due within one year is made up of two series of notes. The first has an expected final payment date of October 26, 2010 and has a legal maturity date of October 26, 2034. The next note matures on November 1, 2010.



## Deposits

HOMEQ commenced issuing deposits when HomeEquity received its letters patent from the Minister of Finance on October 13, 2009. GICs are issued in various terms in accordance with anticipated cash flows from mortgage repayments.

The table below summarizes the timing of maturities of principal amount of deposits issued as of December 31.

(\$ thousands)	Within 1 year	2 to 3 years	4 to 5 years	More than 5 years	December 31, 2009	December 31, 2008
Issued to individuals	13,694	15,553	11,165	—	40,412	—

## Unsecured Subordinated Notes

On October 23, 2009 HOMEQ concluded the sale of \$10 million unsecured subordinated medium term notes due October 31, 2014. The proceeds of the sale were used to purchase an equivalent amount of Series 2007-1B subordinated medium term notes issued by CMT. These notes constitute subordinated indebtedness within the meaning of the Bank Act (Canada) and qualify as Tier 2 B Capital of HomeEquity. The notes have a coupon of 9.71% and are unrated.

## CAPITAL

### Equity

On June 30, 2009 the Conversion of the trust structure was completed, whereby the Trust and its subsidiaries became subsidiaries of HOMEQ. The outstanding units of the Trust were exchanged for common shares of HOMEQ on a one-for-one basis.

HOMEQ has two long-term incentive plans; a Restricted Share Plan (RSP) for management and a Deferred Share Plan (DSP) for Directors. A restricted share granted through the RSP entitles the holder to receive, on the vesting date, a share plus the amount of dividends that would have been paid on the shares respectively if the share had been issued on the date of grant. Subject to the achievement of performance conditions, if any, restricted shares vest equally over three years and the total cost of the grant is recognized over the vesting period.

The DSP allows the Directors to defer a portion of their cash compensation and receive the equivalent amount in shares of the Company. On retiring from the Board, a Director will receive all deferred shares accumulated in the plan. HOMEQ Corp intends to settle the restricted and deferred shares in voting shares of the Company upon vesting and retirement respectively. Until such time, restricted and deferred shares do not trade on the TSX, have no voting rights and cannot be sold or liquidated early.

The table below summarizes HOMEQ's share activity for the period ended December 31, 2009.

	Voting	Management Restricted Share Plan	Directors' Deferred Share Plan	Total number of shares
Balance, December 31, 2008	13,953,592	79,696	90,261	14,123,549
Restricted shares redeemed	53,247	(53,247)	—	—
Restricted share grants, net	—	55,000	—	55,000
Deferred shares earned	—	—	60,492	60,492
Balance, December 31, 2009	14,006,839	81,449	150,753	14,239,041

Periodically, as required, HOMEQ may issue additional shares to maintain its regulatory capital and debt rating as the mortgage portfolio grows.



## Capital Management

Capital is the fundamental building block which enables HOMEQ to support its lending and borrowing operations. The amount of capital required in relation to the size of the HOMEQ's operations is determined by regulation and by the judgement of senior management and the Board.

The overall objective of capital management is to ensure that HOMEQ has sufficient capital to maintain its operations based on current activities and expected business developments in the future. At the same time, HOMEQ must invest its capital to provide a return to shareholders commensurate with the risk of the business and comparable to other financial institutions.

The regulatory capital requirements of HomEquity are determined in accordance with OSFI *Guideline A, Capital Adequacy Requirement (CAR) – Simple Approaches*. The Guideline specifies the types of items included in capital and the measures OSFI will consider in reviewing capital adequacy. There are two capital standards addressed in HomEquity's capital management policy. These are the risk based capital ratio and the assets to capital multiple.

In the determination of its capital levels, HomEquity has implemented an Internal Capital Adequacy Assessment Process ("ICAAP") supported further by an Economic Capital Assessment which are both based on HOMEQ's assessment of the business risks of HomEquity. As a result of this process, HOMEQ has established the capital ratios of HomEquity and has developed a contingency plan to be enacted on the occurrence of pre-determined events.

HOMEQ intends to maintain strong capital levels through the retention of earnings, the management of its risk-weighted asset mix and by maintaining effective access to a variety of sources of additional capital should the need arise.

HOMEQ pays quarterly dividends to shareholders of record on the last day of each fiscal quarter. The amount of dividends paid is at the discretion of the board of directors, is evaluated annually and may be revised subject to business circumstance and expected capital requirements depending on, among other things, HOMEQ's earnings, financial requirements for future operations, the satisfaction of solvency tests imposed by the Ontario Business Corporation Act for the declaration and payment of dividends and other conditions existing from time to time.



The table below summarizes HOMEQ's capital measures (relating solely to HomEquity) as at December 31, 2009.

(\$ thousands)	December 31 2009
Shareholders' equity per HomEquity Bank Consolidated Balance Sheet	76,666
Deductions	301
<b>Tier 1 capital</b>	<b>76,365</b>
Unsecured subordinated debt	8,000
<b>Tier 2 capital</b>	<b>8,000</b>
<b>Total regulatory capital</b>	<b>84,365</b>
Credit risk	440,250
Off balance sheet exposure	6,258
Operational risk	40,331
<b>Total risk-weighted assets</b>	<b>486,839</b>
<b>Capital ratios</b>	
Tier 1 capital ratio	15.7%
Total capital ratio	17.3%
Assets-to-capital multiple	11.8x

### Production capacity

Given the nature of its business, HOMEQ 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. In the near term, future capital expenditure on the existing business is expected to continue on the basis experienced over the prior years.

### FINANCIAL INSTRUMENTS

As reflected in the Note 2 to the consolidated financial statements commencing on page 8 of the 2009 Annual Financial Statements, in the normal course of business, HOMEQ uses derivative instruments such as interest rate swaps and forward rate agreements effectively matching the interest term of its debt to the interest 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 statements of income and changes in shareholders' equity. Fair market values of the derivative instruments are determined using the period end interest rate curves 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 statements of income and changes in shareholders' equity.

HOMEQ 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.

HOMEQ has elected under CICA's Section 3865 – *Hedges* to apply hedge accounting for certain interest rate swaps in its derivative portfolio.

### BUSINESS RISKS

HOMEQ's business strategies and operations expose it to a range of risks that could adversely affect its business, financial condition and operating results. HOMEQ has adopted a risk management framework



("RMF") methodology. The RMF uses a systematic and proactive approach, identifying high priority risks which are continuously reviewed and assessed such that appropriate action can be taken to mitigate those risks over time.

In accordance with the RMF, HOMEQ performs regular monitoring of its risks, assessments, and related action plans. Senior Management and the Board of Directors obtain information that allows them to keep informed regarding the effectiveness of their risk management process and activities. HOMEQ has created a Conduct Review and Risk Management Committee in order to satisfy the above and assist the Board of Directors in fulfilling its responsibilities.

Detailed below are the areas of risk that HOMEQ has identified and deemed to be its primary areas of exposure.

### **Underwriting Risk**

In underwriting new reverse mortgages, HOMEQ uses a proprietary lending model to estimate the timing 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 80% ratio commonly applied for a conventional bank mortgage.

The actual performance of each loan is reviewed on a monthly basis and compared to its expected performance over this time. Based on this exercise, underwriting inputs are refined if deemed appropriate and implemented on a go forward basis. In addition, the model is frequently stress tested using various scenarios. There is a risk in every case that a mortgage is funded in an amount that may result in the full amount of interest and principle not being recovered when the mortgage is due.

The following factors can result in the mortgage not being fully recoverable:

- **Property Risk**

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 underwriting forecasts. The average rate of assumed appreciation used in the initial underwriting of the existing mortgage portfolio is approximately 1.5% 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 is approximately 4.0% per annum. HOMEQ currently uses a rate lower than the 20 year Canadian average as the future appreciation rate. In addition, the initial appraised value of every property is discounted, generally by 7.5% or more, depending on the province, location, and property type.

- **Occupancy Risk**

HOMEQ 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 HOMEQ's proprietary data on the mobility of its clients at the 75% probability. This formula is closely monitored and compared to actual experience on an ongoing basis.

- **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 Interest Risk**

HOMEQ's net interest income is derived from the spread between interest earned on the mortgage portfolio, and the interest paid on the debt and deposits used to fund the portfolio. Spread interest rate risk is the



exposure or potential impact to HOMEQ's earnings and financial condition of changes in interest rates, resulting either from changes in the shape of the yield curve, absolute changes in interest rates across the yield curve or the quality of the assets on which interest is earned. The risk arises when assets and liabilities have mismatched re-pricing dates or are referenced to different underlying instruments.

Risks considered within the broader category of Spread Interest Risk include:

- **Pricing/Mismatch Risk**

This occurs when there are timing differences between:

- The interest reset dates on HOMEQ's assets and interest reset dates on its debt; and,
- The maturity dates of HOMEQ's assets and maturity dates on its debt.

Pricing risk resulting from timing differences between the interest reset dates on the mortgages and interest reset dates on HOMEQ's debt is managed through a matching process. Derivative instruments such as interest rate swaps and forward rate agreements are used to match the proportion of mortgages resetting in a period with a proportion of debt resetting in the same period. 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 debt used to fund them. HOMEQ has internal policies (interest rate risk management policy) regarding the extent of mismatch that it is prepared to accept and has quantified the potential risk involved.

- **Basis Risk**

Situations occur in which the difference between the Prime Rate and the rate on Government of Canada Treasury Bills, on which mortgage rates for a section of the Bank's mortgages are based, and the rate on Bankers' Acceptances, on which a section of the Bank's debt and hedging instruments are based, can deviate from historical norms. This situation can result in a reduction of spread.

- **Cost of Debt Risk**

Circumstances in the capital markets can cause an increase in credit spreads and/or underlying benchmarks which will result in an increase in the cost of debt used by HOMEQ to fund new mortgages or to replace maturing debt. Depending on the interest rate environment in existence at the time, HOMEQ may not be in a position to pass the increased costs on to customers which could result in a decrease in spread. The extent of this risk is quantified based on the extent of new debt issued in a year and various scenarios of increased price. HOMEQ mitigates this risk by staggering the maturities of its debt obligations.

## **Operational Risk Management**

Operational risk involves breakdowns in internal controls and corporate governance which can lead to financial loss through a variety of means. To prevent and detect such occurrences, HOMEQ has implemented policies and procedures to manage and control business activity and specified risk.

### **Liquidity Risk**

Liquidity risk is the potential that HOMEQ may not be capable of meeting its financial obligations when they are due to support the orderly continuation of operations. This can occur as a result of not being able to liquidate assets or obtain funding within the period of time required or as a result of repayments not being received as expected.



Factors leading to liquidity risk can include the following:

- Higher than expected withdrawals - A series of larger than expected redemption of deposits which exceed the amount of liquid assets and cash available from other sources can lead to a liquidity shortage;
- Access to Capital Markets - Periodically, as required, HOMEQ must issue various debt instruments to raise funds for the funding of reverse mortgages. Changes in general market conditions, fluctuations in markets for debt securities and other factors beyond the control of HOMEQ may affect its ability to raise funds as required;
- Uncertain Timing of Reverse Mortgages Cash flows - Whereas the cash flows generated from a portfolio of reverse mortgages is generally predictable, the exact timing thereof is not contractually stipulated to a predetermined date. As a result, fluctuations in the rate of repayment can lead to near term excesses or deficiencies in liquidity; and,
- Concentration and Supply Risk - GIC broker supply risk may arise in the event that a few brokers account for a significant amount of HOMEQ's funding source. This can result in the HOMEQ having to raise funds at above market rates or being forced to dispose of assets at below market value.

HOMEQ has a diversified range and proven source of funding alternatives and has created policies and procedures to ensure that cash flows are accurately predicted and monitored. Access to sufficient funding at the precise moment it is required cannot however be guaranteed. HOMEQ must therefore maintain a sufficient amount of liquid assets to fund its anticipated loan commitments, operations, deposit maturities and interest payments should a shortfall arise.

HOMEQ mitigates liquidity risk in CMT 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.

### **Legal and Regulatory Risk**

Legal and Regulatory Risk is the risk of non-compliance with applicable regulatory and legal requirements. This can be difficult to manage since there are multiple Regulators to comply with.

The Bank has developed and implemented a Legislative Compliance Management Framework in order to manage its regulatory risk.

Risks considered within the broader category of Legal and Regulatory Risk include:

- **Capital Risk**

The amount of capital required in relation to the size of HOMEQ's operations is determined by regulation and by the judgment of the Board and senior management.

The overall objective of capital management is to ensure that HOMEQ has sufficient capital to maintain its operations based on current activities and expected business developments in the future. At the same time HOMEQ must invest its capital to provide a return to shareholders commensurate with the risk of the business and comparable to other financial institutions.

A risk exists that, as a result of the outcome of various occurrences, HOMEQ may find itself in a situation in which it no longer meets its capital requirements as determined by regulation and by the judgment of the Board and senior management.

This risk is managed and controlled in accordance with HOMEQ's policies relating to its capital ratios and declaration of dividends.

- **Money Laundering and Terrorist Financing Risk**

Money laundering is any act or attempted act to disguise the source of money or assets derived from criminal activity.



Terrorist financing provides funds for terrorist activity, the main objective of which is to intimidate and threaten a population or compel a government to do something by intentionally killing, seriously harming or endangering a person, or causing substantial property damage.

As a result of the above, the Bank is required to comply with relevant legislation.

### **Derivative Related risk**

Derivative instruments have either no or an insignificant market value at inception. They obtain value, increase or decrease, as relevant interest 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 HOMEQ does not hold or use any derivative contracts for reasons other than for hedging purposes. No derivative contracts are held for speculative trading purposes.

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

HOMEQ 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 HOMEQ 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 HOMEQ's ability to continue originating reverse mortgages, and its growth may be adversely affected as a result.

HOMEQ issues its GICs in nominee name using the deposit broker network. HOMEQ has distribution agreements with deposit brokers. There can be no assurance that these distribution agreements will continue or new agreements will have similar terms. The termination or alteration of the distribution agreements may adversely affect HOMEQ's ability to continue issuing GICs, and its growth may be adversely affected as a result.

## **CONTROLS AND PROCEDURES**

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

During the year the build-out of operating, control and compliance platforms were put in place to encompass the additional requirements of a deposit taking federally regulated financial institution.

There have been no other significant changes in HOMEQ's internal controls over financial reporting during the year ended December 31, 2009, that have materially affected, or are reasonably likely to materially affect, HOMEQ's internal control over financial reporting.

## **ACCOUNTING POLICIES AND ESTIMATES**

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

#### **▪ 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 HOMEQ in determining the fair value of derivative instruments for periods after January 20, 2009. The EIC requires retrospective adoption without restatement of prior periods. HOMEQ adopted the accounting treatment in the first quarter of 2009.



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

Effective January 1, 2009, the accounting and disclosure requirements of the CICA's new accounting standard, *Section 3064, Goodwill and Intangible Assets*, was adopted. The standard 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. The impact of these standards is that certain items previously included in prepaid expenses which were deferred and amortized, will be expensed as period costs when incurred.

- **Financial Instruments Disclosures**

The CICA's Accounting Standards Board amended CICA Handbook Section 3862, *Financial Instruments - Disclosures*, to enhance the disclosure requirements regarding fair value measurements and the liquidity risk of financial instruments. The amendments became effective for the Company's 2009 annual consolidated financial statements.

### **Critical Accounting Estimates**

The significant accounting policies are outlined in Note 2 to the consolidated financial statements commencing on page 8 of the 2009 Annual Financial Statements. The estimates listed below are considered critical because they refer to material amounts and require management to make estimates that involve uncertainty.

The allowance for credit losses recorded in the balance sheet is maintained at a level which is considered adequate to absorb credit-related losses to the mortgage loan portfolio. A mortgage allowance 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 allowances, in an amount which approximates the present value of projected future cash flow shortfalls, are determined based on the mortgage loan outstanding and the most recently appraised value of the underlying property. HOMEQ has both general and specific allowances as described below.

HOMEQ's specific allowance policy is to cease accruing interest income on a mortgage having a loan-to-value greater than 83%. Any increase or decrease in specific allowances is included with mortgage interest on the consolidated statements of income.

General allowances are provided for losses inherent in the mortgage portfolio but not yet specifically identified and therefore not yet captured in the determination of specific allowances. The Company evaluates and monitors the underwriting performance indicators of mortgages as well as changes in the characteristics of the portfolio. These indicators include a review of general real estate conditions and trends and their potential impact on the portfolio, the expected occupancy term and interest rates experienced over the life of a mortgage compared to initial underwriting assumptions.

During the year a significant review was undertaken, to assess the adequacy of existing general allowances, having last been undertaken approximately five years ago. The most recent findings indicate that the portfolio remains strong with a low loan to value however, other qualitative aspects are becoming evident as the portfolio matures and accordingly the loan provisioning methodologies have been updated as discussed earlier in the MD&A.

HOMEQ also 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.



## Future Accounting and Reporting Changes

### ▪ International Financial Reporting Standards

The Canadian Accounting Standards Board has 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. HOMEQ's 2011 interim and annual financial statements will include comparative 2010 financial statements, adjusted to comply with IFRS.

### IFRS Transition Plan

HOMEQ has developed a comprehensive IFRS implementation plan and established an implementation team to prepare for this transition. Early in 2009, the implementation team completed an assessment of the key areas where changes to accounting policies may be required. The team has now substantially completed the detailed analysis of IFRS requirements within these key areas, and is discussing the results of this analysis with advisors and HOMEQ management.

The table below summarizes the expected timing of activities related to HOMEQ's transition to IFRS.

Identification of key areas for which changes to accounting policies may be required	Complete
Detailed analysis of all relevant IFRS requirements and identification of areas requiring accounting policy changes or those with accounting policy alternatives	Substantially complete
Assessment of first-time adoption (IFRS 1) requirements and alternatives	Substantially complete
Final determination of changes to accounting policies and choices to be made with respect to first-time adoption alternatives	In progress, expected to be complete in Q2 2010
Resolution of the accounting policy change implications on information technology, internal controls and contractual arrangements	In progress, expected to be complete in 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

### Impact of Adopting IFRS on the Organization

The Board of Directors and Audit Committee are regularly updated on the progress of the IFRS implementation plan, and with information regarding the potential for changes to significant accounting policies. As part of the implementation plan, HOMEQ's employees that are involved in the preparation of financial statements are receiving training on the relevant aspects of IFRS and the potential for changes to accounting policies.

As part of its analysis of potential changes to significant accounting policies, the implementation team is assessing what changes may be required to its IT and data systems, business processes and internal controls. HOMEQ has identified that some changes are required to the systems and documentation used to apply hedge accounting for its interest rate swaps, and has been working with its third party vendor to ensure the appropriate changes are in place. To date, the other changes to systems and process that have been identified are minimal and HOMEQ believes the systems and processes can accommodate the necessary changes.

HOMEQ is in the process of identifying any contractual arrangements that may be impacted by potential changes to significant accounting policies.



## **Impact of Adopting IFRS on HOMEQ's Financial Statements**

HOMEQ's implementation team has substantially completed the detailed analysis of IFRS requirements in key areas. The team is currently assessing the results of this analysis with advisors and HOMEQ management in order to make a final determination of the changes that may be required to current accounting policies.

Although HOMEQ has not yet completed the determinations of the full effects of adopting IFRS on its financial statements, included below are highlights of the areas that were initially identified as having the most potential for a change to significant accounting policies.

This is not intended to be complete list of areas where the adoption of IFRS will require a change in accounting policies, but to provide highlights of the analysis performed to date. Preliminary determinations made to date are subject to change. As the IFRS implementation plan continues, HOMEQ will make a final determination of changes to its accounting policies that will result from adopting IFRS, and may identify other changes that will have an impact on the financial statements.

- **Financial Instruments: Recognition and Measurement**

Some differences exist between IFRS and Canadian GAAP with respect to the classification of financial instruments, and the corresponding accounting treatment. HOMEQ is in the process of determining whether these differences will have an impact on the measurement of its financial assets and financial liabilities.

- **Financial Instruments: Impaired Loans**

The requirements of IFRS and Canadian GAAP related to the measurement and recognition of impairment of financial assets carried at amortized cost are generally consistent. Both utilize an incurred loss model and allow general and specific reserves, however some differences exist. HOMEQ is in the process of determining whether any significant changes will be required to its loan provisioning policy.

- **Financial Instruments: Hedge Accounting**

Certain methods of assessing hedge effectiveness that are permitted under Canadian GAAP are not permitted under IFRS. In addition, there are some differences in the guidance provided for measuring hedge ineffectiveness. HOMEQ has preliminarily determined that its current method of assessing hedge effectiveness is permitted under IFRS, and is in the process of determining whether the IFRS requirements will have an impact on its measurement of hedge ineffectiveness.

- **Impairment of Goodwill**

Goodwill is tested annually for impairment under both Canadian GAAP and IFRS. However, there are differences in the methods used to determine whether an impairment loss should be recognized, and the measurement of the impairment loss (if any). Under Canadian GAAP, goodwill is first tested for impairment by comparing the carrying amount of the goodwill and associated assets to their fair value. If the carrying amount of the goodwill and associated assets exceeds their fair value, an impairment loss is calculated by comparing the carrying amount of the goodwill to the implied fair value of the goodwill. Goodwill is tested for impairment under IFRS by comparing the carrying amount of the goodwill and associated assets to their recoverable amount (defined as the higher of the fair value less costs to sell and the value in use). Value in use is determined using discounted estimated future cash flows. HOMEQ is in the process of determining whether these differences will have an impact on the carrying amounts of goodwill and associated assets in its opening IFRS balance sheet.



- Share-based Payments

In certain circumstances, IFRS requires a different measurement of share-based compensation than current Canadian GAAP. In particular, a change may be required to the timing of recognizing the expense associated with the restricted shares granted through the Restricted Share Plan (RSP). HOMEQ is determining the impact of this change on the measurement of compensation expense associated with the RSP.

- Income Taxes

While accounting for income taxes is similar under IFRS and Canadian GAAP, in certain circumstances there are differences in the measurement of future taxes. HOMEQ is reviewing the differences to its current accounting policies to determine whether changes will be required that would have an impact on the financial statements.

### **First-time adoption of IFRS**

The adoption of IFRS requires the application of IFRS 1 *First-time Adoption of International Financial Reporting Standards* (IFRS 1), which provides guidance for an entity's initial adoption of IFRS. IFRS 1 generally requires retrospective application of IFRS effective at the end of its first annual IFRS reporting period. However, IFRS 1 also provides certain optional exemptions and mandatory exceptions to this retrospective treatment.

HOMEQ has identified the following relevant optional exemptions that it has preliminarily decided to elect to apply in its preparation of an opening IFRS statement of financial position as at January 1, 2010, HOMEQ's "Transition Date":

- To apply IFRS 2 Share-based Payments only to equity instruments that were issued after November 7, 2002 and had not vested by the Transition Date.
- To apply IFRS 3 *Business Combinations* prospectively from the Transition Date, therefore not restating business combinations that took place prior to the Transition Date.
- To apply the transition provisions of IFRIC 14 *Determining whether an Arrangement Contains a Lease*, therefore determining if arrangements existing at the Transition Date contain a lease based on the circumstances existing at that date.

As the IFRS implementation plan continues, HOMEQ will make a final determination whether to elect to apply these optional exemptions, and may identify other optional exemptions within IFRS 1 that are relevant to its adoption of IFRS.

IFRS 1 does not permit changes to estimates that have been made previously. Accordingly, estimates used in the preparation of HOMEQ's opening IFRS statement of financial position as at the Transition Date will be consistent with those made under current Canadian GAAP. If necessary, estimates will be adjusted to reflect any difference in accounting policy.

### **Subsequent Disclosures**

Further disclosures of the IFRS transition process are expected as follows:

- HOMEQ's MD&A for the 2010 interim periods and the year ended December 31, 2010 will include updates on the progress of the transition plan, and, to the extent known, information regarding the impact of adopting IFRS on key line items in the annual financial statements.
- HOMEQ's first financial statements prepared in accordance with IFRS will be the interim financial statements for the three months ending March 31, 2011, which will include notes disclosing transitional information and disclosure of new accounting policies under IFRS. The interim financial statements for the three months ending March 31, 2011 will also include 2010 financial statements for the comparative period, adjusted to comply with IFRS, and HOMEQ's transition date IFRS statement of financial position (as at January 1, 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 the difference between the rate on T-Bills and BAs rose to levels higher than historical norms. As a result of the increased costs of capital, spread percentage in recent quarters has been lower than the historical range.

In mid 2008, management took steps to offset the impact of these circumstances by changing the pricing methodology to a posted rate derived from HOMEQ's average cost of borrowing as opposed to a mark-up over the T-Bill rate as had previously been the case. In addition, during 2009 the Canadian debt capital markets were more consistent with historic experience than has been the case since Q3 2007. In particular, the difference between T-Bills and BAs has returned to historical norms. While we remain cautiously optimistic, it is not possible to determine if current market conditions will persist.

With the approval of our application and the launch of HomEquity Bank on October 13, 2009, benefits are anticipated in the following areas:

- Retail deposits represent a stable and cost-effective source of funds that will diversify the wholesale funding strategy previously used;
- Access to additional cost-effective and reliable sources of funding will enable HomEquity to meet the growing financial needs of Canadian seniors, allowing it to increase annual originations and the resulting value of its portfolio of reverse mortgages;
- Access to cost-effective sources of funding will improve margins and enable HomEquity to offer lower consumer pricing;
- HomEquity will benefit from the efficiency of being federally regulated. This will elevate reverse mortgage supervision to a consistent national standard, and in so doing will raise awareness and greater understanding of a solution that meets the specific financial needs of a growing segment of the population.

With the bank deposit funding structure now in place, and the recent introduction of lower interest rates on reverse mortgages, our goal is to return new mortgage origination growth and portfolio growth to the growth rates experienced prior to 2009. The portfolio is expected to increase in value in accordance with the higher origination volumes and additionally, compounding of interest is expected to accelerate as a result of widely predicted increases in Canadian interest rates above the current multi year lows.

After falling each quarter from Q4, 2007, spread percentage reached a low point in Q1 2009. From that point spread began to recover as a result of improving capital market conditions and the growing impact of the posted rate pricing methodology discussed earlier. The introduction of lower reverse mortgage interest rates will have the effect of maintaining spread percentage at recent levels as opposed to the levels achieved prior to Q4 2007. Net interest income is expected to increase in concert with HOMEQ's portfolio growth.

After experienced volatility in mid and late 2008, the Canadian real estate market regained stability in early 2009 and indications are that it will remain stable during the year ahead. HOMEQ's underwriting process has proved to be rigorous, and the portfolio remains well secured. The portfolio average loan-to-value is predicted to remain at approximately 36%, the general allowance at 25 basis points of the portfolio and the specific allowance at under \$1 million.

As a result of the expected increase in demand for reverse mortgages marketing costs and commission rates as a percentage of new mortgages originated will drop to below historic rates. HOMEQ expects that mortgage origination costs as a percentage of originations will drop below the historic range of 10% to



approximately 8% or less. Over the life of the mortgages, the reduction in variable expenditure will offset the impact of lower interest spread percentage.

Mortgage administration expense will increase as a result of the \$0.8 million "step-up" in expenditure referred to earlier associated with the operating a bank. HOMEQ is a highly scalable operation and as such, notwithstanding the short term impact of this increase, mortgage administration expenditure as a percentage of the portfolio will resume the downward trend experienced in the past.

HOMEQ will continue to finance its portfolio of mortgages primarily with deposits and medium term notes. It will source deposits through deposit agents, attempting to expand its network in the forthcoming year. HOMEQ will maintain the level of regulatory liquid assets in accordance with its policy to maintain liquidity sufficient in value to meet its financial obligations.

HOMEQ expects that adjusted net income per share in 2010 will be approximately equal to 2009. Adjusted net income will lag new originations and portfolio growth as the positive impact of increased portfolio growth is offset by lower interest rates on the mortgages, the incremental expenses of operating as a bank and a planned increase in marketing expenditures. As noted in the MD&A, under GAAP, marketing expenditures are expensed in the current year while the mortgages originated earn income over a number of years in the future.

In 2010, management plans to maintain quarterly dividends at the current level of \$0.07 per share.

#### **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, 2010