TRANSFORMING OUR BUSINESS...

2009
ANNUAL
REPORT

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HOMEQ Corporation, through its wholly-owned subsidiary, HomEquity Bank, is the only national provider of reverse mortgages to homeowners aged 60 and over, Canada's fastest growing demographic segment. With almost a quarter century of experience in the marketplace, we enjoy a strong financial position with access to diverse, and cost-effective funding sources. With a seasoned management team, product expertise and skillful marketing we are well positioned for market leadership and growth.

FINANCIAL HIGHLIGHTS

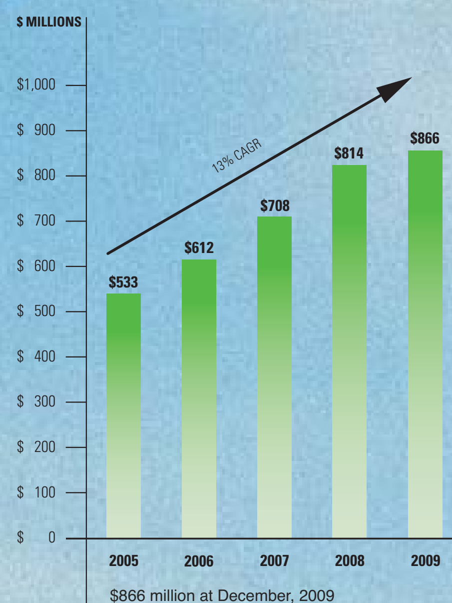
($ thousands except per share and percentage amounts)

	Three months ended December 31,		Twelve months ended December 31,	
	2009	2008	**2009**	2008
OPERATING RESULTS				
Net income (loss)	**345**	15,775	**(1,827)**	29,533
Per share	**0.024**	1.117	**(0.129)**	2.099
Adjusted net income (loss) (1)	**1,815**	1,544	**7,386**	5,636
Per share	**0.127**	0.103	**0.520**	0.401
Return on equity (annualized)	**1.4%**	60.5%	**(1.7%)**	28.9%
Adjusted return on equity (annualized) (2)	**8.4%**	6.9%	**8.4%**	6.2%
Spread income (3)	**6,627**	5,562	**23,315**	21,280
Spread percentage	**3.15%**	2.99%	**3.12%**	3.10%
Dividends per share	**0.14**	0.21	**0.56**	1.02
Mortgage originations	**43,365**	24,554	**110,195**	129,622
Trailing four quarter origination cost %	**9.5%**	9.6%	**9.5%**	9.6%
Trailing four quarter administration expense %	**0.69%**	0.67%	**0.69%**	0.67%
BALANCE SHEET HIGHLIGHTS				
Total assets			**1,016,563**	999,944
Mortgage principal plus accrued interest			**865,659**	814,359
Deposits			**40,093**	–
Medium term debt			**792,328**	804,297
Subordinated debt			**50,335**	60,407
PORTFOLIO QUALITY				
Appraised value of underlying properties			**2,400,000**	2,300,000
Average loan to value			**35.9%**	35.7%
Non-accrual mortgage value			**1,492**	556
Allowance for credit losses			**2,149**	408

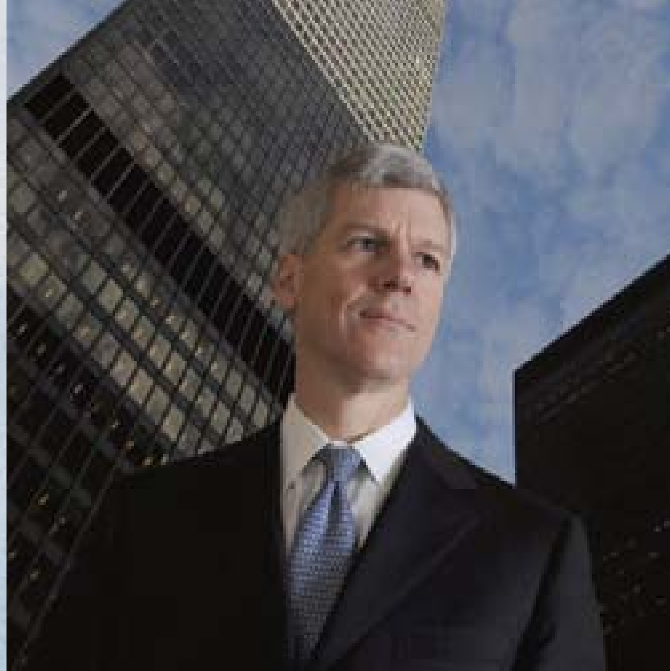
(1) Adjusted net income (loss) is explained in the Financial Results section on page 11.

(2) Adjusted return on equity is explained in the Financial Results section on page 11.

(3) Spread income, a non-GAAP measure, as discussed on pages 22 and 23.



Mortgage Principal Plus Accrued Interest



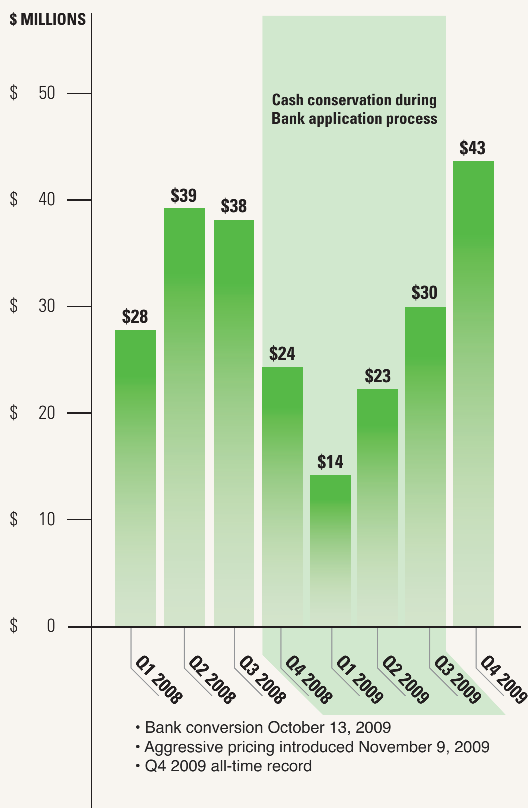
Steven K. Ranson
President & Chief
Executive Officer

LETTER FROM THE CEO

TO OUR SHAREHOLDERS...

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

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.



New Mortgages Originated

Record numbers of new mortgages originated. From our conversion to a Bank in October 2009, our mortgage originations have steadily increased. Our aggressive pricing in early November 2009 was well received in the marketplace.

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 fourth 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,

Steven K. Ranson
President & Chief Executive Officer

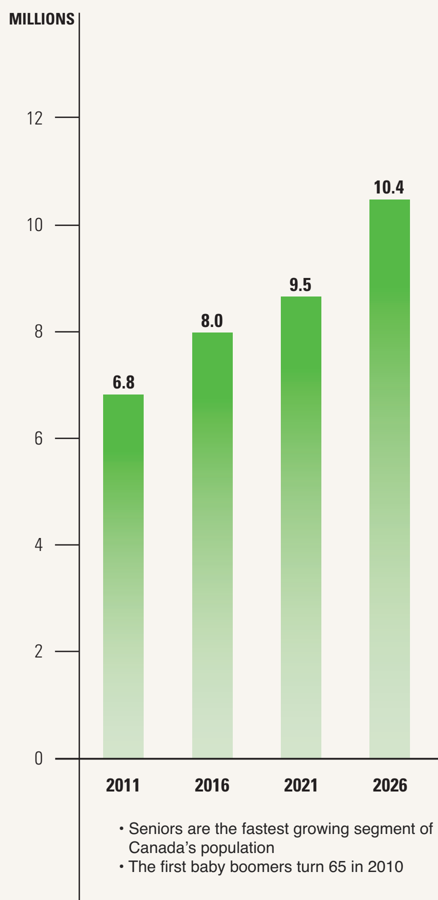
March 4, 2010

TRANSFORMING OUR BUSINESS...
through HomEquity Bank

We are the leading provider of reverse mortgages to a rapidly growing market of seniors. In their retirement years, many seniors seek out more viable lifestyle options, especially through unlocking "liquid" value in their most significant asset – their homes. To meet growing consumer demand, our product line is flexible, feature-rich and packed with functionality.

Our expertise has been established since our formation in 1986, culminating in 2009 with our Schedule I Bank status. Our strong financial position is backed up with our diversified, reliable and cost-effective capital funding sources. To address the needs of a fast-growing seniors market, our experienced management team, strategic vision, and proven marketing techniques position HOMEQ for substantial growth.

As the leader in the reverse mortgage business, HOMEQ is poised to capitalize on current demographic and market trends. In so doing, Canadian seniors can enjoy peace-of-mind and get the most out of their retirement years.



Favourable demographics for business growth

** Info Source: Statistics Canada, Catalogue no. 91-520*

Demographics for business growth. Seniors are the fastest growing segment in Canada's population. In fact, the first group of baby boomers turned 65 in 2010. The burgeoning ranks of Canadian seniors over the next 15 years aligns perfectly with our business model and product offerings.

Leading the Market through Transformation

The transformation of our business was put into action in 2009. At that time, we executed our strategy to become a Schedule I Bank. We had considerable confidence in our ability to conceive a multi-faceted strategy to transform ourselves from an Income Trust to a Corporation with nationally chartered bank status. In addition, we believed that our management team and capable staff would implement a smooth transition to Schedule I status.

A catalyst for our transformation was the challenging credit crisis that continued to engulf the world economy in 2009. The result was that credit lending, particularly in the mortgage sector, largely evaporated. Moreover, financing that was available was priced at uncompetitive rates. In our case, waiting for recovery was not an option. We were determined to pursue a proactive strategy; we refused to put our business on hold. To access multiple sources of funding and provide competitive products to our customers, we pursued our corporate transformation strategy.

A transformation to a Schedule I Bank is a rigorous and demanding process, carefully scrutinized by regulatory bodies. In our application year, out of more than 20 applications, we were the only applicant to receive this designation. Moreover, due to the complexity and range of issues involved in becoming a Schedule I Bank, the typical timeframe is 12–24 months. In our case, due to our experience with our product and our markets, strategic precision, project management skills and implementation teams, we received approval just 11 months after applying.

With our new Schedule I Bank status, we have diversified our capital funding capability. Instead of access to only wholesale funding, a robust retail funding stream is now also available. On a broader scale, the opportunities generated from our business model and structure provide us the confidence that we can service, and support whatever markets and product lines we create.

Our business plan and marketing model will help generate awareness and heightened demand for our product line. Our engaging television commercials generate substantial inquiries and attention for our direct-to-consumer and referral channels. Our extensive referral network includes all major Canadian chartered banks, credit unions, mortgage brokers and financial planning firms. In sum, with access to diversified sources of funding, we are positioned to be the premiere choice for seniors for home equity borrowing.

All of our strategies and plans revolve around our customer – seniors trying to enhance their retirement lifestyle. This is an expanding demographic, estimated to grow by 20% in the next six years. Our products address the fact that a growing number of Canadians are saving less. This results in a challenge to seniors in retirement, where RRSPs, savings and pension plans are often insufficient to meet needs.

Home equity represents the largest portion of a senior homeowner's net worth. But a home is more than a financial instrument, it provides comfort, stability, and a place of special memories. As a result, selling, moving and relocating from a home, especially for this age group, can be trying, both physically and emotionally. This is why senior Canadian homeowners prioritize staying in their home.

The CHIP Home Income Plan, provided by HomEquity Bank, is a practical solution that helps Canadian seniors remain in their homes. Importantly, our plan puts their hard-earned home equity to work – on their behalf. With no payments required until they move or sell, homeowners can maximize their cash flow while preserving their other investments and assets.

As the leader in the reverse mortgage business, HOMEQ is poised to capitalize on current demographic and market trends. In so doing, Canadian seniors can enjoy peace-of-mind and get the most out of their retirement years.

TRANSFORMING OUR BUSINESS…
with Experienced Management

Steven Ranson
President and Chief Executive Officer

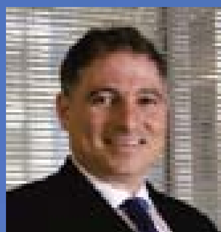
Q: **What are some major strengths of your organization?**

A: **Our established corporate culture, well-defined business philosophy and innovative, capable management team are key to our growth.**

Gary Krikler
Senior Vice President and Chief Financial Officer

Q: **What is a major priority of the company?**

A: **Growth is our priority. To achieve this, over the last year, we transformed reverse mortgages from a niche product into a mainstream financial solution. Our strategy is responsible for higher origination volumes today. More importantly, we're expanding our potential markets for tomorrow.**



Greg Bandler
Senior Vice President, Sales & Marketing

Q: **How will you seize opportunities in today's environment?**

A: **HomEquity Bank has an effective direct-to-consumer channel as well as an extensive referral network. These networks include the major Canadian banks, credit unions, mortgage brokers, and financial planning firms. In sum, we are well positioned to cost-effectively generate origination volumes to match our targets and objectives.**

Scott Cameron
Vice President, Finance & Deposit Services

Q: **What is the impact of retail deposits for the Bank?**

A: **Access to cost-effective, diversified sources of funding firmly places HomEquity Bank on secure financial footing. Being well-capitalized is a foundation for our future growth.**

Celia Cuthbertson
Vice President, General Counsel and Corporate Secretary

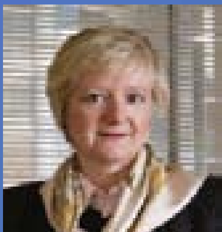
Q: **How is the new regulatory environment affecting HomEquity Bank?**

A: **A single national regulator ensures consistent consumer disclosure and a national standard for the reverse mortgage industry. This environment is beneficial to our clients – and our Bank.**

Keith Laplante
Vice President, National Sales

Q: **What are the avenues of growth?**

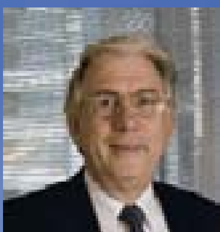
A: **The mainstream acceptance of reverse mortgages will create new opportunities. Many mortgage brokers and financial advisors are reconsidering the benefits of a reverse mortgage for their clients. With heightened appreciation of the benefits of our products, we anticipate that mortgage brokers and financial advisors will be a source of significant origination growth.**



Wendy Dryden
Vice President, Business Development

Q: **What does the transformation from a niche product to a mainstream solution mean from a business perspective?**

A: **With wider acceptance in the marketplace, we can aggressively challenge alternatives, while building our brand and continuing to grow our portfolio.**



Neil Sider
Vice President, Information Technology

Q: **Can your business model sustain rapid growth?**

A: **Regardless of size, we will ensure that our larger entity is flexible – and adaptable. This will enable us to leverage our existing business platforms to improve profitability and enable efficient investments in system enhancements.**

TRANSFORMING OUR BUSINESS...
with CHIP Home Income Plan

LEADING LIFE TO THE FULLEST WITH A CHIP HOME INCOME PLAN

CHIP Home Income Plan, provided by HomEquity Bank, is a reliable and secure financial solution that enables Canadian homeowners 60 plus to access and benefit from the equity in their home.

Our plan has no credit, income, or medical qualifications. As well, regular payments are not required until the property is sold or the owners move. With interest rates comparable to other forms of home equity borrowing, a CHIP Home Income Plan is a long-term borrowing solution that provides seniors with the security that they can benefit from their home equity when they need it.

As these real client stories show, CHIP Home Income Plan helps seniors enjoy retirement on their terms.

MONIQUE O, SAINT-BRUNO-DE-MONTARVILLE, QUÉBEC

When Monique O., 77 years of age, found herself short of cash, she didn't feel right asking her children for help. With a strong independent streak, Monique had always relied on herself.

Monique was intrigued when she saw a CHIP Home Income Plan commercial on television. She inquired about meeting a CHIP representative. At the outset, Monique was skeptical but was reassured by the clear and transparent process.

After careful consideration and consultation with her son, Monique was confident that the CHIP Home Income Plan would meet her needs.

It worked out perfectly for Monique. Through CHIP Home Income Plan, she accessed 34% of the equity of her home. By not accessing the full lending limit of her plan, she can access additional capital for future needs.

Monique felt great relief paying off her existing mortgage. As well, capital that used to service her debt now supplements her monthly cash flow. Monique is especially proud of living in her home while retaining her financial independence.

MARY M, PRITCHARD, BRITISH COLUMBIA

Major life changes can happen at any time. For Mary, 67, a divorce after 40 years of marriage presented some challenges. A priority for Mary was that her home was comfortable and well-maintained.

Mary used her home equity to finance maintenance and improvements to her home. She accessed about 40% of the equity in her home with a CHIP Home Income Plan. Taken as a lump sum, the money financed the construction of a new deck and garage. A hot tub purchase is also planned in the near future.

Mary also used some of the money for cash flow. Her adjustment to her new lifestyle was considerably eased with the knowledge that her future was financially secure.

PATRICK AND ANN O, CALGARY, ALBERTA

It mattered a lot to John O, the son of Patrick, 83 and Ann, 76, that his parents live comfortably in retirement. With Patrick in a long-term care facility while Ann lived in the family home, the bills started piling up.

With Power-of-Attorney, John recommended the CHIP Home Income Plan solution to his parents. With their agreement, he proceeded to secure it.

At the outset, Patrick and Ann accessed about 20% of their home equity to pay off their line of credit and credit card balances. John also arranged an additional $1,000 per month to cover his father's medical expenses.

John couldn't be happier. He says, "CHIP made a lifestyle difference and opened many doors."

BEN AND INGE H, PARRY SOUND, ONTARIO

After 15 years of retirement Ben, 74, and Inge, 72, were worried when they realized their lifetime RRSP savings were running low. To maintain their lifestyle with a consistent and dependable cash flow, Ben and Inge considered a range of options.

When Inge saw a CHIP Home Income Plan on television, she wanted to learn more.

Inge and Ben were excited about accessing their home equity with no payments until such time that they were ready to sell and move.

They accessed over 38% of the equity locked up in their home, investing almost everything in low-risk investments. The income generated by the investments is now supplementing their monthly cash flow.

Inge is thrilled with how things turned out. She says, "I am worry free for the rest of my life. No more financial worries is the most fantastic feeling a person can have. We wanted to stay in our house because we love it. If it wasn't for CHIP, I could have never stayed in my house."

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. 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) 180 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 Corp 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 Corp 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 HomEquity 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.

	2007		2008					2009				
($ thousands, except per share amounts)	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%.

	2007		2008					2009				
($ thousands, except per share amounts)	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.

	2007		2008					2009				
($ thousands)	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 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. 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 HomEquity 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 the 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 $865.7 million, an increase of $51.5 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.

	2007	2008				**2009**			
($ millions)	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)**
Reclassification of 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 originations	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 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.

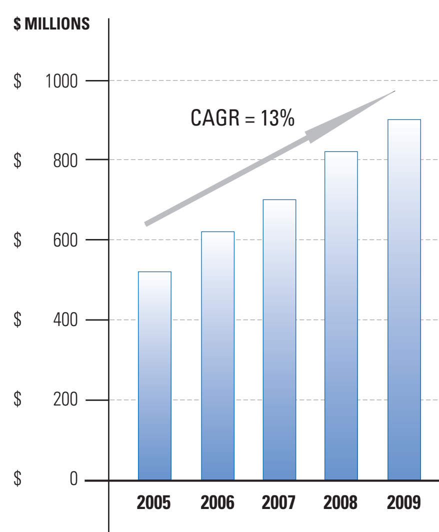
Commencing in Q4, 2008, HOMEQ took specific actions to conserve its cash resources. Steps were taken to reduce the average mortgage amount for new customers, marketing activity was scaled back, overhead expenditure was closely monitored and sales territories were rationalized. As anticipated, these steps 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 13%.



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.

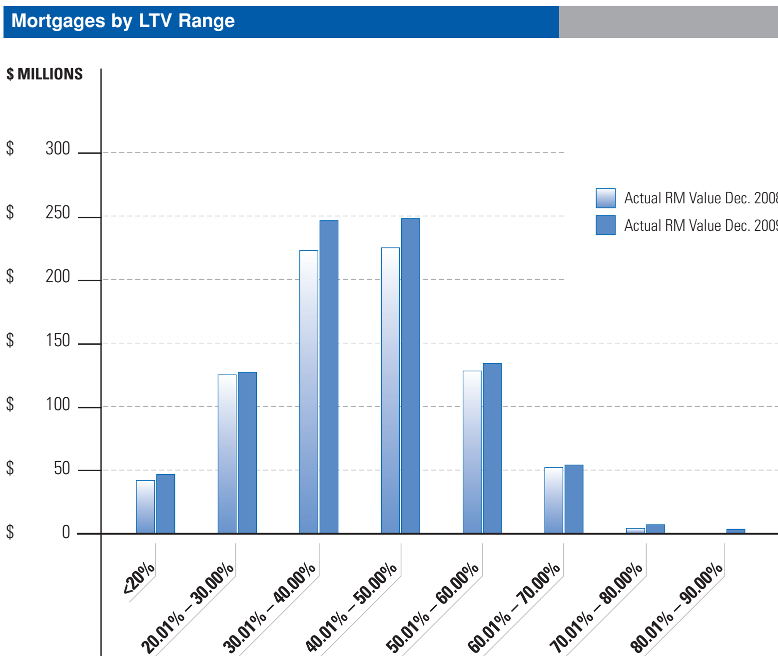
HOMEQ continually monitors and reassesses its underwriting policies, procedures and methodology, paying close attention to, amongst others, real estate trends, interest rate environments and occupancy experience. In particular, during the underwriting process:

- 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 $2.4 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.

Mortgages by LTV Range



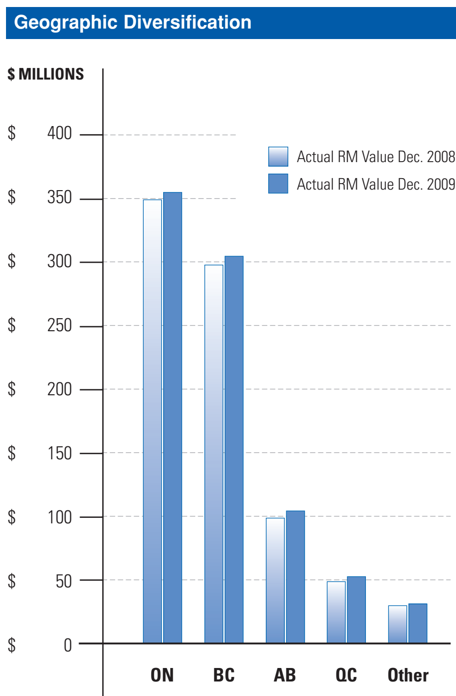
There is an inherent risk that the expected occupancy term ("EOT"), interest rate and property appreciation experienced over the life of a mortgage might vary from the assumed factors used in underwriting the mortgage. In addition, the value of a mortgage may increase unexpectedly as a result of charges 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.

Geographic Diversification



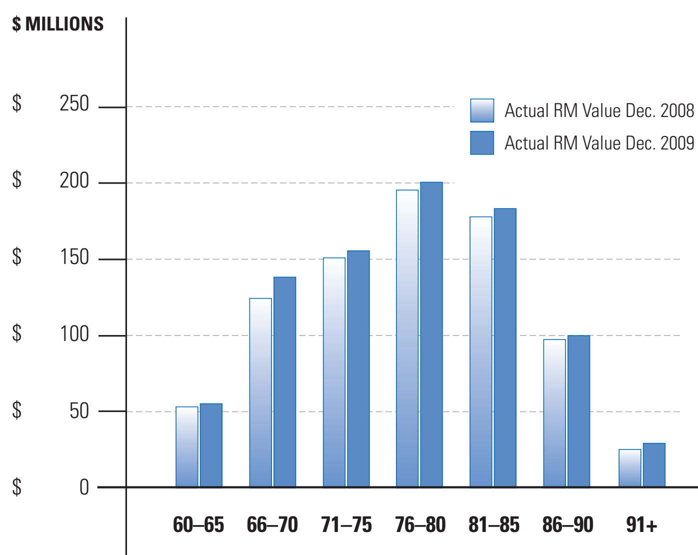
HOMEQ's loan provisioning methodology is reviewed and assessed periodically and is updated to take into account both current circumstances and evolution of the portfolio and business. During 2009 a significant review was undertaken, having last been undertaken comprehensively approximately five years 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.

	2007	2008					2009				
($ thousands)	Q4	Q1	Q2	Q3	Q4	Full Year	**Q1**	**Q2**	**Q3**	**Q4**	**Full Year**
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, $18.8 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.

	2007	2008					2009				
($ thousands)	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 the 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 of $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 0.67% 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.

	2007	2008					2009				
($ thousands)	Q4	Q1	Q2	Q3	Q4	Full Year	**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 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 HomEquity 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 HomEquity, 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'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 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 use 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 banks	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 banks	17,963	**21,972**
Total liquid assets	41,532	**36,488**

Deposits

HOMEQ commenced issuing deposits when HomEquity 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**	–

Debt

The total principal amount of outstanding debt at December 31, 2009 of $844.1 million is $5.1 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.

HOMEQ refinanced $150 million of 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 of medium term notes due within one year 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. The notes have a coupon of 9.71% and are unrated.

($ 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
Unsecured subordinated debt	–	–	10,000	–	**10,000**	–
Total	260,000	415,000	169,115	–	**844,115**	849,186

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
Tier 1 capital	76,365
Unsecured subordinated debt	8,000
Tier 2 capital	8,000
Total regulatory capital	84,365
Credit risk	440,250
Off balance sheet exposure	6,258
Operational risk	40,331
Total risk-weighted assets	486,839
Capital ratios	
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 Note 2 to the consolidated financial statements commencing on page 46, 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 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.

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 risks.

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 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.

Legal and Regulatory Risk

Legal and Regulatory Risk is the risk of non-compliance with applicable regulatory and legal requirements.

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 46 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.

Activity	Status
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 alternative	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 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 a 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 experiencing 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, this reduction 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 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 its Annual Information Form is available on SEDAR at www.sedar.com.

March 4, 2010

Management's Responsibility for Financial Reporting

The consolidated financial statements of HOMEQ Corporation (the Company) have been prepared by and are the responsibility of the management of the Company. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles, including the accounting requirements specified by the Office of the Superintendent of Financial Institutions Canada and reflect, where necessary, management's best estimates and judgments.

Management is also responsible for maintaining systems of internal and administrative controls to provide reasonable assurance that the Company's assets are safeguarded, that transactions are properly executed in accordance with appropriate authorization, and that the accounting systems provide timely, accurate and reliable financial information. Controls include quality standards in hiring and training of employees, written policies, a corporate code of conduct and appropriate management information systems.

The internal control systems are further supported by a legislative compliance framework, which ensures that the Company and its employees comply with all regulatory requirements, as well as a risk management framework that ensures proper risk control, related documentation, and the measurement of the financial impact of risks. In addition, the internal audit function periodically evaluates various aspects of the Company's operations and makes recommendations to management for, among other things, improvements to the control systems.

Every year, the Office of the Superintendent of Financial Institutions Canada makes such examinations and inquiries as deemed necessary to satisfy itself that the Company's subsidiary, HomEquity Bank is in sound financial position and that it complies with the provisions of the *Bank Act (Canada)*.

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

The internal auditors, the external auditors and the Office of the Superintendent of Financial Institutions Canada meet periodically with the Audit Committee, with management either present or absent, to discuss all aspects of their duties and matters arising therefrom.

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

The Board's Audit Committee, consisting of independent directors, has reviewed these consolidated financial statements with management and the auditors and has reported the results of this review to the Board of Directors, which has approved the consolidated financial statements.

Steven K. Ranson, CA
President & Chief Executive Officer

Gary Krikler, CA
Senior Vice President & Chief Financial Officer

Auditors' Report

To the Shareholders of
HOMEQ CORPORATION

We have audited the consolidated balance sheets of HOMEQ Corporation as at December 31, 2009 and 2008, and the consolidated statements of income, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Chartered Accountants
Licensed Public Accountants

Toronto, Canada,
March 4, 2010

Consolidated Balance Sheets

As at December 31	2009	2008
(in thousands of dollars)	$	$
ASSETS		
Cash resources (note 4)		
Cash and cash equivalents	**14,516**	23,569
Interest bearing deposits with banks	**21,972**	17,963
	36,488	41,532
Securities (note 5)		
Held-for-trading	**12,192**	24,502
Loans (note 6)		
Residential reverse mortgages	**919,573**	869,135
Allowance for credit losses	**(2,412)**	(572)
	917,161	868,563
Other		
Derivative instruments (note 16)	**28,544**	44,680
Property and equipment, net of accumulated amortization (note 7)	**659**	601
Goodwill and other intangible assets (note 8)	**19,956**	19,281
Future income tax assets (note 9)	**594**	77
Prepaid expenses and other assets	**969**	708
	50,722	65,347
	1,016,563	999,944
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits (notes 10 and 16)		
Payable on a fixed date	**40,093**	–
	40,093	–
Other		
Derivative instruments (note 16)	**3,347**	7,950
Future income tax liabilities (note 9)	**12,542**	13,090
Income taxes payable	**1,873**	–
Dividends payable	**980**	1,228
Accounts payable and accrued liabilities	**3,939**	2,248
	22,681	24,516
Medium-term debt (notes 11, 15 and 16)	**792,328**	804,297
Subordinated debt (notes 12, 15 and 16)	**50,335**	60,407
Unsecured subordinated debt (notes 13 and 15)	**10,144**	–
	852,807	864,704
	915,581	889,220
Shareholders' equity / Unitholders' equity		
Common shares (notes 1 and 14)	**102,794**	110,724
Deficit	**(1,812)**	–
	100,982	110,724
	1,016,563	999,944

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

On behalf of the Board of Directors:

Pierre B. Lebel
Director

Paul Damp
Director

Consolidated Statements of Income

For the years ended December 31	2009	2008
(in thousands of dollars)	$	$
Interest income		
Mortgage interest (note 6)	**48,532**	56,865
Securities	**178**	1,341
Deposits with banks	**105**	1,459
	48,815	59,665
Interest expense		
Deposits	**133**	–
Medium-term debt	**24,149**	35,450
Subordinated debt	**3,187**	2,787
Unsecured subordinated debt	**186**	–
Commercial paper and liquidity line	**–**	1,233
	27,655	39,470
Net interest income	**21,160**	20,195
Provision for credit losses (notes 3 and 6)	**1,840**	276
Net interest income after provision for credit losses	**19,320**	19,919
Non-interest income		
Mortgage closing fees, net of costs	**802**	915
Mortgage administration fees	**167**	128
	969	1,043
Net interest income and non-interest income	**20,289**	20,962
Non-interest expenses		
Salaries and benefits (note 20)	**5,727**	5,337
Selling, general and administration (note 21)	**6,774**	6,910
Amortization of intangible assets	**96**	96
Amortization of property and equipment	**185**	207
	12,782	12,550
Income before under noted item	**7,507**	8,412
Unrealized losses (gains) on derivative instruments (note 16)	**8,527**	(27,363)
Income (loss) before income taxes	**(1,020)**	35,775
Current income tax expense	**1,873**	–
Future income tax expense (recovery)	**(1,066)**	6,242
Provision for income taxes (note 9)	**807**	6,242
Net income (loss) and total comprehensive income (loss)	**(1,827)**	29,533
Average number of common shares outstanding (note 1)	**14,209**	14,069
Basic and diluted earnings (loss) per share (note 1)	**$ (0.129)**	$ 2.099

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

Consolidated Statements of Changes in Shareholders' Equity

For the years ended December 31	2009	2008
(in thousands of dollars)	$	$
Common shares		
Balance at beginning of year	**–**	–
Conversion from Trust Units (note 1)	**102,547**	–
Issued during the year	**247**	–
Balance at end of year	**102,794**	–
Unitholders' equity		
Balance at beginning of year	**110,724**	93,912
Issued during the year	**238**	1,612
Transition adjustment on adoption of financial instruments standard (note 3)	**(484)**	–
Net income (loss) for the year	**(1,975)**	29,533
Dividends declared	**(5,956)**	(14,333)
Conversion to common shares (note 1)	**(102,547)**	–
Balance at end of year	**–**	110,724
Deficit		
Balance at beginning of year	**–**	–
Net income for the year	**148**	–
Dividends declared	**(1,960)**	–
Balance at end of year	**(1,812)**	–
Total Shareholders' equity / Unitholders' equity (note 1)	**100,982**	110,724

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

Consolidated Statements of Cash Flows

For the years ended December 31	2009	2008
(in thousands of dollars)	$	$
OPERATING ACTIVITIES		
Net income (loss)	**(1,827)**	29,533
Adjust for non-cash items		
Amortization		
Purchase price premiums and origination fees	**3,500**	3,676
Deferred origination commissions	**1,960**	1,515
Deferred deposit commissions	**11**	–
Debt issue costs	**1,227**	1,113
Intangible assets	**96**	96
Property and equipment	**185**	207
Increase in provision for credit losses	**1,840**	276
Compensation expense related to long-term incentive plans	**488**	443
Future income tax expense (recovery)	**(1,066)**	6,242
Unrealized losses (gains) on derivative instruments	**8,527**	(27,363)
	14,941	15,738
Changes in non-cash working capital		
Accrual of interest payable on debt and derivatives	**(5,016)**	(1,698)
Accrual of interest on mortgages	**(53,068)**	(61,028)
Repayments of accrued interest	**36,819**	27,589
Other (note 22)	**2,993**	(1,069)
	(18,272)	(36,206)
Cash used in operating activities	**(3,331)**	(20,468)
INVESTING ACTIVITIES		
Mortgages originated	**(110,195)**	(129,622)
Mortgage principal repayments	**75,144**	56,519
Commissions	**(4,598)**	(5,061)
Decrease (increase) in securities, net	**12,310**	(24,502)
Increase in interest bearing deposits with banks, net	**(4,009)**	(17,963)
Purchase of intangible assets	**(461)**	(78)
Purchase of property and equipment	**(243)**	(133)
Cash used in investing activities	**(32,052)**	(120,840)
FINANCING ACTIVITIES		
Repayments of commercial paper, net	**–**	(76,075)
Increase in deposits	**40,412**	–
Increase in deposit broker commissions	**(246)**	–
Gross proceeds from medium-term debt	**150,000**	165,000
Repayment of medium-term debt	**(155,071)**	(2,566)
Repurchase of subordinated debt	**(10,000)**	–
Gross proceeds from unsecured subordinated debt	**10,000**	–
Increase in debt issue costs	**(599)**	(714)
Dividends	**(8,166)**	(14,623)
Proceeds from shares issued under dividend reinvestment plan	**–**	1,169
Cash provided by financing activities	**26,330**	72,191
Net decrease in cash and cash equivalents, during the year	**(9,053)**	(69,117)
Cash and cash equivalents, beginning of year	**23,569**	92,686
Cash and cash equivalents, end of year (note 4)	**14,516**	23,569
Supplemental cash flow information:		
Interest paid	**31,325**	39,828

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

Notes to Consolidated Financial Statements

(in thousands of dollars except per share amounts)
December 31, 2009 and 2008

1. ORGANIZATION AND BASIS OF PRESENTATION

HOMEQ Corporation (the Company) was incorporated on March 10, 2009 under the laws of the Province of Ontario. The Company is a holding company which invests in its wholly owned subsidiary, HomEquity Bank (formerly Canadian Home Income Plan Corporation), which originates and administers reverse mortgages.

On June 30, 2009, Home Equity Income Trust (the Trust) converted to a corporation, by way of a Plan of Arrangement continuing its business operations as HOMEQ Corporation (the Conversion). The Company continues the business of the Trust. Under the Conversion, the unitholders of the Trust exchanged each of their trust units for common shares of the Company, on a one-for-one basis. All references to "shares" refer collectively to common shares subsequent to the Conversion and to trust 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. These consolidated financial statements of the Company have been prepared using the continuity of interest method for the assets, liabilities and operations of the Trust.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Basis of consolidation

These consolidated financial statements reflect the financial position and results of operations of the Company consolidated with the financial position and results of operations of its subsidiaries. The Company's principal subsidiary is HomEquity Bank (formerly Canadian Home Income Plan Corporation). Transactions and balances between the Company and its subsidiaries are eliminated on consolidation.

Use of estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Allowance for credit losses, fair value of certain financial instruments, income taxes and valuation of goodwill and other intangible assets are areas where management makes significant estimates and assumptions in determining the amounts to be recorded in the consolidated financial statements.

Financial assets and liabilities

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

Financial instruments that are either designated as held-for-trading or available-for-sale are required to be measured at fair value at each balance sheet date.

Under these standards, the Company classifies its mortgages as loans receivable and carries them at amortized cost. The Company's liabilities continue to be classified as other liabilities.

Financial instruments

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

The guidance did not have a material effect on the financial position or earnings of the Company. The Company is exposed to a variety of financial risks in the normal course of business. The financial risk management objectives are described in the Management Discussion and Analysis. The new disclosures required under Section 3862 are included in note 18.

Fair value of financial instruments

The Company presents cash resources, held-for-trading securities and derivative instruments at fair value. Loans, deposits and certain other assets and certain other liabilities are recorded at amortized cost. Except as disclosed in note 18 to these consolidated financial statements, the carrying values of the Company's financial instruments approximate their fair values.

Capital disclosures

Effective January 1, 2008, the CICA's accounting standard, Section 1535, *Capital Disclosures*, was implemented, which requires the disclosure of both qualitative and quantitative information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital, quantitative data about what is considered capital and whether an entity has complied with any capital requirements and consequences of non-compliance with such capital requirements. The new guidance did not have an effect on the financial position or the earnings of the Company. See note 15.

Cash and cash equivalents

Cash and cash equivalent balances have less than 90 days to maturity from the date of acquisition. Cash and cash equivalents consist of cash, Canadian and provincial securities, interest bearing deposits with banks and corporate notes. Cash and cash equivalents are designated as held-for-trading, and accordingly, are carried at fair value. Changes to fair value are recorded in the consolidated statements of income. Investment interest is recognized on an accrual basis.

Securities

Securities balances have more than 90 days to maturity from the date of acquisition and consist of Canadian and provincial securities and corporate notes. Securities are accounted for at settlement date and designated as held-for-trading, and accordingly, are carried at fair value. Changes to fair value are recorded in the consolidated statements of income. Investment interest is recognized on an accrual basis.

Mortgages

Mortgages are lifetime, interest accruing mortgages that are secured by residential real property. Interest income is recognized on an accrual basis on all mortgages and is due together with repayment of the principal at the time the property is vacated by the homeowner(s).

2. Summary of Significant Accounting Policies (cont'd)

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

Mortgage early repayment fees are recorded as revenue when received.

Allowance for credit losses

The allowance for credit losses recorded in the consolidated balance sheets 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. The Company has both specific and general allowances as described below.

Specific allowances

The Company's 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

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.

Prepaid expenses

Prepaid expenses are stated at cost and are amortized over their expected beneficial life.

Income taxes

Income taxes are determined using the liability method. Under this method of tax allocation, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Future income tax assets are recognized to the extent that realization is considered more likely than not. Prior to Conversion, the Trust estimated future taxes based on the effective tax rate on reversing temporary differences in 2011 and thereafter. As a result of the Conversion, the Company is taxable and has accordingly estimated future taxes for 2010.

Prior to the Conversion, the Trust qualified as a mutual fund trust under the *Income Tax Act* (Canada). The Trust distributed all or substantially all of its taxable income to the unitholders. Income tax obligations relating to the distributions are the obligations of the unitholders and accordingly, no current tax provision for income taxes on the income of the Trust was made.

Property and equipment

Computer hardware is recorded at cost and amortized on a straight-line basis over four years. Furniture and equipment are stated at cost and are amortized on a straight-line basis over a term of seven years. Leasehold improvements are recorded at cost and are amortized on a straight-line basis over the term of the related lease. The amortization expense is recognized in the consolidated statements of income.

Deposits

Deposits are payable on a fixed date and consist of fixed-interest rate guaranteed investment certificates. The terms of these deposits range from one year to five years. Deposits are financial liabilities and are measured at cost using the effective interest rate method. Deposit broker commissions are included in deposits on the consolidated balance sheets and are amortized to interest expense over the term of the deposit.

Derivative financial instruments

The Company uses derivative instruments such as interest rate swaps and forward rate agreements, economically hedging the interest term of some of its medium-term, subordinated debt and deposit liabilities 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. Fair value of derivative instruments is determined using an internal valuation model with observable inputs. Realized amounts receivable or payable on derivatives are accrued and recorded as adjustments to interest expense in the consolidated statements of income.

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

Hedge accounting

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

Comprehensive income

CICA Section 1530, *Comprehensive Income*, requires the presentation of a statement of comprehensive income for certain revenues, expenses, gains and losses that are not recorded as part of net earnings but presented in other comprehensive income until it is considered appropriate to recognize it in net earnings. The Company does not have any income from this source and as such a consolidated statement of comprehensive income has not been included in these consolidated financial statements.

Goodwill and other intangible assets

Goodwill reflects the purchase price paid on acquisition of Canadian Home Income Plan Corporation, prior to its continuance as HomEquity Bank, in excess of the fair market value of net tangible assets and identifiable intangible assets acquired. Goodwill is not amortized but is tested for impairment annually.

Costs incurred by HomEquity Bank in obtaining its bank license have been capitalized and are recorded at cost. Bank license costs are not amortized but are tested for impairment annually.

Software is recorded at cost and amortized on a straight-line basis over three years. Amortization expense is recognized in amortization of intangible assets on the consolidated statements of income.

2. Summary of Significant Accounting Policies (cont'd)

Transaction costs for debt liabilities

Debt issue costs incurred by the Company are capitalized and are included in medium-term debt, subordinated debt and unsecured subordinated debt. These costs are amortized over the term of the debt on an effective interest rate method and are included in interest expense in the consolidated statements of income. The Company does not incur any transaction costs related to financial instruments that are designated as held-for-trading.

Long-term incentive plans

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

Earnings per share

Basic and diluted earnings per share are calculated by dividing net income by the average number of fully paid common shares outstanding during the year.

3. CHANGES IN ACCOUNTING POLICIES

Goodwill, intangible assets and financial statement concepts

Effective January 1, 2009, the CICA's new accounting standard, Section 3064, *Goodwill and Intangible Assets*, was adopted by the Company. This 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 new guidance did not have a material effect on the financial position or the earnings of the Company; however the Company reclassified intangible assets relating to application software with net book value of $55 as at December 31, 2008 from property and equipment to goodwill and other intangible assets on the consolidated balance sheets.

Credit risk and the fair value of financial assets and financial liabilities

Effective January 20, 2009 the CICA's Emerging Issues Committee EIC-173 Abstract, *Credit Risk and the Fair Value of Financial Assets and Financial Liabilities*, was adopted by the Company. EIC-173 was released 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 EIC requires the inclusion of credit risk of the counterparty and the Company in determining the fair value of derivative instruments. The EIC requires retrospective adoption without restatement of prior periods.

Under this new guidance, the Company has recorded an adjustment to decrease opening shareholders' equity by $484 for the year ended December 31, 2009. The adjustment is related solely to the recognition of credit risk on the fair value of derivative instruments as at December 31, 2008.

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 additional disclosures are provided in note 18.

Income taxes

Prior to the Conversion, the Company qualified as a mutual fund trust under the *Income Tax Act* (Canada). The Trust distributed all or substantially all of its taxable income to its unitholders. Income tax obligations relating to the distributions are the obligations of the unitholders and accordingly, no current tax provision for income taxes on the income of the Trust was made. As a result of the Conversion, the Company is taxable at corporate rates.

Change in accounting estimate

Allowances for credit losses

During 2009, the Company increased its accounting estimate of allowances for credit losses principally related to general allowances by $1,741. The increase was related to periodic review and assessment of the Company's general allowance methodology updated to take into account both current circumstances and evolution of the portfolio and business. During 2009, the significant review was undertaken because of factors in the economic environment and the experience gained of a maturing mortgage portfolio, including volatility in housing prices across Canada, increasing number of mortgages which exceed loan-to-value of 50%, expected occupancy terms exceeding original projections and the limitations inherent in the appraisal process. The review incorporated 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 included 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.

This change has been fully recorded in the current year as it is a change in estimate. The presentation of the provision has also changed. Previously, the increase or decrease in the general allowance was included in mortgage interest and is now presented separately in the consolidated statements of income as provision for credit losses.

4. CASH RESOURCES

The following table shows the details of cash resources on the consolidated balance sheets:

	December 31, 2009 $	December 31, 2008 $
Cash and non-interest bearing deposits with banks	**8,218**	6,087
Treasury bills issued or guaranteed by provinces	**6,298**	10,988
Corporate notes	**–**	6,494
Cash and cash equivalents	**14,516**	23,569
Interest bearing deposits with banks	**21,972**	17,963
Total cash resources	**36,488**	41,532

5. SECURITIES

For the year ended December 31, 2009, the yield on these investments ranges between 0.24% and 0.53% with a weighted average rate of 0.27% (December 31, 2008 – 2.0%).

The following table shows the details of securities on the consolidated balance sheets:

	Remaining term to maturity				
	Within 1 year $	**1 to 5 years $**	**Over 5 years $**	**December 31, 2009 $**	December 31, 2008 $
Treasury bills issued or guaranteed by Canada	**3,996**	–	–	**3,996**	13,458
Treasury bills issued or guaranteed by provinces	**6,499**	–	–	**6,499**	1,495
Other debt securities	**1,697**	–	–	**1,697**	9,549
	12,192	–	–	**12,192**	24,502

6. LOANS

Residential reverse mortgages

The following table shows the details of the residential reverse mortgage balance on the consolidated balance sheets:

	December 31, 2009 $	December 31, 2008 $
Mortgage principal plus accrued interest	**865,659**	814,359
Mortgage purchase price premiums, net of accumulated amortization	**33,572**	36,839
Mortgage origination fees, net of accumulated amortization	**2,305**	2,538
Deferred commissions, net of accumulated amortization	**18,037**	15,399
	919,573	869,135

Geographic region and loan-to-value

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

Province	**December 31, 2009 $**	December 31, 2008 $	**December 31, 2009 %**	December 31, 2008 %
Ontario	**357,338**	349,055	**41.3**	42.9
British Columbia	**312,428**	296,758	**36.1**	36.4
Alberta	**105,770**	94,274	**12.2**	11.6
Quebec	**54,389**	44,606	**6.3**	5.5
Other	**35,734**	29,666	**4.1**	3.6
	865,659	814,359	**100.0**	100.0

Loan-to-value	**December 31, 2009 $**	December 31, 2008 $	**December 31, 2009 %**	December 31, 2008 %
Less than 30.0%	**173,715**	171,280	**20.1**	21.0
30.1% – 40.0%	**242,436**	225,849	**28.0**	27.7
40.1% – 50.0%	**246,051**	226,884	**28.4**	27.9
50.1% – 60.0%	**135,881**	130,057	**15.7**	16.0
60.1% – 70.0%	**54,820**	53,018	**6.3**	6.5
Greater than 70.1%	**12,756**	7,271	**1.5**	0.9
	865,659	814,359	**100.0**	100.0

Impaired loans

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

	December 31, 2009 $	December 31, 2008 $
Mortgage principal plus accrued interest	**1,755**	720
Specific allowance	**(263)**	(164)
	1,492	556
Appraised value of underlying properties	**1,798**	670

Allowance for credit losses

The following table shows the details of allowance for credit losses on the consolidated balance sheets:

	December 31, 2009 $	December 31, 2008 $
Specific allowances		
Balance, beginning of year	**(164)**	(45)
Provision for credit losses	**(171)**	(119)
Write-offs	**70**	–
Recoveries	**2**	–
Balance, end of year	**(263)**	(164)
General allowances		
Balance, beginning of year	**(408)**	(251)
Provision for credit losses	**(1,741)**	(157)
Balance, end of year	**(2,149)**	(408)
Total allowances	**(2,412)**	(572)

Mortgage interest

The following table shows the details of mortgage interest on the consolidated statements of income:

	December 31, 2009 $	December 31, 2008 $
Interest income	**53,068**	61,028
Early repayment fees	**924**	1,028
Less:		
Amortization of deferred commissions	**(1,960)**	(1,515)
Amortization of purchase price premiums and origination costs	**(3,500)**	(3,676)
	48,532	56,865

7. PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	Cost $	Accumulated amortization $	December 31, 2009 Net book value $	December 31, 2008 Net book value $
Computer hardware	**755**	**384**	**371**	237
Furniture and equipment	**116**	**70**	**46**	59
Leasehold improvements	**624**	**382**	**242**	305
	1,495	**836**	**659**	601

8. GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets consist of the following:

	December 31, 2009 $	December 31, 2008 $
Goodwill	**19,109**	19,109
Bank license costs	**427**	117
Software – amortized (1)	**420**	55
	19,956	19,281

(1) Software had a cost of $603 and accumulated amortization of $183.

9. INCOME TAXES

Components of income tax

The following table shows the details of the Company's provision for income taxes:

	December 31, 2009 $	December 31, 2008 $
Current income taxes		
Federal	**1,098**	–
Provincial	**775**	–
	1,873	–
Future income taxes		
Federal	**(627)**	6,242
Provincial	**(439)**	–
	(1,066)	6,242
Provision for income taxes	**807**	6,242

Reconciliation of income taxes

The Company's future income tax provision relates to temporary differences at December 31, 2009. At December 31, 2008, the future income tax provision related to the impact of the taxes estimated to be paid by the Company from January 1, 2011. The reconciliation of statutory and effective rates of tax is as follows:

	December 31, 2009 $	December 31, 2008 $
Combined Canadian federal and provincial income tax rate applied to income (loss) before income taxes	**33.0%**	33.5%
Tax expense (recovery) calculated at statutory rate	**(337)**	11,985
Increase (decrease) in income taxes due to:		
Income distributed to unitholders	**(340)**	(11,985)
Impact of tax rate changes	**1,732**	6,192
Other	**(248)**	50
Provision for income taxes	**807**	6,242

Components of future income tax balances

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

	December 31, 2009 $	December 31, 2008 $
Future income tax assets		
Property and equipment	**14**	39
Non-capital losses	**–**	38
Allowance for credit losses	**580**	–
	594	77
Future income tax liabilities		
Mortgages	**7,367**	6,839
Derivative instruments	**5,172**	6,251
Debt issue and deferred costs	**3**	–
	12,542	13,090

At December 31, 2009, the Company's estimates of the effective tax rate on reversing temporary differences by tax year are presented in the table below:

	December 31, 2009 %	December 31, 2008 %
2010	**30.5**	–
2011	**27.9**	29.5
2012	**26.1**	28.0
2013	**25.5**	28.0
2014 and thereafter	**25.1**	28.0

Prior to Conversion, the Trust qualified as a mutual fund trust under the *Income Tax Act* (Canada). The Trust distributed all or substantially all of its taxable income to its unitholders. Accordingly, the Trust estimated future taxes based on the effective tax rate on reversing temporary differences in 2011 and thereafter. As a result of the Conversion, the Company is taxable and has accordingly estimated future taxes for 2010.

10. DEPOSITS

All deposits are payable on a fixed date and are issued in Canada.

The following table summarizes the deposits outstanding as at December 31, 2009:

	Maturity term				
	Within 1 year $	2 to 3 years $	4 to 5 years $	December 31, 2009 $	December 31, 2008 $
Individuals	13,609	15,450	11,118	40,177	–
Adjustment in carrying value of hedged deposits (see note 16)	–	(34)	(50)	(84)	–
	13,609	15,416	11,068	(40,093)	–
Effective interest rate	1.22%	2.33%	3.30%		–

11. MEDIUM-TERM DEBT

The following table summarizes the medium-term debt outstanding as at December 31, 2009:

Series	Expected final payment	Interest basis	Interest rate at December 31, 2009	Fair market value at December 31, 2009 $	December 31, 2009 $	December 31, 2008 $
2007-1	Nov. 1, 2009	Fixed rate	–	–	–	150,000
2009-1	Oct. 26, 2010	Floating rate (1)	1.838%	150,116	150,000	–
2005-1	Nov. 1, 2010	Fixed rate	4.296%	112,193	110,000	110,000
2007-3	May 2, 2011	Fixed rate	5.613%	130,266	125,000	125,000
2008-1	May 16, 2011	Fixed rate	5.764%	172,422	165,000	165,000
2006-3	Aug. 1, 2012	Fixed rate	4.542%	118,351	115,000	115,000
2006-1	Feb. 1, 2013	Fixed rate	4.637%	107,063	105,000	105,000
2007-2	June 15, 2013	Floating rate (2)	1.583%	14,004	14,115	19,186
				804,415	784,115	789,186
Interest payable					7,858	8,722
Interest payable on derivative instruments					–	1,251
Interest receivable on derivative instruments					(3,954)	(1,053)
Debt issue costs, net of accumulated amortization					(1,614)	(2,169)
Adjustment in carrying value of hedged debt (see note 16)					5,923	8,360
					792,328	804,297

(1) Rate is reset on the 26th day of January, April and July 2010 based on the three-month bankers acceptance rate plus 1.40%.

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

The Company has a best efforts obligation to refinance the series 2006-3, 2007-3, 2008-1 and 2009-1 notes on the respective expected final payment dates. If a note remains outstanding after the expected final payment date, the interest will become the one-month Bankers' Acceptance rate plus the following spreads calculated and payable monthly: 2006-3 – 1.25%, 2007-3 – 3.00%, 2008-1 – 4.00% and 2009-1 – 3.00% until legal maturity. The series 2007-1 notes were repaid on November 1, 2009. The legal maturity dates of these notes range from August 1, 2031 to October 26, 2034. Fair value of medium-term debt is determined using average quoted market rates provided to the Company by capital market dealers.

12. SUBORDINATED DEBT

The following table summarizes the subordinated debt outstanding as at December 31, 2009:

Series	Expected final payment	Interest basis	Interest rate at December 31, 2009	Fair market value at December 31, 2009 $	December 31, 2009 $	December 31, 2008 $
2007-1B	Nov. 1, 2012	Fixed rate	6.663%	**9,860**	**10,000**	20,000
2007-2B	June 15, 2013	Fixed rate	7.582%	**19,935**	**20,000**	20,000
2006-2B	Aug. 1, 2013	Fixed rate	5.803%	**18,793**	**20,000**	20,000
				48,588	**50,000**	60,000
Interest payable					**719**	830
Interest receivable on derivative instruments					**(143)**	(70)
Debt issue costs, net of accumulated amortization					**(241)**	(353)
					50,335	60,407

The Company has a best efforts obligation to refinance the series 2006-2B and 2007-1B notes on the respective expected final payment dates. If a note remains outstanding after the expected final payment date, the interest will become the one-month Bankers' Acceptance rate plus the following spreads calculated and payable monthly: 2006-2B – 1.75% and 2007-1B – 3.50% until legal maturity. The legal maturity dates of these notes range from August 1, 2031 to November 1, 2032. The series 2007-2B note is repayable after the 2007-2 medium-term note is repaid in full. On October 23, 2009, the Company repurchased $10,000 of series 2007-1B with the proceeds of the unsecured subordinated debt (see note 13). Fair value of subordinated debt is determined using average quoted market rates provided to the Company by capital market dealers.

13. UNSECURED SUBORDINATED DEBT

The following table summarizes the subordinated debt outstanding as at December 31, 2009:

Maturity	Interest basis	Interest rate at December 31, 2009	Fair market value at December 31, 2009 $	December 31, 2009 $	December 31, 2008 $
Oct. 31, 2014	Fixed rate	9.713%	**10,277**	**10,000**	–
Interest payable				**183**	–
Debt issue costs, net of accumulated amortization				**(39)**	–
				10,144	

Fair value of the unsecured subordinated debt is determined using quoted market rates provided to the Company by a capital market dealer.

14. SHARE CAPITAL

A summary of the changes to the Company's share capital pursuant to the Conversion from an income trust to a corporation on December 31, 2009 is as follows:

Share capital

Authorized: An unlimited number of common shares

Issued share capital	December 31, 2009 Number of Shares	December 31, 2009 Amount $
Balance, beginning of year	–	–
Conversion from Trust units – June 30, 2009	**14,215,433**	**102,547**
Shares earned and granted under the long-term incentive plans (1)	**23,608**	**247**
Balance, end of year (2)	**14,239,041**	**102,794**

Trust units	December 31, 2009 Number of units	December 31, 2009 Proceeds $	December 31, 2008 Number of units	December 31, 2008 Proceeds $
Balance, beginning of year	**14,123,549**		13,933,047	
Units issued under distribution reinvestment plan	–	–	148,456	1,169
Units earned and granted under the long-term incentive plans (1)	**91,884**	**238**	42,046	443
Conversion to HOMEQ Corporation shares	**(14,215,433)**	–	–	–
Balance, end of year	–	**238**	14,123,549	1,612

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

(2) Includes 81,449 restricted shares issued under the Restricted Share Plan and 150,753 deferred shares issued under the Deferred Share Plan.

The Company has two long-term incentive plans: a Restricted Share Plan (RSP) for management and a Deferred Share Plan (DSP) for Directors. Prior to Conversion these plans were unit plans. Upon Conversion, the entitlements to units under the plans were converted to entitlements to an equivalent number of shares, and will continue to be held subject to the terms and conditions of their grant, with no change to the applicable vesting schedules.

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. As at December 31, 2009, 191,920 restricted shares have been issued since the inception of the plan and 81,449 shares remain within the plan, none of which have vested. For the year ended December 31, 2009 55,000 restricted shares (December 31, 2008 – 27,100) have been issued.

The non-employee Directors may elect to receive their compensation in whole or in part in the form of deferred shares under the DSP in lieu of cash compensation. On retiring from the Board, a Director will receive all deferred shares accumulated in the plan. The maximum number of shares that may be issued under the DSP is limited to 500,000. As at December 31, 2009, the Directors have earned 150,753 shares under the DSP. For the year ended December 31, 2009 60,492 deferred shares (December 31, 2008 – 24,331) have been issued.

For the year ending December 31, 2009, Directors fees and executive compensation expense under the long-term incentive plans was $488 (December 31, 2008 – $443). The Company intends to settle the restricted and deferred shares in shares of the Company upon vesting and retirement, respectively. Until such time, these shares do not trade on the Toronto Stock Exchange, have no voting rights and cannot be sold or liquidated early.

15. CAPITAL MANAGEMENT

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

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

The Company's subsidiary, HomEquity Bank, received its Letters Patent and Order to Commence as a federally regulated Schedule I bank from the Minister of Finance on October 13, 2009. As a chartered bank, HomEquity Bank has access to retail deposits sourced through deposit brokers, which became part of capital resources. The regulatory capital requirements of HomEquity Bank are specified by the Office of the Superintendent of Financial Institutions (OSFI) in its *Guideline A, Capital Adequacy Requirement (CAR) – Simple Approaches*. The Guideline specifies the types of items included in capital and the measures OSFI will consider in reviewing capital adequacy. The OSFI capital requirements were not applicable to the prior year as the bank charter was only received on October 13, 2009.

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

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

	December 31, 2009
Shareholders' equity per HomEquity Bank's consolidated balance sheet	76,666
Deductions	301
Tier 1 capital	76,365
Unsecured subordinated debt	8,000
Tier 2 capital	8,000
Total regulatory capital	84,365
Credit risk	440,250
Off-balance sheet exposure	6,258
Operational risk	40,331
Total risk-weighted assets	486,839
Capital ratios	
Tier 1 Capital Ratio (1)	15.7%
Total Capital Ratio (2)	17.3%
Assets-to-Capital Multiple (3)	11.8x

(1) The Tier 1 Capital Ratio is defined as Tier 1 capital divided by total risk-weighted assets.

(2) The Total Capital Ratio is defined as total regulatory capital divided by total risk-weighted assets.

(3) The Assets-to-Capital Multiple is calculated by dividing total assets, including specified off-balance sheet items net of other specified deductions, by total capital.

15. Capital Management (cont'd)

During the year ended December 31, 2009 HomEquity Bank complied with the OSFI guideline related to capital ratios and the assets-to-capital multiple. Both the Tier 1 and Total Capital Ratios remain above OSFI's stated minimum capital ratios of 7% and 10%, respectively, for a well capitalized financial institution. HomEquity Bank's Assets-to-Capital Multiple remains below the maximum permitted by OSFI.

HomEquity Bank's wholly owned subsidiary, CHIP Mortgage Trust's ("CMT") borrowings are subject to debt-to-mortgage covenants. The covenants are: a maximum senior debt-to-mortgage ratio of 93% when it has commercial paper outstanding, a maximum of 95% when its senior rated debt consists only of medium-term notes and a maximum total debt-to-mortgage ratio of 98%. CMT is also required to maintain minimum cash on hand equivalent to 2% of its mortgage portfolio value. At December 31, 2009, the senior debt-to-mortgage ratio was 90.4% (December 31, 2008 89.1%), the total debt-to-mortgage ratio was 97.5% (December 31, 2008 96.3%) and CMT held more than the required amount of cash. The Company closely monitors business performance to manage compliance with these covenants.

16. DERIVATIVE INSTRUMENTS

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

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

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

Fair values

Fair market values of the interest rate derivatives are determined using the period-end market rates compared to the rates in the derivative contract. Changes in fair value resulting in unrealized gains or losses are recorded in the consolidated statements of income.

Notional amounts

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

The following table summarizes the fair values, notional principal and weighted average rates of the derivative instruments outstanding as at December 31, 2009. The floating rate for all instruments is based on the CDOR-BA rate for terms ranging from one to twelve months.

	Weighted average rate		Notional principal		Fair values	
Interest rate contracts	December 31, 2009	December 31, 2008	December 31, 2009 $	December 31, 2008 $	December 31, 2009 $	December 31, 2008 $
Receive fixed						
Swaps	**4.139%**	4.223%	**650,000**	815,000	**28,248**	44,511
Forward rate agreements	**–**	2.764%	**–**	40,000	**–**	169
Pay fixed						
Swaps	**1.545%**	–	**25,000**	–	**288**	–
Forward rate agreements	**0.330%**	–	**60,000**	–	**8**	–
ASSETS			**735,000**	855,000	**28,544**	44,680
Receive fixed						
Swaps	**2.222%**	–	**35,000**	–	**188**	–
Forward rate agreements	**–**	–	**–**	–	**–**	–
Pay fixed						
Swaps	**2.246%**	3.904%	**211,000**	127,000	**3,146**	7,465
Forward rate agreements	**1.169%**	2.283%	**10,000**	136,000	**13**	485
LIABILITIES			**256,000**	263,000	**3,347**	7,950

Maturity terms

The following table summarizes the notional principal and fair value by term to maturity of derivative instruments outstanding as at December 31, 2009. Maturity dates range from May 2010 to November 2014.

	Remaining term to maturity				
	Within 1 year $	1 to 3 years $	3 to 5 years $	December 31, 2009 $	December 31, 2008 $
Notional principal					
Swaps	**110,000**	**455,000**	**110,000**	**675,000**	815,000
Forward rate agreements	**60,000**	**–**	**–**	**60,000**	40,000
Derivative assets	**170,000**	**455,000**	**110,000**	**735,000**	855,000
Swaps	**102,000**	**89,000**	**39,500**	**230,500**	127,000
Forward rate agreements	**10,000**	**–**	**–**	**10,000**	136,000
Derivative liabilities	**112,000**	**89,000**	**39,500**	**240,500**	263,000
Fair values					
Swaps	**3,076**	**19,201**	**6,259**	**28,536**	44,511
Forward rate agreements	**8**	**–**	**–**	**8**	169
Derivative assets	**3,084**	**19,201**	**6,259**	**28,544**	44,680
Swaps	**199**	**2,237**	**898**	**3,334**	7,465
Forward rate agreements	**13**	**–**	**–**	**13**	485
Derivative liabilities	**212**	**2,237**	**898**	**3,347**	7,950

16. Derivative Instruments (cont'd)

Hedge accounting results

The Company's fair value hedges consist of interest rate swaps that are used to protect against changes in fair value of fixed-rate medium-term debt and retail deposits due to movements in market interest rates. Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded as unrealized losses (gains) on derivative instruments in the consolidated statements of income, along with adjustments to the carrying value of the financial instruments that are attributable to the hedged risk. The Company elected under Section 3865, *Hedges*, to apply hedge accounting to the interest rate swaps detailed below.

During 2008, the Company entered into interest rates swaps having a notional amount of $159,000 to hedge $159,000 of the $165,000 series 2008-1 fixed-rate medium-term debt issued during that year. The hedges are effective at December 31, 2009. The fair value of these swaps is positive $5,058 at December 31, 2009 (December 31, 2008 – positive $8,300) and is recorded as derivative instruments asset on the consolidated balance sheets. For the year ended December 31, 2009, the Company has recorded a loss of $3,242 (December 31, 2008 – gain of $8,300) to unrealized losses (gains) on derivative instruments in the consolidated statements of income. For the year ended December 31, 2009 the carrying value of the fixed-rate medium-term debt has been adjusted by $2,437 (December 31, 2008 – $8,360) with a corresponding gain (2008 – loss) to unrealized losses (gains) on derivative instruments in the consolidated statements of income (see note 11). For the year ended December 31, 2009, a loss of $805 (December 31, 2008 – $60) arising from hedge ineffectiveness was recorded.

During 2009, the Company entered into interest rates swaps having a notional amount of $10,000, to hedge $10,000 of deposits issued during the year. The hedges are effective at December 31, 2009. The fair value of these swaps is negative $64 at December 31, 2009 (December 31, 2008 – Nil) and is recorded as derivative instruments liability on the consolidated balance sheets. For the year ended December 31, 2009, the Company has recorded a loss of $64 (December 31, 2008 – Nil) to unrealized losses (gains) on derivative instruments in the consolidated statements of income. For the year ended December 31, 2009 the carrying value of the deposits has been adjusted by $84 (December 31, 2008 – Nil) with a corresponding gain (2008 – Nil) to unrealized losses (gains) on derivative instruments in the consolidated statements of income (See note 10). For the year ended December 31, 2009, a gain of $20 (December 31, 2008 – Nil) arising from hedge ineffectiveness was recorded.

Derivative – related risks

Market risk

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

Credit risk

Credit risk on derivative financial instruments is the risk of a financial loss occurring as a result of a default of a counterparty on its obligation to the Company. Credit risk is limited by dealing only with Schedule 1 Canadian Chartered banks as counterparties. The maximum derivative credit exposure to the Company is the fair value of derivative contracts presented in the summary table above. The Company's exposure to risks arising from other financial instruments is disclosed in note 17.

Interest rate contracts	National principal	Replacement cost (1)	Credit risk equivalent (2)	Risk-weighted assets (3)	Fair value
Swaps					
Maturing within 1 year	110,000	3,076	3,076	615	3,076
Maturing in 1 to 3 years	455,000	19,201	21,476	4,295	19,201
Maturing in 3 to 5 years	110,000	6,259	6,809	1,362	6,259
Forward rate agreements					
Maturing within 1 year	60,000	8	–	–	8
	735,000	28,544	31,361	6,272	28,544

(1) Replacement costs represents the cost of replacing all contracts that have a positive fair value, using current market rates.

(2) Credit risk equivalent represents the total replacement cost plus an amount representing the potential future credit exposure, as outlined in OSFI's Capital Adequacy Guideline.

(3) Risk-weighted assets represent the credit risk equivalent, weighted based on the creditworthiness of the counterparty, as prescribed by OSFI.

17. FINANCIAL INSTRUMENTS – FINANCIAL RISKS

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

Credit risk (non-derivative)

Credit risk is the potential for financial loss if a borrower or counterparty in a transaction fails to meet its obligations in accordance with agreed terms. Credit risk on the Company's cash and cash equivalents is mitigated by maintaining cash balances at Schedule 1 Canadian Chartered banks. Credit risk on the mortgage loans is mitigated by following Board approved underwriting policies. In particular, during the underwriting process every property is appraised by a certified appraiser with particular attention paid to the property type, location and days on market of each comparative property. The initial appraised value is subsequently discounted, typically by between 7.5% and 30%. A rate of future property appreciation assumed for the life of the mortgage is low in comparison with the Canadian average of approximately 4.4% for the past 20 years. The average rate of assumed appreciation used in the initial underwriting of the existing mortgage portfolio is approximately 1.5%. Each mortgage originated is limited in maximum dollar amount and loan-to-value ratio in accordance with internal guidelines. The Company also obtains a first charge on the underlying property securing the mortgage. Credit risk is mitigated further by the geographic diversity and the collateralization of the portfolio by mortgages with a most recently appraised value of $2.4 billion.

Interest rate risk

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

17. Financial Instruments – Financial Risks (cont'd)

Interest rates on approximately 77% of the mortgage portfolio are based on the Government of Canada Treasury-bill and bond rates whereas interest rates on the debt and derivative instruments are based on the Bankers' Acceptance rates. Historically, changes in interest rates do not impact each benchmark rate equally which may result in a reduction in spread.

Liquidity risk

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

The following table summarizes the expected final payment dates of debt principal and interest payable and deposit maturities:

	Within 1 year $	**2 to 3 years $**	**4 to 5 years $**	**December 31, 2009 Total $**
Deposits	**13,609**	**15,416**	**11,068**	**40,093**
Interest payable on medium-term debt	**7,857**	**–**	**–**	**7,857**
Interest payable on subordinated debt	**719**	**–**	**–**	**719**
Interest payable on unsecured subordinated debt	**183**	**–**	**–**	**183**
Derivative instruments	**212**	**2,237**	**898**	**3,347**
Interest payable on derivative instruments	**–**	**–**	**–**	**–**
Debt principal (1)				
Medium-term debt	**260,000**	**405,000**	**119,115**	**784,115**
Subordinated debt	**–**	**10,000**	**40,000**	**50,000**
Unsecured subordinated debt	**–**	**–**	**10,000**	**10,000**
Total	**282,580**	**432,653**	**181,081**	**896,314**

(1) Certain tranches of debt have refinancing terms upon their expected final payment dates. See notes 11 and 12.

	Within 1 year $	2 to 3 years $	4 to 5 years $	December 31, 2008 Total $
Interest payable on medium-term debt	8,722	–	–	8,722
Interest payable on subordinated debt	830	–	–	830
Derivative instruments	595	2,514	4,841	7,950
Interest payable on derivative instruments	1,250	–	–	1,250
Debt principal (1)				
Medium-term debt	150,000	110,000	529,186	789,186
Subordinated debt	–	–	60,000	60,000
Total	161,397	112,514	594,027	867,938

(1) Certain tranches of debt have refinancing terms upon their expected final payment dates. See notes 11 and 12.

Interest rate sensitivity

The Company is exposed to interest rate risk as a result of the mismatch, or gap, between the maturity or repricing date of interest sensitive assets and liabilities. The following table summarizes the gap position at December 31, 2009 for the selected period intervals. Figures in parentheses represent an excess of liabilities over assets or a negative gap position.

The Company estimates that an annualized 100 basis point decrease in interest rates would increase net interest income after tax over the next twelve months by $130. A 100 basis point increase in interest rates would decrease net income after tax over the next twelve months by a similar amount. These sensitivities are hypothetical and should be used with caution.

2009 (in thousands except % amounts)	Floating $	0 to 3 months $	4 to 12 months $	1 to 3 years $	Over 3 years $	Non-interest rate sensitive $	Total $
Assets							
Cash resources	**8,218**	**6,298**	**–**	**–**	**–**	**–**	**14,516**
Weighted average interest rate	**0.25%**	**0.24%**	**–**	**–**	**–**	**–**	**0.25%**
Interest bearing deposits	**–**	**20,376**	**1,596**	**–**	**–**	**–**	**21,972**
Weighted average interest rate	**–**	**0.27%**	**0.41%**	**–**	**–**	**–**	**0.28%**
Securities	**–**	**6,499**	**5,693**	**–**	**–**	**–**	**12,192**
Weighted average interest rate	**–**	**0.25%**	**0.30%**	**–**	**–**	**–**	**0.27%**
Loans	**113,851**	**135,162**	**435,111**	**123,417**	**55,706**	**53,914**	**917,161**
Weighted average interest rate	**4.46%**	**5.64%**	**5.40%**	**7.21%**	**8.03%**	**–**	**5.40%**
Derivative instruments	**–**	**13,601**	**14,943**	**–**	**–**	**–**	**28,544**
Weighted average interest rate	**–**	**4.43%**	**4.00%**	**–**	**–**	**–**	**4.20%**
Other assets	**–**	**–**	**–**	**–**	**–**	**22,178**	**22,178**
Weighted average interest rate	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Total	**122,069**	**181,936**	**457,343**	**123,417**	**55,706**	**76,092**	**1,016,563**
Liabilities and shareholders' equity							
Deposits	**–**	**–**	**13,609**	**15,450**	**11,118**	**(84)**	**40,093**
Weighted average interest rate	**–**	**–**	**1.22%**	**2.33%**	**3.30%**	**–**	**–**
Medium term debt	**–**	**–**	**274,115**	**405,000**	**105,000**	**8,213**	**792,328**
Weighted average interest rate	**–**	**–**	**2.81%**	**5.37%**	**4.64%**	**–**	**4.33%**
Subordinated debt	**–**	**–**	**–**	**10,000**	**40,000**	**335**	**50,335**
Weighted average interest rate	**–**	**–**	**–**	**6.66%**	**6.69%**	**–**	**6.64%**
Unsecured subordinated debt	**–**	**–**	**–**	**–**	**10,000**	**144**	**10,144**
Weighted average interest rate	**–**	**–**	**–**	**–**	**9.71%**	**–**	**9.58%**
Derivative instruments	**–**	**2,160**	**1,187**	**–**	**–**	**–**	**3,347**
Weighted average interest rate	**–**	**3.79%**	**4.06%**	**–**	**–**	**–**	**3.89%**
Other	**–**	**–**	**–**	**–**	**–**	**19,334**	**19,334**
Weighted average interest rate	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Shareholders' equity	**–**	**–**	**–**	**–**	**–**	**100,982**	**100,982**
Weighted average interest rate	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Total	**–**	**2,160**	**288,911**	**430,450**	**166,118**	**128,924**	**1,016,563**
Derivative instruments	**–**	**(142,500)**	**(321,000)**	**353,000**	**110,500**	**–**	**–**
Interest rate sensitivity gap	**122,069**	**37,276**	**(152,568)**	**45,967**	**88**	**(52,832)**	**–**
Cumulative gap	**122,069**	**159,345**	**6,777**	**52,744**	**52,832**	**–**	**–**
2008							
Total assets	174,393	170,176	436,719	89,684	54,101	74,871	999,944
Total liabilities and shareholders' equity	–	5,227	171,909	400,000	280,000	142,808	999,944
Derivative instruments	–	(258,000)	(312,000)	337,000	233,000	–	–
Interest rate sensitivity gap	174,393	(93,051)	(47,190)	26,684	7,101	(67,937)	–
Cumulative gap	174,393	81,342	34,152	60,836	67,937	–	–

18. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table summarizes the fair values of the Company's financial instruments. The estimated fair value amounts are designed to approximate amounts at which financial instruments could be exchanged in a current transaction between willing parties who are under no compulsion to act.

The Company uses a fair value hierarchy to categorize the inputs used in valuation techniques to measure fair value of financial instruments. The classifications are as follows: the use of quoted market prices for identical financial instruments (Level 1); internal models using observable market information as inputs (Level 2) and internal models without observable market information as inputs (Level 3). The Company had no Level 1 and Level 3 financial instruments at December 31, 2009 and there have been no transfers between levels.

Due to the estimation process and the need to use judgement, the aggregate fair value amounts should not be interpreted as being necessarily realizable in an immediate settlement of the instruments.

	December 31, 2009			December 31, 2008		
	Carrying value	**Fair value**	**Fair value over carrying value**	Carrying value	Fair value	Fair value over carrying value
Assets						
Cash Resources (1)	**36,488**	**36,488**	**–**	41,532	41,532	–
Securities (1)	**12,192**	**12,192**	**–**	24,502	24,502	–
Loans (2)	**917,161**	**917,161**	**–**	868,563	868,563	–
Derivative instruments (3)	**28,544**	**28,544**	**–**	44,680	44,680	–
Other (4)	**22,178**	**22,178**	**–**	20,667	20,667	–
	1,016,563	**1,016,563**	**–**	999,944	999,944	–
Liabilities						
Deposits (5)	**40,093**	**40,549**	**456**	–	–	–
Derivative instruments (3)	**3,347**	**3,347**	**–**	7,950	7,950	–
Other (4)	**19,334**	**19,334**	**–**	16,566	16,566	–
Medium-term debt (6)	**792,328**	**812,628**	**20,300**	804,297	800,089	(4,208)
Subordinated debt (6)	**50,335**	**48,923**	**(1,412)**	60,407	60,418	11
Unsecured subordinated debt (6)	**10,144**	**10,421**	**277**	–	–	–
Shareholders' equity	**100,982**	**100,982**	**–**	110,724	110,724	–
	1,016,563	**1,036,184**	**19,621**	999,944	995,747	(4,197)

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

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

(2) Loans are recorded at amortized cost. The carrying value of the mortgage loans approximates fair value as the prevailing interest rates reset in accordance with the provisions of the underlying mortgage terms.

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

(4) Certain other assets and certain other liabilities are recorded at amortized cost. The carrying value of these other assets and other liabilities are assumed to approximate their fair value due to their short-term nature.

(5) Fair value of deposits is determined by discounting the contractual cash flows using the market interest rates currently offered for deposits with similar terms.

(6) Fair value of medium-term debt, subordinated debt and unsecured subordinated debt are determined using average quoted market rates provided to the Company by capital market dealers.

19. COMMITMENTS

The Company's annual lease obligations are as follows:	$
2010	463
2011	482
2012	480
2013	477
2014	484
Thereafter	490

20. SALARIES AND BENEFITS

The following table shows the details of the salaries and benefits on the consolidated statements of income:

	December 31, 2009 $	December 31, 2008 $
Mortgage origination	**782**	780
Mortgage servicing and administration	**178**	171
Overhead	**4,767**	4,386
	5,727	5,337

21. SELLING, GENERAL AND ADMINISTRATION

The following table shows the details of selling, general and administration on the consolidated statements of income:

	December 31, 2009 $	December 31, 2008 $
Marketing	**2,028**	3,794
Professional services	**2,839**	1,477
Office expenses	**1,183**	1,109
Other	**335**	433
Business and capital taxes	**260**	–
Mortgage servicing and administration	**129**	97
	6,774	6,910

22. CONSOLIDATED STATEMENTS OF CASH FLOW

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

	December 31, 2009 $	December 31, 2008 $
Prepaid expenses and other assets	**(261)**	4
Intangible assets	**(310)**	(117)
Income taxes payable	**1,873**	–
Accounts payable and accrued liabilities	**1,691**	(956)
	2,993	(1,069)

23. FUTURE ACCOUNTING CHANGES

Transition to 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 the Company, effective for fiscal years beginning on or after January 1, 2011. Accordingly, the Company 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.

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

24. SUBSEQUENT EVENT

On March 4, 2010 the Company's Board of Directors approved the payment of a quarterly dividend of $0.07 per share on the outstanding common shares of the Company, which is equivalent to an annual dividend of $0.28 per share. The dividend was payable to shareholders of record at the close of business on March 29, 2010 and is payable on April 13, 2010.

25. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2009 consolidated financial statements.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Pierre Lebel, LL.B, MBA
Chairman of the Board
Vancouver, British Columbia
Mr. Lebel is chairman of Imperial Metals Corporation

Heather Briant, MBA, ICD.D
Toronto, Ontario
Ms. Briant is the Senior Vice President, Human Resources of Cineplex Entertainment LP.

Paul Damp, CA
Toronto, Ontario
Mr. Damp is the managing partner of Kestrel Capital Partners

Daniel Jauernig, CA, CMA
Toronto, Ontario
Mr. Jauernig is the President and Chief Executive Officer of Classified Ventures Inc.

Steven Ranson, CA
Toronto, Ontario
Mr. Ranson is the President and Chief Executive Officer of the Company and HomEquity Bank.

Paula Roberts, ICD.D
Toronto, Ontario
Ms. Roberts is the Executive Vice President of Plan International Canada Inc.

Gary Samuel, LL.B
Toronto, Ontario
Mr. Samuel is a co-founder and partner of Crown Realty Partners

OFFICERS

Greg Bandler
Senior Vice President, Sales and Marketing

Gary Krikler, CA
Senior Vice President and Chief Financial Officer

Scott Cameron, CA
Vice President, Finance and Deposit Services

Celia Cuthbertson, LL.B
Vice President, General Counsel and Corporate Secretary

Wendy Dryden
Vice President, Business Development

Keith Laplante
Vice President, National Sales

Neil Sider, Ph.D.
Vice President, Information Technology

From left to right: Paula Roberts, Gary Samuel, Paul Damp, Heather Briant, Pierre Lebel, Daniel Jauernig, and Steven Ranson.

2009 has been a year of impressive milestones for HOMEQ Corporation and HomEquity Bank. Transforming ourselves from an Income Trust to a Schedule I Bank in an 11 month timeframe speaks to our organizational strengths. These include capable management and staff, strategic vision, precision and execution. Our unique retirement solutions are well received, and needed in the market. We are building – and maintaining a competitive edge. With years of expertise in our market and products, a responsible and disciplined approach to capital funding, and a strategic team that is second to none, we are poised for substantial growth.

Pierre Lebel
Chairman of the Board

AUDITORS

Ernst & Young LLP
P.O. Box 251
222 Bay Street
Ernst & Young Tower
Toronto, Ontario M5K 1J7

REGISTRAR AND TRANSFER AGENT

Computershare
100 University Avenue
Toronto, Ontario M5J 2Y1
For any inquiries or change of address please call: Toll free: 1 800 663 9097

SHARE LISTING

The shares are listed on the Toronto Stock Exchange under the symbol HEQ

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HOMEQ CORPORATION
Suite 600, St. Clair Avenue West
Toronto, Ontario M4V 1K9
T 416 925 4757
F 416 925 9938
www.homeq.ca