



**MCAN MORTGAGE CORPORATION**

**MANAGEMENT'S DISCUSSION AND  
ANALYSIS OF OPERATIONS**

**DECEMBER 31, 2006**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF OPERATIONS**

*This Management's Discussion and Analysis of Operations ("MD&A") should be read in conjunction with the consolidated financial statements and accompanying notes for the year ended December 31, 2006. This MD&A has been prepared as at March 2, 2007.*

*Additional information regarding MCAN Mortgage Corporation (the "Company", "MCAN" or "we"), including copies of our continuous disclosure materials such as the Annual Information Form, is available on our website at [www.mcanmortgage.com](http://www.mcanmortgage.com) or through the System for Electronic Document Analysis and Retrieval ("SEDAR") website at [www.sedar.com](http://www.sedar.com).*

**A NOTE ABOUT FORWARD LOOKING STATEMENTS**

*This report may contain forward-looking statements, including statements regarding the business and anticipated financial performance of the Company. These statements are subject to a number of risks and uncertainties that may cause actual results to differ materially from those contemplated by the forward-looking statements. Some of the factors that could cause such differences include legislative or regulatory developments, competition, technology change, global market activity, interest rates, changes in government and economic policy and general economic conditions in geographic areas where the Company operates. Reference is made to the risk factors disclosed in the Company's 2007 Annual Information Form, which are incorporated herein by reference. These and other factors should be considered carefully and undue reliance should not be placed on the Company's forward-looking statements. We do not undertake to update any forward-looking statements.*

**RESULTS OF OPERATIONS**

MCAN reported net income of \$15.2 million for the year ended December 31, 2006, up from \$14.1 million in the prior year. Earnings per share were \$1.24 compared to \$1.18 in the prior year, an increase of 5%.

**Selected Financial Information**

(in thousands, except for per share amounts)	2006 <sup>(1)</sup>	2005 <sup>(1)</sup>	2004 <sup>(2)</sup>	Change from 2005	%
Net investment income	\$ 18,971	\$ 17,714	\$ 22,437	\$ 1,257	7.1%
Operating expenses	<u>3,856</u>	<u>3,585</u>	<u>10,043</u>	<u>271</u>	<u>7.6%</u>
Income before income taxes	15,115	14,129	12,394	986	7.0%
Provision for (recovery of) income taxes and large corporation taxes	<u>(96)<sup>(3)</sup></u>	<u>13<sup>(3)</sup></u>	<u>793</u>	<u>(109)</u>	<u>(838.5%)</u>
Net income	<u>\$ 15,211</u>	<u>\$ 14,116</u>	<u>\$ 11,601</u>	<u>\$ 1,095</u>	<u>7.8%</u>
Earnings per share	\$ 1.24	\$ 1.18	\$ 1.12	\$ 0.06	5.1%
Diluted earnings per share	\$ 1.24	\$ 1.18	\$ 1.09	\$ 0.06	5.1%
Dividends per share	\$ 1.18	\$ 0.97	\$ 1.11	\$ 0.21	21.6%
Assets	\$ 498,107	\$ 434,369	\$ 454,365	\$ 63,738	14.7%
Liabilities	413,496	353,205	379,400	60,291	17.1%
Shareholders' equity	84,611	81,164	74,965	3,447	4.2%
Number of common shares outstanding at year-end	12,373	12,141	11,747	232	1.9%
Book value per common share	\$ 6.84	\$ 6.69	\$ 6.38	\$ 0.15	2.2%
Common share price – close	\$ 11.40	\$ 9.63	\$ 8.80	\$ 1.77	18.4%
Market capitalization	\$ 141,052	\$ 116,918	\$ 103,374	\$ 24,134	20.6%

1. Includes the mortgage origination and servicing business on an equity accounted basis for the full year.

2. Includes the mortgage origination and servicing business on a consolidated basis to April 19, 2004 and on an equity accounted basis thereafter.

3. In 2005, we commenced charging income taxes directly to retained earnings rather than to income as it is more likely than not that we will pay dividends (which are deductible from taxable income) in amounts sufficient to recover current or future tax liabilities.

**Net Investment Income**

(in thousands)	2006	2005	2004
<b>Investment Income</b>			
Mortgage interest	\$ 24,642	\$ 20,225	\$ 16,229
Interest on loans and other investments	4,528	3,097	1,966
Interest on cash and cash equivalents	571	412	659
Fees	3,161	3,356	4,920
Marketable securities	2,802	3,802	755
Equity income from MCAP Commercial LP	1,840	1,915	613
Gain (loss) on sale of mortgages	53	(17)	1,494
Gain on sale of MCAP Financial Corporation	-	-	4,967
Other income	-	-	2,958
	<b>37,597</b>	<b>32,790</b>	<b>34,561</b>
<b>Financial Expenses</b>			
Term deposit interest and expenses	14,710	11,688	9,876
Mortgage expenses	3,037	2,740	1,831
Provision for losses	879	648	417
	<b>18,626</b>	<b>15,076</b>	<b>12,124</b>
<b>Net Investment Income</b>	<b>\$ 18,971</b>	<b>\$ 17,714</b>	<b>\$ 22,437</b>

Net investment income was \$19.0 million compared to \$17.7 million in the same period of 2005, an increase of \$1.3 million.

Mortgage interest income increased by \$4.4 million over the prior year. This variance relates to an increase in the average mortgage yield to 6.99% in 2006 from 6.05% in 2005 and an \$18 million increase in the average mortgage portfolio (from \$328 million in 2005 to \$346 million in 2006).

Interest on loans and other investments increased by \$1.4 million over 2005, due to increases in the prime rate and a significantly higher average balance.

Interest on cash and cash equivalents increased by \$159,000 compared to the prior year due to higher average cash balances and increases in the prime rate.

In the current year, fees of \$3.2 million were recognized compared to \$3.4 million in 2005. Commitment fees earned on our residential construction loan portfolio decreased to \$2.2 million in 2006 from \$2.4 million last year. The decrease in commitment fee income is due to a higher volume of construction loan payouts in 2005. When a construction loan repays prior to maturity, the remaining unamortized fees are recognized directly to income. The balance of the fees in both years relates mainly to mortgagor fees, which include extension, renewal and letter of credit fees.

Marketable securities income decreased by \$1.0 million over 2005. The decrease is primarily due to only \$1.0 million of gains from the sale of marketable securities in 2006 compared to gains of \$2.3 million in 2005 (including the reversal of prior write-downs of \$330,000). The decrease was partly offset by higher distributions in 2006 as a result of a higher average portfolio.

During the fourth quarter of 2006, there was a general market decline in income trust units as a result of statements made by the federal government. We sold down a portion of our portfolio and realized gains of \$689,000 in the quarter. Due to the events of the fourth quarter of 2006, the net unrealized gain on the Company's marketable securities portfolio decreased to \$813,000 at the end of 2006 from \$2.5 million at December 31, 2005.

Equity income of \$1.8 million from our ownership in MCAP Commercial LP ("MCLP") was comparable to \$1.9 million last year. Current year equity income includes a \$201,000 gain on the dilution of our investment in MCLP. During 2006, MCLP issued non-voting units to a partnership of certain senior managers of MCLP such that MCAN's interest in MCLP was reduced from 25% to 22.8%.

There were gains on sale of mortgages of \$53,000 in 2006 compared to losses of \$17,000 last year. There were few mortgage sales in both years due primarily to narrow spreads.

Term deposit interest and expenses increased by \$3.0 million over 2005. The increase was due to an increase in the average term deposit interest rate to 3.82% in 2006 from 3.17% in 2005 and a \$26 million increase in the average term deposit balance to \$354 million in 2006 from \$328 million in 2005.

Mortgage expenses were \$3.0 million compared to \$2.7 million in 2005. The increase is primarily due to higher mortgage servicing expenses on the residential construction and commercial portfolios, consistent with the increase in the size of both portfolios.

Provisions for losses were \$879,000 in 2006, of which \$856,000 related to mortgages and \$77,000 related to loans receivable and other investments, net of a \$54,000 recovery of mortgages that had previously been written off. This compares to \$648,000 of provisions in 2005 which were comprised of \$605,000 of provisions for mortgages and \$43,000 of provisions relating to loans receivable and other investments. The provisions for losses on mortgages were higher in 2006, as our mortgage book grew more significantly in the current year than in 2005. Write-offs were 0.2 basis points (\$6,000) on average mortgage balances, compared to 1.3 basis points (\$44,000) in the prior year.

Impaired loans net of specific allowances ended the year at 0.28% of the total loan portfolio, compared to 0.53% at December 31, 2005. We continue to proactively monitor loan arrears, and to take prudent steps to collect overdue accounts.

### Operating Expenses

(in thousands)	2006	2005	2004
Salaries and benefits	\$ 1,785	\$ 1,749	\$ 4,594
General and administrative	2,071	1,836	5,449
	<b>\$ 3,856</b>	<b>\$ 3,585</b>	<b>\$ 10,043</b>

Operating expenses were \$271,000 higher than last year. Salaries and benefits were comparable to the prior year, while general and administrative expenses increased as a result of a one-time expense recovery in 2005.

### Income Taxes

(in thousands)	2006	2005	2004
Provision (recovery) against income	\$ (96)	\$ 13	\$ 793
Charge (recovery) to retained earnings	(387)	302	-
	<b>\$ (483)</b>	<b>\$ 315</b>	<b>\$ 793</b>

In 2005, management determined that it was more likely than not that sufficient dividends would be paid to shareholders in future periods to recover current and future taxes. Since that time, we have charged (recovered) our current and future tax liability directly to retained earnings. In 2006, our recovery of current and future taxes was \$387,000 (2005 - charge of \$302,000). The recovery of taxes of \$96,000 (2005 - provision of \$13,000) recorded in the consolidated statements of income relates to the payment (recovery) of large corporations, corporate minimum and other taxes which cannot be recovered from payment of future dividends.

### Cash Flows

Operating activities provided cash flows of \$15 million in 2006, and provided \$11 million in 2005. This change relates mostly to higher net income and increased distributions from MCLP in 2006.

Investing activities used cash flows of \$80 million in 2006 compared to \$6 million provided in 2005, primarily as a result of a substantial increase in mortgages and loans and other investments in 2006 compared to a small decrease in the prior year.

Financing activities provided cash flows of \$50 million in 2006 compared to \$32 million used in 2005. The term deposit inflow in 2006 is consistent with asset growth in the year, while there was a net term deposit outflow in 2005 as our assets decreased.

### Summary of Three Year Results of Operations

In 2004, we consolidated the mortgage origination and servicing business to April 19<sup>th</sup>. After that point and for all of 2005 and 2006, we equity accounted for our interest in the mortgage origination and servicing business through our investment in MCLP.

Net investment income increased in 2006 over the prior year, primarily due to increased returns from higher mortgage and loan and other investment balances and increases in the prime rate. In 2005 and 2006, marketable securities income increased over 2004 due to higher gains on sale. The decrease in net investment income in 2005 compared to 2004 was primarily due to the gain on the sale of MCAP Financial Corporation, significantly higher mortgage trading income and income from various elements of the mortgage origination and servicing business, all in 2004.

Operating expenses in 2006 were comparable to the prior year, with 2005 slightly lower due to a one-time expense recovery. There was a significant decrease in operating expenses in 2005 compared to 2004, mostly due to the three and a half months of the mortgage origination and servicing business included in 2004.

The 2006 provision for (recovery of) income taxes was comparable to the prior year as current and future taxes were charged (recovered) to retained earnings in both years. There was a significant decrease in the provision from 2004, as current and future income taxes were not charged (recovered) to retained earnings at that time.

### SUMMARY OF FOURTH QUARTER RESULTS

The Company reported net income for the quarter ended December 31, 2006 of \$5.2 million (\$0.42 per share), up from \$5.0 million (\$0.41 per share) a year earlier as follows:

(in thousands, except for per share amounts)

<b>For the Quarters Ended December 31</b>	<b>2006</b>	<b>2005</b>
Net investment income	\$ 6,232	\$ 6,222
Operating expenses	1,080	1,145
Income before income taxes	5,152	5,077
Provision for (recovery of) income taxes and large corporation taxes	(54)	28
Net income	\$ 5,206	\$ 5,049
Basic and diluted earnings per share	\$ 0.42	\$ 0.41
Dividends per share	\$ 0.21	\$ 0.19

### Net Investment Income

(in thousands)

<b>For the Quarters Ended December 31</b>	<b>2006</b>	<b>2005</b>
<b>Investment Income</b>		
Mortgage interest	\$ 6,858	\$ 5,459
Interest on loans and other investments	1,414	770
Interest on cash and cash equivalents	163	108
Fees	791	928
Marketable securities	1,133	1,843
Equity income from MCAP Commercial LP	1,584	953
Gain (loss) on sale of mortgages	25	(9)
	<b>11,968</b>	<b>10,052</b>
<b>Financial Expenses</b>		
Term deposit interest and expenses	4,461	3,115
Mortgage expenses	848	755
Provision for (recovery of) losses	427	(40)
	<b>5,736</b>	<b>3,830</b>
<b>Net Investment Income</b>	<b>\$ 6,232</b>	<b>\$ 6,222</b>

Net investment income was comparable to the prior year. The main changes consisted of increases in mortgage interest (\$1.4 million), interest on loans and other investments (\$644,000) and equity income from MCLP (\$631,000), offset by higher term deposit interest and expenses (\$1.3 million), a decrease in gains on sales of marketable securities (\$752,000) and higher provisions for losses (\$467,000).

The increase in mortgage interest reflected a \$30 million increase in the average balance and a 0.99% increase in the yield on the portfolio. Fees of \$791,000 were comparable to \$928,000 in the same period last year. Gains from sales of marketable securities were \$689,000 in the quarter as we sold down our portfolio as a result of statements made by the federal government. Gains from sales of marketable securities were \$1.4 million in 2005 including the reversal of prior write-downs of \$468,000. Unrealized gains on the portfolio at the end of December were \$813,000 compared to \$3.3 million at September 30, 2006 and \$2.5 million at December 31, 2005. Equity income from our ownership in MCLP was \$1.6 million in the quarter compared to \$953,000 last year. MCLP realized significant income from the origination of construction loans and from the securitization of residential mortgages and commercial leases.

The \$1.3 million increase in term deposit interest and expenses in 2006 was due to a 0.96% increase in the average interest rate and a \$50 million increase in the average outstanding balance. Mortgage expenses were \$848,000 compared to \$755,000 in the same period last year, consistent with the increase in the average mortgage balance over 2005. Provisions for losses of \$427,000 were the result of a \$30 million increase in the mortgage portfolio in the quarter and the related general allowance. Impaired loans net of specific allowances were 0.28%, down from 0.53% at December 31, 2005 and 0.54% at September 30, 2006.

**Operating Expenses**

Operating expenses of \$1.1 million during the quarter were comparable to last year as follows:

(in thousands)

For the Quarters Ended December 31	2006	2005
Salaries and benefits	\$ 477	\$ 618
General and administrative	603	527
	<b>\$ 1,080</b>	<b>\$ 1,145</b>

**SELECTED QUARTERLY FINANCIAL DATA**

(in thousands, except per share amounts)	2006				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net investment income	\$3,982	\$4,380	\$4,377	\$6,232	\$3,915	\$3,704	\$3,873	\$6,222
Operating expenses	893	960	923	1,080	857	850	733	1,145
Income before income taxes	3,089	3,420	3,454	5,152	3,058	2,854	3,140	5,077
Provision for (recovery of) income taxes and large corporation taxes	13	(37)	(18)	(54)	28	(75)	32	28
Net income	<u>\$3,076</u>	<u>\$3,457</u>	<u>\$3,472</u>	<u>\$5,206</u>	<u>\$3,030</u>	<u>\$2,929</u>	<u>\$3,108</u>	<u>\$5,049</u>
Basic and diluted earnings per share	\$0.25	\$0.28	\$0.29	\$0.42	\$0.26	\$0.25	\$0.26	\$0.41
Dividends per share	\$0.55	\$0.21	\$0.21	\$0.21	\$0.40	\$0.19	\$0.19	\$0.19

Quarterly results have been relatively stable with the exception of the fourth quarters of 2005 and 2006. These periods had significant gains on sales of marketable securities and substantial equity income from MCLP due to the seasonality of MCLP's business.

**FINANCIAL POSITION**

Total assets were up \$64 million from December 31, 2005. This change mainly reflects a \$60 million increase in mortgages and a \$21 million increase in loans and other investments, partially offset by a \$15 million decrease in cash.

**Assets**

(in thousands)	2006		2005		2004	
Cash and cash equivalents	\$ 17,685	3.5%	\$ 33,093	7.6%	\$ 47,315	10.4%
Marketable securities	12,473	2.5	14,764	3.4	12,965	2.9
Mortgages	395,788	79.5	335,675	77.3	314,157	69.1
Loans and other investments	53,377	10.7	32,755	7.5	63,358	13.9
Equity investment in MCLP	17,340	3.5	16,811	3.9	14,896	3.3
Other assets	1,444	0.3	1,271	0.3	1,674	0.4
	<b>\$ 498,107</b>	<b>100.0%</b>	<b>\$ 434,369</b>	<b>100.0%</b>	<b>\$ 454,365</b>	<b>100.0%</b>

Cash equivalents include treasury bills, term deposits and bankers' acceptances. These investments ensure adequate liquidity to meet maturing term deposit and new mortgage commitments. We manage our cash and cash equivalents in the \$15 million range. The 2005 balance was high as we had significant mortgage repayments near the end of the year and incorporated a deliberate strategy to increase cash balances at year-end to assist in a conversion of the term deposit administration system that took place in the first quarter of 2006.

Marketable securities comprise a diversified portfolio of real estate investment, income and royalty trusts. These investments are supported by the Company's equity base, and they provide for improved returns on, and diversification of, our investment portfolio. Our investment policy limits marketable securities investment to the lesser of 70% of regulatory capital or \$25 million. The portfolio grew considerably in 2006 until November, at which point we began to sell down the portfolio as a result of statements made by the federal government. In late 2005, we had a similar sell down due to market uncertainty at that time.

We invest in insured and uninsured single family mortgages. Uninsured mortgages may not exceed 75% of the value of the real estate securing such loans. For the purposes of this ratio, value is the appraised value of the property as determined by a qualified

appraisal at the time of funding. Residential mortgages insured by the Canada Mortgage and Housing Corporation ("CMHC") or Genworth Financial Mortgage Insurance Company Canada may exceed this ratio.

Uninsured residential construction loans are made to homebuilders to finance residential construction projects. These loans generally have a floating rate of interest and terms of one to two years. During the year, our regulator, the Superintendent of Financial Institutions Canada ("OSFI"), increased our limit on conventional construction loans from 200% to 250% of regulatory capital. Non-residential construction loans may comprise up to one half of this limit. The maximum single conventional construction loan may not exceed the lesser of \$13.5 million or 20% of regulatory capital as per our internal limits. In 2006, there was strategic growth in the residential construction portfolio to achieve better spreads at manageable risk compared to other mortgage categories.

Our mortgage book increased by \$60 million in 2006 (see Note 5 to the consolidated financial statements). This increase primarily reflected a \$34 million increase in the construction loan book (from \$151 million to \$185 million) and a \$21 million increase in commercial mortgages from 2005. Mortgages increased by \$22 million in 2005, due to a significant increase in construction loans, partly offset by a decrease in uninsured single-family mortgages.

Loans and other investments consist of loans to related parties and private companies, deferred purchase price receivables, interests in securitization programs, real estate and bonds (see Note 6 to the consolidated financial statements). Loans and investments increased by \$21 million in 2006 as a result of advances on existing loans to private companies. In 2005, there was a \$31 million decrease due to the repayment of investor loans and loans to private companies, in addition to the sale of investments in bonds.

Our largest single investment is our minority interest in MCLP. Based on our ownership interest, we believe that income from MCLP will constitute a significant component of our income in 2007 and future years.

Other assets include prepaid expenses, accounts receivable, capital assets and deferred costs.

#### Liabilities and shareholders' equity

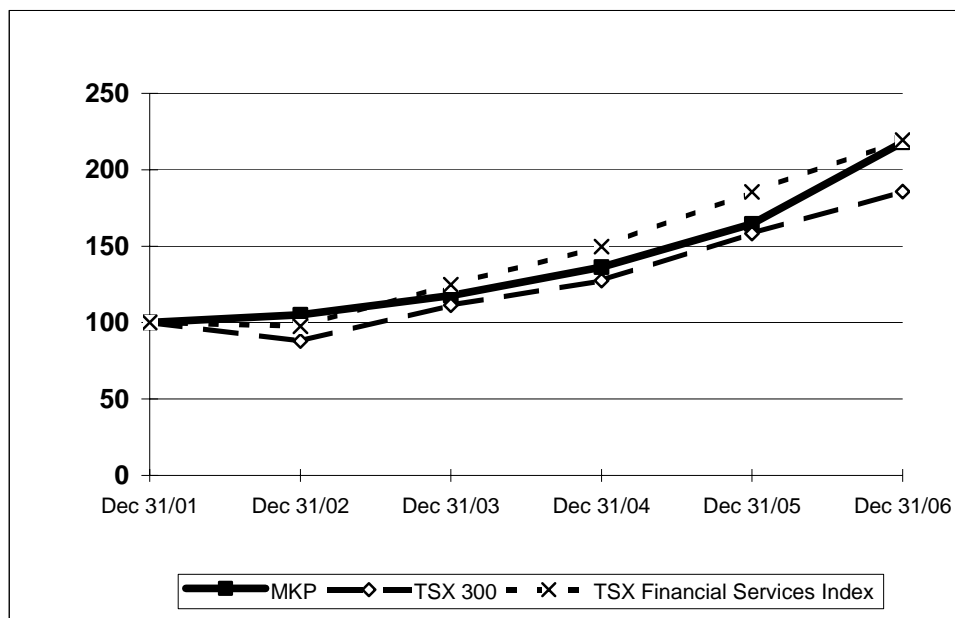
(in thousands)	2006	2005	2004	Change from	
				2005	2004
<b>Liabilities</b>					
Term deposits	\$ 408,734	\$ 347,182	\$ 371,335	\$ 61,552	\$ 37,399
Accounts payable and accrued charges	4,448	5,346	7,654	(898)	(3,206)
Future taxes payable	314	677	411	(363)	(97)
	413,496	353,205	379,400	60,291	34,096
<b>Shareholders' equity</b>					
Share capital	78,211	75,880	71,927	2,331	6,284
Contributed surplus	510	510	510	-	-
Retained earnings	5,890	4,774	2,528	1,116	3,362
	84,611	81,164	74,965	3,447	9,646
	<b>\$ 498,107</b>	<b>\$ 434,369</b>	<b>\$ 454,365</b>	<b>\$ 63,738</b>	<b>\$ 43,742</b>

The increase in term deposit liabilities during the year was consistent with the \$64 million increase in assets as we issued new term deposits to fund our asset growth. The prior year decrease was in line with the change in asset levels over 2005.

Total shareholders' equity of \$85 million was up \$3.4 million from December 31, 2005 and up \$9.6 million from December 31, 2004. The majority of this change reflects increases in share capital as shares were issued for cash in September 2005 and are also issued quarterly under the dividend reinvestment plan at the average closing price for the 20 days preceding such issues.

**PERFORMANCE GRAPH**

The following graph compares MCAN's cumulative total shareholder return (assuming an investment of \$100 on December 31, 2001) on the shares during the period from January 1, 2002 to December 31, 2006, with the S&P/TSX Composite Index (Total Return) and the S&P/TSX Financial Services Index (Total Return), assuming reinvestment of all dividends.



	Dec 31 2001	Dec 31 2002	Dec 31 2003	Dec 31 2004	Dec 31 2005	Dec 31 2006	Compound Annual Growth
MCAN	100	105	118	136	164	218	16.9%
TSX	100	88	111	128	158	186	13.2%
TSX Financial Services	100	97	125	150	186	219	17.0%

*Note: Dividends declared on MCAN's common shares are assumed to be reinvested at the closing price on the payment date.*

**DESCRIPTION OF CAPITAL STRUCTURE**

The authorized share capital of the Company consists of an unlimited number of common shares with no par value. At December 31, 2006, there were 12,372,939 common shares outstanding. At March 2, 2007, there were 12,444,989 common shares outstanding. Additional information related to the share capital is included in Note 15 to the consolidated financial statements.

**DIVIDEND POLICY AND RECORD**

Our dividend policy is to pay out substantially all of our taxable income to our shareholders. As a mortgage investment corporation ("MIC"), we can deduct dividends paid to shareholders during the year and within 90 days thereafter from income for tax purposes. Consequently, these dividends are taxable in the shareholders' hands as interest. In addition, a MIC can pay certain capital gains dividends which are taxed as capital gains in the shareholders' hands. We intend to continue to declare dividends on a quarterly basis.

Dividends per share over the past three years are as follows:

<b>Fiscal Period</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
First Quarter	\$ 0.55	\$ 0.40	\$ 0.27
Second Quarter	0.21	0.19	0.17
Third Quarter	0.21	0.19	0.17
Fourth Quarter	0.21	0.19	0.19
Special (November 10, 2004)	-	-	0.31
	<b>\$ 1.18</b>	<b>\$ 0.97</b>	<b>\$ 1.11</b>
Taxable Dividends	\$ 1.06	\$ 0.855	\$ 0.50
Capital Gains Dividends	0.12	0.115	0.61
	<b>\$ 1.18</b>	<b>\$ 0.97</b>	<b>\$ 1.11</b>

Our dividends are regulated by OSFI under Regulatory and Legislative Advisory No. 2003-04, Capital Structure - Declaration and Payment of Dividends. Approval is required from OSFI if a dividend is deemed to be a "Large Dividend" as calculated under this advisory. As a MIC, we pay out substantially all of our taxable income to shareholders, whereas other financial institutions generally pay out only a portion of their taxable income to their shareholders. Over the past three years, we have requested and received dividend approvals from OSFI on numerous occasions. We plan to request approval from OSFI for our dividends in 2007 and future years if required.

The Board of Directors declared a first quarter dividend of \$0.31 per share to be paid March 30, 2007 to shareholders of record as of March 15, 2007. This dividend comprises the regular quarterly dividend which the Board increased to \$0.23 (from \$0.21) and a \$0.08 extra dividend. The Board designated \$0.12 of this dividend as a capital gains dividend.

Under the Income Tax Act (the "Tax Act"), we can deduct dividends paid up to 90 days following year-end against the previous year's taxable income. The extra dividend payable on March 30, 2007 is necessary to fully offset taxable income in 2006 and reflects a combination of factors, but primarily the capital gains realized on the sales of marketable securities in the latter part of the year. While there will generally be an element of dividend adjustment in the first quarter of each year to equate dividends to taxable income, the amount of such adjustment will depend on factors which cannot be predicted.

#### OFF BALANCE SHEET ARRANGEMENTS

We enter into certain off balance sheet arrangements in the ordinary course of business.

We commit to fund mortgages in advance of funding at agreed upon interest rates. Substantially all of these commitments relate to floating rate loans.

We have established a facility with an investment dealer to provide short positions in Government of Canada Bonds, which are used to manage interest rate risk on commitments and mortgages held for sale. At December 31, 2006, we did not have any outstanding hedging instruments. Details of our commitments and hedges are included in Notes 2, 5 and 18 to the consolidated financial statements.

#### CONTRACTUAL OBLIGATIONS

We have contractual obligations to make principal and interest payments on term deposits and an operating lease. In addition, we have outstanding commitments for future fundings of mortgages intended for our own portfolio, as discussed above.

(in thousands)	<b>Less than one year</b>	<b>One to five years</b>	<b>Over five years</b>	<b>Total</b>
Term deposits	\$ 373,934	\$ 34,800	\$ -	\$ 408,734
Operating lease	109	441	85	635
Mortgage fundings	135,978	-	-	135,978
	<b>\$ 510,021</b>	<b>\$ 35,241</b>	<b>\$ 85</b>	<b>\$ 545,347</b>

#### TRANSACTIONS WITH RELATED PARTIES

In 2006, we purchased certain corporate services and mortgage and loan origination services at a cost of \$2.7 million from MCLP and \$828,000 from MCAP Service Corporation ("MSC"), while we received fees of \$2.0 million from MCLP, \$65,000 of fees and interest from MSC and \$437,000 of interest from Warehouse Trust, an entity which is beneficially owned by MCLP. Corporate services include premises and systems. The fees received from MCLP and MSC include commitment, extension, renewal and letter of credit fees.

We use MCLP's and MSC's systems, including networks, subsystems, and general ledger. We also receive technology support from MSC. We plan to use the systems of both entities in the foreseeable future.

In 2004, we entered into an arrangement with MCLP to sublease space at 200 King Street West, Toronto, Ontario, expiring in 2012.

The Company settled an amount of \$7.5 million relating to two guarantees provided by Interior Capital Corporation ("ICC"), an entity acquired in 2000. The Company signed agreements with the vendors to recover the costs related to the settlement of such guarantees and in February 2004 received \$3.5 million as partial recovery from the vendor shareholders. The remainder was financed over five years with interest at 4.0%. The majority of the vendor shareholders of ICC are related to the Company. The balance outstanding at December 31, 2006 was \$1.3 million.

During 2002, the Board established the Executive Share Purchase Plan (the "Share Purchase Plan") whereby the Board can approve loans to key personnel for the purpose of purchasing the Company's shares. The maximum amount of loans approved under the Share Purchase Plan is limited to 10% of the issued and outstanding common shares. At December 31, 2006, \$715,000 of loans were outstanding. Subsequent to year-end, loans of \$527,000 were advanced under the Share Purchase Plan and the approved amount of loans was increased from \$1,050,000 to \$1,250,000. The loans under the Share Purchase Plan bear interest at prime plus 1% and have a five-year term. Additional information related to the Share Purchase Plan is included in Note 15 to the consolidated financial statements.

## **MATCHING**

In order to minimize the effect of interest rate movements, our policy is to manage the repricing dates of our invested assets and debt obligations in accordance with Board approved limits. In addition, we endeavour to stagger the maturities of invested assets and term deposits to produce an orderly turnover of assets and liabilities.

Our primary objective is to obtain profitable interest rate spreads rather than to attempt to capitalize on fluctuations in interest rates. To the extent that we are successful in matching the repricing dates of our invested assets and our term deposits, the leveraged portion of our mortgage portfolio will remain largely insensitive to swings in market interest rates.

We have established and maintain liquidity policies which meet the standards set under the Trust and Loan Companies Act (the "Trust Act") and any regulations or guidelines issued by OSFI.

## **BORROWING**

We derive our net investment income from the investment of our equity and the difference or spread between amounts earned on our mortgages and other investments and the cost of the term deposits that we issue to fund such investments. We have two significant capital tests that must be closely monitored. First, as a MIC, we are limited by the Tax Act to a liabilities to capital ratio of 5:1 (or an assets to capital ratio of 6:1), based on our non-consolidated balance sheet measured at its tax value. Second, as we are a loan company under the Trust Act, OSFI regulates our consolidated regulatory assets to capital. In this regard, OSFI granted us a 9:1 consolidated regulatory assets to capital ratio effective December 28, 2001. We borrow to the extent that we are satisfied that the borrowing and additional investments will increase our overall profitability.

OSFI has issued guidelines to federally regulated companies for capital adequacy, which include meeting a minimum regulatory capital to risk-weighted assets ratio of 10% for total capital and 7% for Tier 1 capital.

Our income tax assets and capital, regulatory assets and capital and maximum assets and ratios over the past three years are as follows:

December 31 (in thousands)	2006	2005	2004
<b>Tax Act Test</b>			
Income Tax Assets	\$ 499,714	\$ 438,669	\$ 461,073
Income Tax Capital	\$ 86,245	\$ 85,664	\$ 80,434
Income Tax Assets to Capital ratio	5.79	5.12	5.73
Maximum Assets (non-consolidated)	\$ 517,470	\$ 513,984	\$ 482,604
Maximum Assets to Capital ratio	6.00	6.00	6.00
<b>Regulatory Test (OSFI)</b>			
Regulatory Assets	\$ 505,508	\$ 471,841	\$ 480,814
Regulatory Capital	\$ 81,294	\$ 69,460	\$ 68,351
Regulatory Assets to Capital ratio	6.22	6.79	7.03
Maximum Regulatory Assets (consolidated)	\$ 731,646	\$ 625,140	\$ 615,159
Maximum Regulatory Assets to Capital ratio	9.00	9.00	9.00
Total Regulatory Capital to Risk-Weighted Assets ratio	17.58%	21.33%	19.07%
Minimum Total Regulatory Capital to Risk-Weighted Assets ratio	10.00%	10.00%	10.00%
Tier 1 Regulatory Capital to Risk-Weighted Assets ratio	18.30%	24.92%	20.92%
Minimum Tier 1 Regulatory Capital to Risk-Weighted Assets ratio	7.00%	7.00%	7.00%

We are limited to the lowest maximum assets amount in the above two asset tests, and the maximum leverage permitted under the Tax Act is more constraining on the Company than the regulatory assets to capital ratio mandated by OSFI. We manage our assets to a level of 5.75 times capital to provide a prudent cushion between the maximum and total actual assets.

We fund the majority of our investments through the issue of Canada Deposit Insurance Corporation ("CDIC") insured term deposits with varying maturities in most provinces of Canada.

## LIQUIDITY

We closely monitor our liquidity position to ensure that we have sufficient cash to meet liability obligations as they become due. The Investment Committee ("ICB") is responsible for liquidity management, including the review and approval of liquidity policies. In general, we maintain liquid investments and credit facilities in excess of 20% of term deposits maturing within 100 days. In addition, all marketable securities and single-family mortgages are readily marketable within a time frame of one to three months, thus providing us with added flexibility to meet liquidity needs. We have access to capital through our ability to issue CDIC insured term deposits. These term deposits also provide us with the ability to fund asset growth as needed. We also have a \$20 million overdraft facility in place to fund asset growth or meet short-term obligations as required. Our liquidity position and our access to capital markets support our ability to meet current and future commitments. We are not aware of any contingencies or known events that are likely to materially affect our liquidity position.

## RISK MANAGEMENT

We operate in changing regulatory and economic environments. As a result, our management and the Board of Directors are particularly diligent in their consideration of issues of risk. Our goal is not to eliminate risk, as this would result in significantly reduced earnings, but rather to be proactive in our assessment and management of risk, as a means to gain a strategic advantage and ultimately enhance shareholder value. For a discussion of the material risks affecting the Company, reference is made to the risk factors described in the 2007 Annual Information Form, which is incorporated herein by reference.

Our senior management is responsible for the quality of processes, policies, procedures and controls and for internal reporting on a day-to-day basis. Oversight and guidance rests with the Board of Directors.

We are exposed to various inherent risks, particularly interest rate risk and credit risk. We mitigate these risks through investment diversification, and by diligent management of assets and liabilities.

We evaluate our exposure to a variety of changes in interest across the term spectrum of our assets and liabilities, including both parallel and non-parallel changes in interest rates. By managing and matching the terms of invested assets and term deposits so that they offset each other, we reduce risks associated with interest rate changes, and in conjunction with liquidity management policies, we also manage cash flow mismatches.

Credit losses occur when a counterparty fails to meet its obligations to the Company and the value realized on sale of the underlying security deteriorates below the carrying amount of the exposure. All members of management are subject to limits on

their ability to commit the Company to credit risk. Credit and commitment exposure is closely monitored through a reporting process that includes a formal quarterly review involving senior management and the ICB.

Furthermore, our exposure to credit risk is managed through risk management policies and procedures that emphasize the quality and diversification of our investments. Our policies establish limits on concentration by asset class, risk rating, geographic region, dollar limit and borrower. We use these policies to assess credit risk and portfolio quality.

Market risk on marketable securities is managed through prudent investment selection and diversification by security and industry.

Ultimately, risk management is controlled at the highest level of the Company. Our Asset and Liability Management Committee reviews and manages these risks on a monthly basis. Our Board of Directors reviews and approves all risk management policies and procedures with respect to asset and liability mismatch risk, liquidity risk and credit risk. All other key risk exposures are reported to the Board of Directors by management.

## **PEOPLE**

As at December 31, 2006, we had twelve employees compared to eleven at December 31, 2005.

## **BRANDING**

On September 15, 2006, the Company changed its name from MCAP Inc. to MCAN Mortgage Corporation following the receipt of approval from OSFI. The name change was approved by shareholders on May 4, 2006 at the Annual and Special Meeting of Shareholders.

Concurrent with the name change, the Company changed the name of its deposit liabilities from debentures to term deposits. The Company's term deposits remain insured pursuant to the standard terms of coverage set out by CDIC.

## **REGULATORY COMPLIANCE**

Our Chief Compliance Officer ensures that management understands the impact of all relevant legislation affecting the business, assesses compliance with current and pending legislation and works with management to address any gaps in policies and procedures. We use a Legislative Compliance Management System that ensures all managers assess their compliance with relevant legislation on a semi-annual basis. Senior management liaises with regulators to keep them apprised of Company progress and changes to our business. Our Chief Compliance Officer reports at least annually to the Chairman of the Conduct Review, Corporate Governance & Human Resources Committee of the Board of Directors.

## **INTERNAL AUDIT**

We outsource our Internal Audit function to Protiviti - Independent Risk Consulting. The Internal Audit function has unrestricted access to our operations, senior management and the Chairman of the Audit Committee of the Board of Directors. Internal Audit performs an evaluation of business risk and then undertakes internal audits of those areas that are deemed to be of greatest risk. Internal Audit reports quarterly to the Audit Committee of the Board of Directors.

In addition, our External Auditors review the effectiveness of internal controls to the extent necessary to conduct an audit of our annual financial statements, and report to the Audit Committee of the Board of Directors annually on matters that come to their attention.

## **OUTLOOK**

In 2006, our primary focus was to fully invest the balance sheet while maintaining historical spreads. We are subject to maximum asset levels under both the Tax Act and the Trust Act. The maximum asset level permitted under the Tax Act, which is the most constraining for us, effectively limits assets to 6 times capital on a non-consolidated basis, measured at tax values. We manage our assets to a level of 5.75 times capital to provide a prudent cushion between the maximum and total actual assets. Due to significant 2006 asset growth, we were slightly over our 5.75 internal limit at December 31, 2006, in the amount of \$4 million. In 2007, we plan to maintain our asset level at 5.75 times capital. Maintaining our balance sheet at a level of full investment will depend on our ability to find assets with satisfactory yields at manageable levels of risk. Our operations and income are a function of the interest rate environment and the availability of mortgage product at reasonable yields. The availability of mortgage product for us and the yields thereon is based on market competition.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The notes to our consolidated financial statements provide detailed information on our significant accounting policies, the method of applying those policies, and the material components of the amounts in the consolidated balance sheets, statements of income and retained earnings, and statements of cash flows. The policies discussed below are considered particularly important, as they require management to make judgments involving estimations. We have control procedures to ensure that these policies are applied consistently and that the policies are independently reviewed on at least an annual basis. Changes to accounting

policies are made only after an appropriate amount of research and discussion has occurred and independent advice is obtained. Estimates are considered carefully and reviewed at an appropriate level within the Company. We believe that our estimates of the value of our assets and liabilities are appropriate.

### **Allowance for Credit Losses**

The allowance for credit losses reduces the carrying value of mortgage assets to provide for an estimate of the principal amounts that borrowers may not repay in the future. In assessing the estimated realizable value of assets, we must rely on estimates and exercise judgment regarding matters for which the ultimate outcome is unknown. A number of factors can affect the amount that we ultimately collect, including the quality of our own underwriting process and credit criteria, the diversification of the portfolio, the underlying security relating to the loans and the overall economic environment. Specific allowances include all of the accumulated provisions for losses on particular assets required to reduce the related assets to estimated realizable value. The general allowance represents losses that we believe have been incurred but not yet specifically identified. Reserving rates depend on asset class, as different classes have varying underlying risks. Based on our best judgment, we believe that the general allowance is indicative of probable losses within the next two years based on current economic conditions and risk profile. However, future changes in circumstances could materially affect our future provisions for credit losses from those provisions determined in the current year, and there could be a need to increase or decrease the allowance for credit losses. Details of our accounting policies and balances of the allowances for credit losses can be found in Notes 2 and 5 to the consolidated financial statements. Details of the allowance for credit losses by mortgage, loan and other investment type can be found in the 2007 Annual Information Form.

### **Income Taxes**

As a MIC, we can deduct dividends paid to our shareholders from our calculation of taxable income. When it is considered more likely than not that future dividends will be sufficient to recover current or future income tax liabilities, we charge the related provision for future and current taxes directly to retained earnings. The provision for income taxes consists of various taxes that cannot be recovered from the payment of future dividends. Details of our accounting policies and balances relating to income taxes can be found in Notes 2 and 14 to the consolidated financial statements. During 2005, we determined that it was more likely than not that sufficient dividends will be paid to recover current and future taxes. We will continue to proactively monitor on a quarterly basis that this is an appropriate position.

### **FUTURE CHANGES IN ACCOUNTING POLICY**

The Canadian Institute of Chartered Accountants has issued new accounting requirements for financial instruments, hedges and other comprehensive income. Financial assets are required to be classified as held for trading, held to maturity, loans and receivables, or available for sale, and financial liabilities are required to be classified as held for trading or other. When the Company adopts the new requirements on January 1, 2007, marketable securities and mortgages will be classified as available for sale. Upon adopting the requirements, the Company will revalue its marketable securities and mortgages at fair value. The Company will include the gains and losses on re-measuring in a new section of shareholders' equity called other comprehensive income. The impact of re-measuring the marketable securities and mortgages at fair value on January 1, 2007 will be recognized in opening accumulated other comprehensive income and is discussed in Notes 4 and 5 to the consolidated financial statements. Results for prior periods will not be restated.

### **DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING**

#### **Disclosure Controls and Procedures**

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), on a timely basis so that appropriate decisions can be made regarding public disclosure. Company management, with the participation of the CEO and CFO, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Multilateral Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings) as of December 31, 2006 and has concluded that such disclosure controls and procedures are effective.

#### **Internal Control over Financial Reporting**

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian generally accepted accounting principles. Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. During the interim period ended December 31, 2006, the Company did not make any changes in its internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**FINANCIAL INSTRUMENTS**

The fair value of financial items approximates recorded amounts unless otherwise disclosed in the notes to the consolidated financial statements. Details regarding the fair value of specific items are included in Note 2 to the consolidated financial statements. Off balance sheet financial instruments are discussed in Off Balance Sheet Arrangements above.