



**INTERIM QUARTERLY
MANAGEMENT DISCUSSION &
ANALYSIS**

**For the quarter ended
March 31, 2010**



Financial highlights (\$ thousands except per share and percentage amounts)	Three months ended March 31,	
	2010	2009
OPERATING RESULTS		
Net income	79	3,091
Per share	0.01	0.22
Adjusted net income (1)	1,520	1,509
Per share	0.11	0.11
Return on equity (annualized)	0.3%	11.2%
Adjusted return on equity (annualized) (2)	7.0%	6.8%
Spread income (3)	6,430	5,685
Spread percentage	3.03%	2.95%
Dividends per share	0.07	0.18
Mortgage originations	47,260	14,680
Trailing four quarter origination cost %	7.8%	9.8%
Trailing four quarter administration expense %	0.72%	0.63%
BALANCE SHEET HIGHLIGHTS		
Total assets	1,034,548	1,000,289
Mortgage principal plus accrued interest	904,968	825,868
Deposits	97,989	—
Medium term debt	757,147	806,652
Subordinated debt	50,025	60,324
Book value per share	7.03	7.84
PORTFOLIO QUALITY		
Appraised value of underlying properties	2,511,241	2,303,122
Average loan to value	36%	36%
Non-accrual mortgage value	1,971	702
Allowance for credit losses	2,613	549

- (1) Adjusted net income is explained in the Financial Results section on page 8 of the MD&A
(2) Adjusted return on equity is explained in the Financial Results section on page 8 of the MD&A
(3) Spread income, a non-GAAP measure, as discussed on pages 12 and 13 of the MD&A



TO OUR SHAREHOLDERS:

We are pleased to present the unaudited quarterly financial results for HOMEQ Corporation (HOMEQ) for the quarter ended March 31, 2010.

Following a strong end to 2009, we entered 2010 with significant momentum and optimism. The success in Q1 2010 of our subsidiary HomEquity Bank in its new capacity as a Schedule 1 bank has exceeded our expectations and we are excited about our potential.

During the quarter our origination volume of \$47 million set new first quarter and all time records, exceeding the previous record by 9%. We believe that volumes of this magnitude, previously unheard of until Q4, 2009, affirm the transition of a formerly niche product into one of more widespread acceptance. Reverse mortgages offer seniors greater flexibility in financing their retirement lifestyles than competing alternatives and are gaining understanding and acceptance amongst a widening segment of the population. At the core of HomEquity Bank is a trusted brand, a relevant product line, and effective customer and partner relationships.

We are experiencing sustained demand throughout the country, and the volume of inquiries and applications continues to grow. As an indication of the motivation of our prospective customers, we have noticed that the sales cycle is shortening thus enabling us to become more efficient and to provide funds to new customers faster than previously experienced.

The increased origination volume is having a corresponding positive effect on the portfolio which grew by 10% over Q1 2009. The larger portfolio, together with an improvement in spread percentage, resulted in growth of net interest income of 16%.

The future looks bright. It is based on an intersection of demographics, product alternatives and expertise. It is estimated that the number of Canadian seniors will grow by 20% in the next six years and increasingly they 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.

Sincerely,

Handwritten signature of Pierre Lebel in black ink.

Pierre Lebel
Chairman, Board of Directors

Handwritten signature of Steven K. Ranson in black ink.

Steven K. Ranson
President & Chief Executive Officer

May 5, 2010



MANAGEMENT DISCUSSION AND ANALYSIS

The following management discussion and analysis (MD&A) of HOMEQ Corporation should be read in conjunction with the unaudited interim consolidated financial statements for the three month period ended March 31, 2010 and the MD&A and audited annual consolidated financial statements and notes for the year ended December 31, 2009. These are available on SEDAR at www.sedar.com. This MD&A has been prepared based on information available as at May 5, 2010. Unless otherwise indicated, all amounts are stated in Canadian dollars and have been primarily derived from the Company's annual or interim consolidated financial statements prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). 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 May 5, 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

HOMEQ Corporation is the continuing company of Home Equity Income Trust (the Trust) subsequent to a 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.

HOMEQ through its subsidiary HomEquity Bank provides reverse mortgages, under the CHIP Home Income Plan brand, to homeowners aged 60 and over, Canada's fastest growing demographic segment. The objective of HOMEQ is to increase net income and return on equity through the profitable growth of the mortgage portfolio.

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

- HomEquity Bank originates and finances reverse mortgages and provides mortgage administration services on the reverse mortgage portfolio. HomEquity Bank issues Guaranteed Investment Certificate deposits to fund its mortgage portfolio. HomEquity Bank has been the main underwriter of reverse mortgages in Canada since its predecessor, Canadian Home Income Plan ("CHIP"), pioneered the concept in 1986. CHIP received its Letters Patent and Order to Commence as a federally regulated Schedule I bank, HomEquity Bank, from the Minister of Finance on October 13, 2009. The continuance as a bank (the "Continuance") allows access to 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 Bank.
- CHIP Mortgage Trust (CMT), a wholly owned subsidiary of HomEquity Bank, finances a segment of the reverse mortgages originated by HomEquity Bank by issuing 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.

FINANCIAL HIGHLIGHTS

Operational Overview

The first quarter of 2010 continued the momentum and strong finish experienced in 2009. Originations of new mortgages of \$47.3 million set a new first quarter and all time record, exceeding the previous first quarter record by 67.7%. Origination volume was more than three times that of Q1 2009 and 9.0% higher than the previous all time record set in Q4 2009. In part as a result of the record origination volumes, the trailing four quarter mortgage origination cost decreased to 7.8% from 9.8% in Q1 2009. The trailing four quarter mortgage administration expense was 0.72% in Q1 2010, an increase from the 0.63% in Q1 2009 due mainly to the additional expenses of operating as a bank.



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 and origination salaries and benefits, which are deferred and amortized over the period the mortgages are expected to earn interest, origination costs such as marketing 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.

In 2009 HOMEQ changed its corporate structure from an income trust to a taxable entity. The resulting significant change in financial presentation will make comparison to periods prior to Q2 2009 somewhat inconsistent.

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

(\$ thousands, except per share amounts)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Interest income ⁽¹⁾ ⁽²⁾	14,814	15,014	15,139	14,833	13,077	12,524	11,961	11,273	10,861
Interest expense	9,768	10,075	10,154	9,473	8,492	7,201	6,268	5,694	5,555
Net interest income	5,046	4,939	4,985	5,360	4,585	5,323	5,693	5,579	5,306
Provision for credit losses ⁽¹⁾	(6)	(30)	(66)	(174)	23	(40)	(1,784)	(39)	(201)
Non interest income ⁽²⁾	22	37	38	31	25	36	66	40	19
Net interest income and other income	5,062	4,946	4,957	5,217	4,633	5,319	3,975	5,580	5,124
Non interest expenses ⁽²⁾	3,139	2,669	3,049	2,913	2,903	2,893	2,904	3,300	3,055
Income before undernoted items	1,923	2,277	1,908	2,304	1,730	2,426	1,071	2,280	2,069
Less:									
Unrealized (gain) loss on derivative instruments	(14,306)	6,360	(1,671)	(17,746)	(2,271)	5,384	1,595	3,819	1,971
Current income tax expense (recovery)	—	2	—	(2)	—	—	973	900	869
Future income tax expense (recovery)	3,184	(1,282)	63	4,277	910	2,108	(1,300)	(2,784)	(850)
Net income (loss)	13,045	(2,803)	3,516	15,775	3,091	(5,066)	(197)	345	79
Per share	0.93	(0.20)	0.25	1.12	0.22	(0.36)	(0.01)	0.02	0.01
Average number of shares outstanding	13,981	14,061	14,113	14,124	14,153	14,213	14,229	14,239	14,260

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

(2) For the periods 2009 and prior, mortgage closing fees, net of costs and mortgage origination salaries and benefits have been reclassified to interest income from non interest income and non interest expenses respectively



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)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Net Income (loss) before tax	16,229	(4,083)	3,579	20,050	4,001	(2,958)	(524)	(1,539)	98
Add (deduct)									
Unrealized (gain) loss on derivatives	(14,306)	6,360	(1,671)	(17,746)	(2,271)	5,384	1,595	3,819	1,971
Conversion costs	—	—	—	—	522	524	65	—	—
Adjustment to provision for credit losses	—	—	—	—	—	—	1,741	—	—
Adjusted net income before tax	1,923	2,277	1,908	2,304	2,252	2,950	2,877	2,280	2,069
Notional taxes	(635)	(751)	(630)	(760)	(743)	(974)	—	—	—
Tax provision as reported less tax effect of above items and changes in future income tax rates	—	—	—	—	—	—	(791)	(466)	(549)
Adjusted net income	1,288	1,526	1,278	1,544	1,509	1,976	2,086	1,815	1,520
Per share	0.09	0.11	0.09	0.11	0.11	0.14	0.15	0.13	0.11
Average number of shares outstanding	13,981	14,061	14,113	14,124	14,153	14,213	14,229	14,239	14,260

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)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Shareholders' equity	103,779	97,774	97,798	110,724	110,890	102,547	102,486	100,982	100,196
Add (deduct)									
Derivative instruments, net	(12,085)	(7,044)	(8,630)	(22,119)	(23,231)	(17,344)	(16,271)	(14,101)	(12,818)
Adjusted shareholders' equity	91,694	90,730	89,168	88,605	87,659	85,203	86,215	86,881	87,378
Adjusted return on equity (annualized)	5.6%	6.7%	5.7%	6.9%	6.8%	9.1%	9.7%	8.4%	7.0%

A discussion of various elements impacting net income follows. 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. Net interest income in Q1 2010 was \$5.3 million, an increase of \$0.7 million or 15.7% over Q1 2009. Spread percentage was 3.03% for the quarter, eight basis points higher than the 2.95% spread earned in Q1 2009. The improvement in spread percentage primarily reflects that the Canadian debt capital markets have recently been more consistent with historic experience. 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 during 2008 and 2009.

During the quarter, in order to reduce liquidity risk, HOMEQ repurchased \$34.4 million of its medium term debt maturing later in 2010. Related to this transaction, HOMEQ reduced the notional amount of its derivatives by \$4.4 million. The cost of the transaction was \$0.3 million. In addition, in accordance with its asset and liability matching policy, HOMEQ unwound \$5.0 million of derivatives in the quarter, having a gain of \$0.2 million. The net cost of these two transactions of \$0.1 million is included in net interest income in the quarter.

Non-Interest Expenses

Non-interest expenses in Q1 2010 of \$3.1 million were \$0.2 million or 5.2% higher than Q1 2009. HOMEQ's non-interest expenses have increased by approximately \$0.8 million a year relating to additional expenditure incurred in operating as a bank. In addition, in Q1 2010 marketing expenses were increased by \$0.2 million following a significant reduction in marketing activity in Q1 2009. Non-interest expenses in Q1 2009 of \$2.9 million included \$0.5 million of conversion costs which are non-recurring.

HOMEQ's efficiency ratio for Q1 2010 improved to 57.4% compared to 63.0% in Q1 2009.

Derivatives

Under GAAP, derivatives are valued at fair 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 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 the rates increase or the yield curve steepens, the fair value will decrease. As rates decrease or the yield curve flattens the fair value of the derivative portfolio increases. In addition, as the derivative contracts approach maturity, the fair value will reduce.

HOMEQ recorded \$2.0 million of unrealized loss on its derivatives in Q1 2010 as a result of the increase in rates and the steeper yield curve at March 31, 2010 compared to December 31, 2009. In Q1 2009, a \$2.3 million unrealized gain was recorded as rates and the yield curve had decreased during the period.

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 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 became subject to corporate income and has recorded a current tax expense of \$0.9 million in Q1 2010. Prior to the Conversion, HOMEQ distributed all of its taxable income to its unitholders and was not subject to corporate taxes.

HOMEQ also recorded a future tax recovery of \$0.9 million in Q1 2010 mainly as a result of lower tax rates in future periods and the impact on future taxes due to the reduction of mark to market of the derivatives. 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.

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 March 31, 2010.

Net Income and Adjusted Net Income

For the first quarter of 2010 HOMEQ reported net income of \$0.1 million. As a result of increased net interest income offset by increased non-interest expenses discussed above, HOMEQ's adjusted net income of \$1.5 million or \$0.11 per share was comparable to that of Q1 2009.

Return on Equity and Adjusted Return on Equity

HOMEQ reported a return on equity of 0.3% for Q1 2010 and an adjusted return on equity of 7.0% in comparison to 11.2% and 6.8% respectively in Q1 2009.

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 Q1 2010 was \$905.0 million, an increase of \$79.3 million or 9.6% over Q1 2009. The following table shows the growth in the mortgage portfolio on a quarterly basis for the past nine quarters.

(\$ millions)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Opening mortgage balance (1)	707.8	737.7	767.5	798.2	814.2	825.7	832.9	837.0	865.7
Originations	28.2	39.0	37.8	24.6	14.7	22.7	29.5	43.4	47.3
Accrued interest	15.2	15.2	15.3	15.2	14.1	13.6	12.9	12.4	12.0
Repayments of principal	(9.5)	(16.4)	(15.2)	(15.4)	(11.2)	(20.0)	(26.1)	(17.7)	(13.8)
Repayments of accrued interest	(4.0)	(8.0)	(7.2)	(8.4)	(6.1)	(9.1)	(12.2)	(9.7)	(6.2)
Reclassification of specific allowance (2)	—	—	—	—	—	—	—	0.3	—
Ending mortgage balance (1)	737.7	767.5	798.2	814.2	825.7	832.9	837.0	865.7	905.0
Loan to value of new originations	31%	32%	30%	27%	28%	28%	29%	33%	34%
Total repayments as % of opening balance	1.9%	3.3%	2.9%	3.0%	2.1%	3.5%	4.6%	3.3%	2.3%
Trailing 4 quarters:									
Originations	129.9	135.5	138.9	129.6	116.1	99.8	91.5	110.2	142.9
Total repayments	(82.7)	(82.6)	(80.0)	(84.1)	(87.9)	(92.6)	(108.5)	(112.1)	(114.8)

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

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

HomeEquity Bank sources customer leads through its marketing and referral network. There has been increased demand for reverse mortgages throughout the country, and the volume of inquiries and applications continues to grow. As an indication of the motivation of prospective customers, the sales cycle is shortening making the origination process more efficient.

The first quarter of 2010 continued the momentum and strong finish experienced in 2009. New mortgage originations of \$47.3 million were more than three times that of Q1 2009 and 67.7% higher than Q1 2008. Demand for reverse mortgages continues to increase throughout the country and the company is benefiting from the increasing experience and skill set of its sales force and referral partners. In addition the recent reduction in rates has made the product more appealing to a larger proportion of the senior population.



Accrued interest in Q1 2010 of \$12.0 million decreased 14.9% from \$14.1 million in Q1 2009 mainly due to the 148 basis point reduction in yield earned on the mortgage portfolio. The impact of the reduction in the yield was partially offset by the 7.6% growth in the average mortgage portfolio from Q1 2009.

Total repayments of principal and interest of \$20.0 million in Q1 2010 were \$2.7 million or 15.6% higher than Q1 2009. As a percentage of the opening mortgage balance, total repayments were at the lower end of historical experience. Short-term fluctuations in the level of originations and repayments will have an impact on the total portfolio balance in the future.

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 March 31, 2010, 15 loans had a loan to value greater than 83% having a balance of \$2.0 million, net of a \$0.3 million specific allowance, a net increase of \$0.1 million in the quarter. The appraised value of the property securing the mortgages is \$2.4 million before disposition costs. There were 13 mortgages with a loan-to-value greater than 83% at December 31, 2009.

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 1.4%;
- 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 \$47.3 million of new mortgages originated in Q1 2010 was 34% comparable to levels experienced prior to Q4 2008 when the Company began to conserve its cash resources while it applied for its bank license. For the entire mortgage portfolio, the most recently appraised value of the underlying properties was approximately \$2.5 billion, for a loan-to-value ratio of approximately 36% at March 31, 2010, comparable to that of December 31, 2009.

The general allowance increased by \$0.2 million to \$2.3 million in accordance with the loan provisioning policy, 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 general allowances for credit losses equates to 0.25% of the total mortgage balance.



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 and GIC's used 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"). The difference between the Prime Rate and the rate on T-Bills, on which 76% of the mortgage portfolio's rates are based, and the rate on BAs, on which 89% of HOMEQ's debt and hedging instruments are based, have recently returned to historical norms after deviating by up to 100 basis points over the last two years.

Since the beginning of the credit crisis the Bank of Canada benchmark interest rate has declined significantly and the corresponding decreases to the Prime Rate and interest rates on T-Bills and BAs resulted in reductions both to HOMEQ's yield and cost of funds.

Since Q2 2008, the interest rate on new mortgage originations has been set at a rate which is derived from HOMEQ's average cost of borrowing. This portion of the mortgage portfolio has grown to 24% of the total portfolio. Until the proportion of the mortgage portfolio earning the posted rate increases, the yield earned on the mortgage portfolio will continue to be primarily driven by the portion of the portfolio based on Prime and T-Bills.

In the fourth quarter of 2009, HomeEquity Bank reduced its posted rates on new mortgages by an average of approximately 1.00% to between 3.75% (variable rate mortgages) and 6.10% (5 year mortgages). Over a period of time the lower interest rates earned on new originations will have a downward effect on spread percentage but will be partially offset by the effect of increased volumes and improved origination and administration efficiencies. In addition, borrowing costs can be effectively managed by having access to more than one source of funds.

Interest income earned on the mortgage portfolio in Q1 2010 was \$12.0 million, a decrease of \$2.2 million or 15.5% from Q1 2009 due primarily to the lower interest rate environment. The average yield earned on the mortgage portfolio of 5.53% was 148 basis points lower than Q1 2009. The reduced yield was partially offset by the 7.6% increase in the average mortgage portfolio from March 31, 2009.

HOMEQ funds its mortgage portfolio with a combination of debt (89%) and with GIC deposits (11%) (the "funding portfolio"). The debt consists of senior and subordinated medium term debt and unsecured subordinated debt. The cost of funds of the senior debt averaged 103 basis points above the benchmark at March 31, 2010 in comparison to 91 basis points at March 31, 2009 and 54 basis points at March 31, 2008.

Two debt maturities in Q4 of 2010 have an average spread to the benchmark of approximately 80 basis points. The rate of interest paid on refinancing these maturities will affect the overall cost of funds of the debt portfolio.

Interest expense on the funding portfolio in Q1 2010 was \$5.6 million, a decrease of \$2.9 million or 34.6% from Q1 2009 due to a 156 basis point decrease in the average interest rate on the funding portfolio to 2.50%. During Q1 2010, HOMEQ repurchased \$34.4 million of the medium term debt maturing later in 2010 and reduced related derivatives by \$4.4 million resulting in additional interest expenses in the current quarter of \$0.3 million. In accordance with its asset and liability matching policy, the Company unwound \$5.0 million of derivatives in the quarter, resulting in a gain of \$0.2 million. The net result of the two transactions in the quarter was an increase in interest expense of \$0.1 million and an increase in the cost of funds of 0.07% to 2.50%. The repurchase of the debt will have an offsetting benefit during the remainder of the term.

Spread percentage in Q1 2010 of 3.03% was eight basis points higher than Q1 2009. The improvement in spread percentage reflects that the Canadian debt capital markets have been more consistent with historic experience. Without the impact of the transactions described above, spread percentage would have been 3.10%.

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.

HOMEQ has elected under The Canadian Institute of Chartered Accountants Handbook Section 3865 – *Hedges* to apply hedge accounting for certain interest rate swaps in its derivative portfolio. The designated hedges are effective at March 31, 2010. The objective of these hedges is to protect against changes in the fair value of the deposits and debt due to changes in the underlying benchmark interest rate.

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

(\$ thousands)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Mortgage interest income (1)	15,199	15,214	15,302	15,036	14,177	13,595	12,877	12,321	11,985
Average mortgage balance (2) (4)	721,258	752,014	781,435	805,422	820,369	829,548	832,866	848,452	882,799
Average mortgage yield – annualized (%)	8.45%	8.11%	7.77%	7.41%	7.01%	6.57%	6.13%	5.76%	5.53%
Interest expense	9,768	10,075	10,154	9,474	8,492	7,201	6,268	5,694	5,555
Average funding portfolio balance (3) (4)	755,397	804,337	851,007	850,102	848,448	847,809	846,418	864,221	900,225
Cost of funds – annualized (%)	5.19%	5.02%	4.73%	4.42%	4.06%	3.41%	2.94%	2.61%	2.50%
Spread (\$)	5,431	5,139	5,148	5,562	5,685	6,394	6,609	6,627	6,430
Spread (%)	3.27%	3.09%	3.04%	2.99%	2.95%	3.17%	3.20%	3.15%	3.03%

(1) Net of specific allowances, excludes early repayment fees and amortization of purchase price premiums, deferred commissions and deferred mortgage fees and costs

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

(3) Reflects the principal portion of deposits and 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 8% of the value of mortgages originated, and to focus on improving sales and marketing efficiencies in order to reduce this percentage over time.

The recent growth in mortgage origination volumes has come with a significant improvement in origination efficiency. Total origination costs of \$2.8 million in the quarter were \$0.7 million higher than Q1 2009 but resulted in an origination cost percentage of 6.0% in comparison to 14.7% in Q1 2009. The trailing four quarter origination cost of 7.8% was the lowest ever achieved, 20.4% lower than Q1 2009. Marginal origination cost percentage on a trailing four quarter basis of 5.6% improved 1.9 percentage points, 25.3% better than Q1 2009.

With the growing demand for reverse mortgages and an increasing experience level amongst the sales force, HOMEQ has seen a shortening of the sales cycle time and a corresponding increase in the volume of business that can be handled within the existing sales structure. The improvement in efficiency will partially offset the impact of a reduction in spread which has resulted from lower rates.

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

(\$ thousands)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Mortgage originations	28,235	39,019	37,814	24,554	14,680	22,690	29,460	43,365	47,260
Origination expenses									
Commissions	1,153	1,278	1,400	1,230	856	943	1,166	1,681	1,279
Direct origination expenses									
Origination salaries and benefits	198	195	198	189	201	193	191	197	185
Marketing	1,059	865	1,097	774	428	356	581	663	588
Marginal origination costs	2,410	2,338	2,695	2,193	1,485	1,492	1,938	2,541	2,052
Origination overhead expenses									
Salaries and benefits	1,055	1,041	1,057	1,233	1,082	1,077	1,106	1,502	1,233
Office	308	248	288	266	264	283	283	353	326
Subtotal	1,363	1,289	1,345	1,499	1,346	1,360	1,389	1,855	1,559
50% inclusion	681	645	673	749	673	680	695	927	779
Total origination cost	3,091	2,983	3,368	2,942	2,158	2,172	2,633	3,468	2,831
Origination cost (%)									
Marginal origination cost									
Current quarter	8.5%	6.0%	7.1%	8.9%	10.1%	6.6%	6.6%	5.9%	4.3%
Trailing four quarter	7.3%	7.2%	7.4%	7.4%	7.5%	7.9%	7.8%	6.8%	5.6%
Total origination cost									
Current quarter	10.9%	7.7%	8.9%	12.0%	14.7%	9.6%	8.9%	8.0%	6.0%
Trailing four quarter	9.5%	9.2%	9.4%	9.6%	9.8%	10.6%	10.8%	9.5%	7.8%



Mortgage Administration Expense

Cost effective administration of its mortgages is an important objective of HOMEQ. In Q1 2010, administration costs were \$1.7 million, \$0.4 million or 32.8% higher than Q1 2009 partially due to the increased costs associated with operating as a Schedule 1 Bank. The added annual overhead expenses to HOMEQ are approximately \$0.8 million. The average mortgage portfolio increased 7.6% from Q1 2009. As a percentage of the average mortgage portfolio, mortgage administration expenses were 0.76% in Q1 2010, compared to 0.61% in Q1 2009.

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

(\$ thousands)	2008				2009				2010
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Average mortgage balance	721,296	752,014	781,368	805,422	820,369	829,548	832,866	848,452	882,799
Administration expenses									
Mortgage servicing and administration	73	65	66	64	75	67	88	77	75
Origination overhead expenses	681	645	673	749	673	680	695	927	779
Professional services	405	276	379	417	878	981	502	478	508
Amortization of capital assets	77	81	76	69	60	64	66	91	102
Business and capital taxes	-	-	-	-	-	-	215	45	72
Other	161	93	86	93	116	65	63	91	151
Less:									
Conversion costs	—	—	—	—	(522)	(524)	(65)	—	—
Mortgage administration fees	(21)	(37)	(39)	(31)	(25)	(36)	(66)	(39)	(20)
Total administration expenses	1,376	1,123	1,241	1,361	1,255	1,297	1,498	1,670	1,667
Administration expense (%)									
Annualized	0.75%	0.59%	0.63%	0.67%	0.61%	0.63%	0.72%	0.79%	0.76%
Trailing four quarters	0.77%	0.71%	0.67%	0.67%	0.63%	0.64%	0.66%	0.69%	0.72%

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 cash flows, 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 debt, 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:

- GIC Deposits – HomEquity Bank 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 HomEquity Bank'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"). HomEquity Bank 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 deposits come from affiliated deposit agents of some of these banks.

- Medium Term Notes – CMT has the option of raising funds through the issuance of medium term debt.

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 period, CMT operated within these covenants. At March 31, 2010, the senior debt-to-mortgage ratio was 89.0% and the total debt-to-mortgage ratio was 96.2%.

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. We expect that 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 7,400 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 of HOMEQ.

(\$ thousands)	March 31, 2010	December 31, 2009
Cash and non-interest bearing deposits with banks	22,183	8,218
Treasury bills issued or guaranteed by Provinces	—	6,298
Cash and cash equivalents	22,183	14,516
Interest bearing deposits with banks	3,498	21,972
Total liquid assets	25,681	36,488

Deposits

HOMEQ commenced issuing GIC deposits when HomEquity Bank received its letters patent from the Minister of Finance on October 13, 2009. GICs are issued in terms ranging from one to five years in accordance with anticipated cash flows from mortgage repayments.

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

(\$ thousands)	Within 1 year	2 to 3 years	4 to 5 years	More than 5 years	March 31, 2010	December 31, 2009
Issued to individuals	37,762	33,646	27,228	—	98,636	40,412

Debt

The total principal amount of outstanding debt at March 31, 2010 of \$808.5 million was \$35.6 million lower than December 31, 2009 due to HOMEQ repurchasing \$34.4 million of its debt and regular repayments. HOMEQ repurchased of the debt, in order to reduce the magnitude of maturities scheduled for the third quarter of the year. The repurchase also reduced the negative carry on its cash resources.

The table below summarizes the timing of the expected final payments of the debt at March 31, 2010. Approximately 73% of these instruments can be extended from their expected final payment dates to their legal maturities which range from 2031 to 2034. The remaining notes have a bullet payment requirement at their respective expected final payment dates.

The \$225.6 million of medium term notes due within one year of March 31, 2010 is made up of two series of notes. The first series has an expected final payment date of October 26, 2010 and has a legal maturity date of October 26, 2034. The second series matures on November 1, 2010.

On October 23, 2009 HOMEQ concluded the sale of \$10 million of 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 debt issued by CMT. These notes constitute subordinated indebtedness within the meaning of the *Bank Act (Canada)* and qualify as Tier 2 B Capital of HomEquity Bank. The notes have a coupon of 9.71% and are unrated.



The table below summarizes the timing of expected final payment dates and maturities of principal amounts of debt issued.

(\$ thousands)	Within 1 year	2 to 3 years	4 to 5 years	More than 5 years	March 31, 2010	December 31, 2009
Medium-term debt	225,600	510,000	12,884	—	748,484	784,115
Subordinated debt	—	10,000	40,000	—	50,000	50,000
Unsecured subordinated debt	—	—	10,000	—	10,000	10,000
Total	225,600	520,000	62,884	—	808,484	844,115

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.

During Q1 2010, the Board of Directors approved an Option and Share Appreciation Rights Plan as third long term incentive plan. The plan is subject to shareholder approval at the annual general meeting on May 13, 2010. In March 2010, subject to shareholder approval of the plan, 82,000 stock options were granted to senior management of HOMEQ. These stock options were valued at \$0.1 million, have a term of seven years and vest equally over three years.

The table below summarizes HOMEQ's share activity for the period ended March 31, 2010.

	Voting	Management Restricted Share Plan	Directors' Deferred Share Plan	Total number of shares
Balance, December 31, 2009	14,006,839	81,449	150,753	14,239,041
Restricted shares redeemed	35,750	(35,750)	—	—
Restricted share grants, net	—	28,700	—	28,700
Deferred shares earned	—	—	11,555	11,555
Balance, March 31, 2010	14,042,589	74,399	162,308	14,279,296

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

On March 23, 2010 HOMEQ introduced an optional Dividend Reinvestment Plan (the "Plan") for shareholders. The Plan was available to shareholders beginning with cash dividends paid on April 13, 2010 to shareholders of record March 29, 2010.

Shareholders participating in the Plan will be able to use the cash dividends paid on their existing HOMEQ shares to purchase additional shares. Under the Plan, HOMEQ determines whether the additional shares are



purchased on the secondary market or are newly issued by HOMEQ. Newly issued shares will be priced at the volume weighted average trading price of the HOMEQ shares on the Toronto Stock Exchange on the five trading days preceding the dividend payment date, subject to a possible discount of up to 5%.

HOMEQ's Board of Directors has determined that, until otherwise decided and announced, shares purchased under the Plan will be newly issued and at a discount of 4%. Therefore, participating shareholders will receive shares valued at 104 percent of the cash dividend being reinvested. Further details of the Plan can be found on the Company's website at www.homeq.ca.

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

In the determination of its capital levels, HomEquity Bank 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 Bank. As a result of this process, HOMEQ has established the capital ratios of HomEquity Bank 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 Bank).

(\$ thousands)	March 31 2010	December 31 2009
Shareholders' equity per HomEquity Bank's consolidated balance sheet	75,798	76,666
Deductions	425	301
Tier 1 capital	75,373	76,365
Unsecured subordinated debt	8,000	8,000
Tier 2 capital	8,000	8,000
Total regulatory capital	83,373	84,365
Credit risk	455,769	440,250
Off-balance sheet exposure	5,581	6,258
Operational risk	39,950	40,331
Total risk-weighted assets	501,300	486,839
Capital ratios		
Tier 1 capital ratio	15.0%	15.7%
Total capital ratio	16.6%	17.3%
Assets-to-capital multiple	12.1x	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 Note 2 to the consolidated financial statements commencing on page 46 of the 2009 Annual Report, 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.

The areas of risk that HOMEQ has identified and deemed to be its primary areas of exposure are described below and on pages 30 through 33 in the MD&A or the Company's Annual Report.

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 portion of the Bank's mortgages are based, and the rate on Bankers' Acceptances, on which a portion 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.

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 redemptions 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 Mortgage 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 sources 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.

CONTROLS AND PROCEDURES

Changes in Internal Controls over Financial Reporting

There have been no significant changes in HOMEQ's internal controls over financial reporting during the period ended March 31, 2010, 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

HOMEQ's significant accounting policies are outlined in Note 2 of the annual consolidated financial statements on pages 46 through 50 of the 2009 Annual Report. There have been no changes in significant accounting policies during the period ending March 31, 2010.

Critical Accounting Estimates

There have been no changes to the critical accounting estimates from those disclosed in the Company's Annual Report

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.

During Q1 2010, the implementation team continued to discuss the results of detailed analysis with advisors and HOMEQ management. These discussions are expected to continue through Q2 2010, after which HOMEQ will finalize its determination of changes to accounting policies under IFRS and begin to determine the impact on the opening IFRS balance sheet (as at January 1, 2010).

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-Q3 2010
Resolution of the accounting policy change implications on information technology, internal controls and contractual arrangements	In progress, expected to be complete in Q2-Q3 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 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 information technology 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 derivative contracts, 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.

At this time HOMEQ cannot quantify the impact that the future adoption of IFRS will have on its financial statements, however, such impact may be material.

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: Recognition and Measurement**

In accordance with current Canadian GAAP, certain revenue and expenses directly related to the origination of mortgages are included in the carrying value of the mortgage and recognized over the estimated period the mortgage will earn interest. While IFRS requires similar treatment, the description of costs that should be deferred is different. HOMEQ is in the process of determining whether this difference will have a significant impact on the carrying value of the mortgages and the timing of recognizing certain expenses.

- **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, and whether those changes will have a significant impact on the measurement of its allowance for credit losses.

- 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 will 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 future 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 an increasing seniors population.

The November 2009 introduction of lower interest rates on reverse mortgages and the efficiency of HOMEQ's marketing campaigns is creating a significant increase in new customer inquiries and new funded mortgages. Based on recent experience we believe that originations in 2010 will be in the range of between \$180 million and \$200 million. This forecast anticipates a moderate increase in interest rates and a slowing rate of increase in housing prices in the second half of the year. The portfolio is expected to grow by between 10% and 15% over 2010 as a result of increasing origination volumes and compound interest, net of repayments.

With the continued normalization of credit capital market spreads, particularly the spread between T-bill rates and BA rates, HOMEQ expects spread percentage to be relatively constant over the next few quarters. Approximately 76% of the mortgage portfolio is at fixed contractual spreads over Prime or T-bill rates and 89% of the Bank's funding is locked in at a fixed spread above BA's. While the new lower pricing initiative, and the offsetting benefit of lower cost GIC's, will each have an impact on spread percentage over the longer term, it will be minimal in the next few quarters as each represents relatively small portions of the Bank's total mortgage and funding activities. Net interest income is expected to increase in concert with HOMEQ's portfolio growth.

The next significant debt maturity is in Q4 2010 and this debt is at an average spread of 80 basis points over BA's. It is not possible to predict at this time the average cost at which this debt will be refinanced.



As a result of the increase in demand for reverse mortgages, marketing costs and commission rates as a percentage of new mortgages originated have dropped to below historic rates. HOMEQ expects that mortgage origination costs as a percentage of originations will remain at approximately 8% or less.

Mortgage administration expense has increased as a result of the \$0.8 million “step-up” in expenditure associated with 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 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 the incremental expenses of operating as a bank and a planned increase in marketing expenditures. Marketing expenditures are expensed in the current year while mortgages originated effectively earn only six months of income in the first year and then continue to 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 its Annual Information Form is available on SEDAR at www.sedar.com.

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