

FIRST NATIONAL

FINANCIAL CORPORATION



Report to Shareholders

Period Ended September 30, 2018

FIRST NATIONAL

FINANCIAL CORPORATION



Fellow Shareholders:

First National's performance for the three and nine months ended September 30, 2018 was strong.

Mortgages under administration (“MUA”) increased 5% to a record \$105.0 billion from \$100.2 billion at September 30, 2017. New mortgage originations climbed 10% to \$5.4 billion from \$4.9 billion a year ago. Revenue was, in turn, 13% higher than a year ago at \$321.8 million.

Despite tighter mortgage spreads, the Company's business model efficiently converted MUA growth into solid earnings. As a result, third quarter net income was \$51.9 million (\$0.85 per common share) compared to \$58.8 million (\$0.96 per common share) in Q3 2017. The third quarter dividend payout ratio as a percentage of net income attributable to common shareholders was 54%.

These results, taken together with the excess capital generated over several years and our belief that near-term growth can be funded from operations, supported a determination by the Company's Board of Directors to raise the common share dividend and authorize a special dividend to common shareholders.

More specifically, the regular monthly common share dividend has been increased to an annualized rate of \$1.90 from \$1.85 per share, commencing with the dividend payable on December 17, 2018. Additionally, common shareholders of record on November 30, 2018 will receive a special dividend in the amount of \$1.00 per common share, also payable on December 17, 2018. We are pleased with the cash flow that the business is producing and confident that First National can continue to serve our customers, partners and shareholders well in the quarters ahead.

Going into the fourth quarter of 2018, we are optimistic that the trend established in the first three quarters will continue. We also expect a tight interest spread environment similar to what has existed for most of 2018. Overall, the Company will continue to generate income and cash flow from its \$30 billion portfolio of mortgages pledged under securitization and \$72 billion servicing portfolio, and focus on the value inherent in its significant single-family renewal book.

Yours sincerely,

Stephen Smith
Chairman and Chief Executive Officer

Moray Tawse
Executive Vice President

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of October 30, 2018. This discussion should be read in conjunction with the unaudited condensed consolidated financial statements and accompanying notes of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the three months (the "period") ended September 30, 2018. The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").

This MD&A contains forward-looking information. Please see "Forward-Looking Information" for a discussion of the risks, uncertainties and assumptions relating to these statements. The selected financial information and discussion below also refer to certain measures to assist in assessing financial performance. These other measures such as "Pre-FMV EBITDA" and "After-tax Pre-FMV Dividend Payout Ratio" should not be construed as alternatives to net income or loss or other comparable measures determined in accordance with IFRS as an indicator of performance or as a measure of liquidity and cash flow. These measures do not have standard meanings prescribed by IFRS and therefore may not be comparable to similar measures presented by other issuers.

Unless otherwise noted, tabular amounts are in thousands of Canadian dollars.

Additional information relating to the Company is available in First National Financial Corporation's profile on the System for Electronic Data Analysis and Retrieval ("SEDAR") website at www.sedar.com.

General Description of the Company

First National Financial Corporation is the parent company of First National Financial LP ("FNFLP"), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over \$105 billion in mortgages under administration ("MUA"), First National is Canada's largest non-bank originator and underwriter of mortgages and is among the top three in market share in the mortgage broker distribution channel.

Third Quarter 2018 Results Summary

Management is pleased with the results for the third quarter of 2018. Despite new mortgage insurance rules announced in late 2016 and tighter underwriting on uninsured mortgages required under OSFI's revised B-20 guidelines for 2018 which the Company has adopted, single family origination increased 23% year over year in the third quarter of 2018. Combined with commercial segment origination and steady renewals, First National increased its total origination by 8% in the quarter compared to the third quarter in 2017. Unfortunately with tighter mortgage spreads and a trend toward increased securitization, normalized earnings were lower by about 5%.

- MUA grew to \$105.0 billion at September 30, 2018 from \$100.2 billion at September 30, 2017, an increase of 5%; the growth from June 30, 2018, when MUA was \$103.6 billion, was also 5% on an annualized basis;
- Total new single-family mortgage origination was \$3.9 billion in the third quarter of 2018 compared to \$3.2 billion in 2017 comparative quarter, an increase of 23%. The Company attributes this to the relaunch of its Excalibur program and strong growth in the Toronto and Montreal regions. The commercial segment had a slower quarter with origination down 14% as volumes decreased to \$1.5 billion in the third quarter of 2018 from \$1.7 billion in the third quarter of 2017. The Company attributes this to timing and a very strong 2017 performance. For the nine months to September 30, 2018, new commercial origination increased 6% over the same period in 2017. Overall new origination increased by 10% in the quarter;
- The Company took advantage of opportunities in the quarter to renew \$1.8 billion of single-family mortgages. In 2017 third quarter, the Company renewed \$1.7 billion of single-family mortgages. For the commercial segment, renewals decreased to \$295 million from \$313 million;
- Revenue for the third quarter of 2018 increased by 13% to \$321.8 million from \$284.3 million in the 2017 comparative quarter. The increase is related to the rising interest rate environment offset by lower revenue from gains on financial instruments. Interest revenue on securitized mortgages increased by \$38.3 million as the portfolio composition moved to mortgages with higher interest rate coupons. Because of changing interest rates and the adoption of hedge accounting in 2018, gains of financial instruments were lower by \$20.0 million year over year. Without this component of revenue, revenue increased by 23%. Placement fee revenues were higher in the 2018 quarter as the comparative 2017 fees were affected by fair value accounting. Effectively \$14.4 million of gains on financial instruments were recognized in the second quarter of 2017 detracting from placement fees subsequently earned on the related mortgages when they were placed in the third quarter of 2017;
- Income before income taxes decreased from \$80.0 million in the third quarter of 2017 to \$71.1 million in the comparative 2018 quarter. This measure decreased significantly because of changing capital markets conditions and the manner in which such gains and losses on financial instruments are accounted for. In aggregate, the impact from financial instruments decreased this measure by \$5.6 million comparing the 2017 quarter to the 2018 quarter; and
- The Company's earnings before income taxes, depreciation and amortization and gains and losses on financial instruments ("Pre-FMV EBITDA") for the quarter increased by 22%, from \$51.8 million to \$63.0 million in the 2018 quarter. These earnings are higher in the 2018 quarter due to lower placement fee revenues in the 2017 quarter which, as described above, suffered from accounting conventions related to interest rate hedging. If this amount is added back to 2017, Pre-FMV EBITDA would have decreased by 5% from 2017 to 2018 due to tighter mortgage spreads and increased securitization which delays the earning's process.

The Company's Board of Directors announced both an increase to the regular monthly dividend from \$1.85 to \$1.90 per common share on an annualized basis effective with the dividend payable on December 17, 2018; and a special common share dividend in the amount of \$1.00 per share, payable on December 17, 2018 to shareholders of record on November 30, 2018. This payment reflects the Board's determination that the Company has generated excess capital in the past several years and that the capital needed for near-term growth can be generated from current operations.

Selected Quarterly Information

Quarterly Results of First National Financial Corporation

(\$000s, except per share amounts)

	Revenue	Net Income for the period	Pre-FMV EBITDA for the period ⁽¹⁾	Net Income per Common Share	Total Assets
2018					
Third Quarter	\$321,835	\$51,958	\$62,989	\$0.85	\$35,597,827
Second Quarter	\$290,935	\$46,347	\$56,048	\$0.76	\$35,794,066
First Quarter	\$256,701	\$35,902	\$50,368	\$0.59	\$33,846,283
2017					
Fourth Quarter	\$270,015	\$45,948	\$61,093	\$0.75	\$32,776,278
Third Quarter	\$284,315	\$58,809	\$51,826	\$0.96	\$31,548,130
Second Quarter	\$292,200	\$68,768	\$68,275	\$1.13	\$30,832,883
First Quarter	\$232,238	\$36,127	\$53,084	\$0.58	\$29,901,289
2016					
Fourth Quarter	\$290,754	\$71,797	\$61,064	\$1.18	\$30,394,465

(1) This non-IFRS measure adjusts income before income taxes by adding back expenses for amortization of intangible and capital assets but it also eliminates the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments.

With First National's large portfolio of mortgages pledged under securitization, quarterly revenue is driven primarily by the gross interest earned on the mortgages pledged under securitization. The gross interest on the mortgage portfolio is dependent both on the size of the portfolio of mortgages pledged under securitization as well as mortgage rates. Because mortgage rates and MUA have both increased, revenue has also increased. Net income is partially dependent on conditions in bond markets, which affect the value of gains and losses on financial instruments arising from the Company's interest rate hedging program. Accordingly, the movement of this measurement between quarters is related to factors external to the Company's core business. By removing this volatility and analyzing Pre-FMV EBITDA, management believes a more appropriate measurement of the Company's performance can be assessed.

Generally, in the years after the credit crisis in 2008, the Company grew its origination volumes which provided larger servicing and securitization portfolios. To the extent the Company employed securitization strategies, net interest margins were locked in for five and ten year terms. These margins were wide in 2008 as financial institutions maintained mortgage rates despite a significant drop in the cost of funds. Since 2008, such margins have steadily declined with competitive pressures and new securitizations are at much tighter spreads. For the Company this has meant that as high spread securitization transactions have matured and been replaced with new securitizations, profitability has decreased. This trend is evident in the Pre-FMV EBITDA figures above. In the third quarter 2017, Pre-FMV EBITDA was lower than expected as placement fees were negatively affected by a rising interest rate environment. The Company earned \$14.4 million as a gain on holding short bonds in the second quarter 2017. Consistent with the Company's reporting practice, this amount was deducted from earnings to determine Pre-FMV EBITDA. However this gain reduced the value of the hedged mortgages and when these were placed in the third quarter 2017, earnings were negatively affected. Using normalized earnings, third quarter 2018 earnings are lower compared to those in the third quarter of 2017. This is due to tighter mortgage spreads and more securitization which delays the earning's process in comparison to placement fees which are earned in the same period as origination.

Outstanding Securities of the Corporation

At September 30, 2018 and October 30, 2018, the Corporation had 59,967,429 common shares; 2,887,147 Class A preference shares, Series 1; 1,112,853 Class A preference shares, Series 2; and 175,000 April 2020 senior unsecured notes outstanding.

Selected Annual Financial Information and Reconciliation to Pre-FMV EBITDA

(\$000s, except per share amounts)

	2017	2016	2015
For the Year ended December 31,			
Income Statement Highlights			
Revenue	1,078,768	1,049,818	915,315
Interest expense – securitized mortgages	(511,939)	(495,681)	(488,659)
Brokerage fees	(83,260)	(103,719)	(107,045)
Salaries, interest and other operating expenses	(193,032)	(169,129)	(161,821)
Add (deduct): realized and unrealized (gains) losses on financial instruments	(56,259)	(27,750)	52,143
Pre-FMV EBITDA ⁽¹⁾	234,278	253,539	209,933
Amortization of capital assets	(5,135)	(4,660)	(4,114)
Amortization of intangible assets	—	(2,500)	(5,000)
Add (deduct): realized and unrealized gains (losses) on financial instruments	56,259	27,750	(52,143)
Provision for income taxes	(75,750)	(72,300)	(39,245)
Net income	209,652	201,829	109,431
Common share dividends declared	184,400	98,946	90,451
Per Share Highlights			
Net income per common share	3.42	3.28	1.71
Dividends per common share	3.08	1.65	1.51
At Year End			
Balance Sheet Highlights			
Total assets	32,776,278	30,394,465	27,926,732
Total long-term financial liabilities	174,693	174,556	174,420

Notes:

- (1) Pre-FMV EBITDA is not a recognized earnings measure under IFRS and does not have a standardized meaning prescribed by IFRS. Therefore, Pre-FMV EBITDA may not be comparable to similar measures presented by other issuers. Investors are cautioned that Pre-FMV EBITDA should not be construed as an alternative to net income or loss determined in accordance with IFRS as an indicator of the Company's performance or as an alternative to cash flows from operating, investing and financing activities as a measure of liquidity and cash flows.

Vision and Strategy

The Company provides mortgage financing solutions to the residential and commercial mortgage markets in Canada. By offering a full range of mortgage products, with a focus on customer service and superior technology, the Company believes that it is the leading non-bank mortgage lender in the industry. The Company intends to continue leveraging these strengths to lead the “non-bank” mortgage lending industry in Canada, while appropriately managing risk. The Company's strategy is built on four cornerstones: providing a full range of mortgage solutions for Canadian single-family and commercial customers; growing assets under administration; employing technology to enhance service to mortgage brokers and borrowers, lower costs and rationalize business processes; and maintaining a conservative risk profile. An important element of the Company's strategy is its direct relationship with the mortgage borrower. The Company is considered by most of its borrowers as the mortgage lender. This is a critical distinction. It allows the Company to communicate with each borrower directly throughout the term of the related mortgage. Through this relationship, the Company can negotiate new transactions and pursue marketing initiatives. Management believes this strategy will provide long-term profitability and sustainable brand recognition for the Company.

Key Performance Drivers

The Company's success is driven by the following factors:

- Growth in the portfolio of mortgages under administration;
- Growth in the origination of mortgages;
- Raising capital for operations; and
- Employing innovative securitization transactions to minimize funding costs.

Growth in Portfolio of Mortgages under Administration

Management considers the growth in MUA to be a key element of the Company's performance. The portfolio grows in two ways: through mortgages originated by the Company and through third-party mortgage servicing contracts. Mortgage originations not only drive revenues from placement and interest from securitized mortgages, but perhaps more importantly, longer-term value from servicing rights, renewals and the growth of the customer base for marketing initiatives. As at September 30, 2018, MUA totalled \$105.0 billion, up from \$100.2 billion at September 30, 2017, an increase of 5%. This compares to \$103.6 billion at June 30, 2018, representing an annualized increase of 5%.

Growth in Origination of Mortgages

Direct origination by the Company

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. Increased origination satisfies demand from its institutional customers and produces volume for the Company's own securitization programs. In the third quarter of 2018, the Company's single-family origination grew at a steady rate. Whether it is the effect of OSFI guideline B-20 or gaining market share in the mortgage broker channel, the Company experienced higher origination across the country except for its Calgary and Vancouver offices which continue to suffer from regional real estate related issues: Toronto (+35%), Vancouver (+2%), Calgary (no growth) and Montreal (+54%). In aggregate, the Company's single-family origination increased in the third quarter of 2018 by 23%. The commercial segment growth slowed down as volume decreased 14% over 2017's third quarter. This was due to timing of origination. June 2018 had unusually high closings of about \$250 million in excess of 2017 comparative figures. For the year to date, new commercial origination was up 6% over 2017. Together, overall new origination for the third quarter of 2018 increased 10% year over year.

Third Party Mortgage Underwriting and Fulfillment Processing Services

In 2015, the Company launched its third party underwriting and fulfillment processing services business with a large Canadian schedule I bank ("Bank"). The business is designed to adjudicate mortgages originated by the Bank through the single-family residential mortgage broker channel. First National employs a customized software solution based on its industry leading MERLIN technology to accept mortgage applications from the Bank in the mortgage broker channel and underwrite these mortgages in accordance with the Bank's underwriting guidelines. The Bank funds all the mortgages underwritten under the agreement and retains full responsibility for mortgage servicing and the client relationship. Management considers the agreement a way to leverage the capabilities and strengths of First National in the mortgage broker channel and add some diversity to the Company's service offerings.

Relaunch of Excalibur Mortgage Products

In 2018, the Company relaunched its alternative single family (“Excalibur”) mortgage products. Alternative lending describes single family residential mortgages that are originated using broader underwriting criteria than those applied in originating prime mortgages. Alternative borrowers are generally considered “A” quality borrowers in terms of their credit histories, but do not qualify for a prime mortgage because of non-conformities, such as the degree of income disclosure and verification required. The Excalibur program also includes a product for borrowers with recently remediated credit. These mortgages generally have higher interest rates than prime mortgages. Although the Company’s original alternative program was discontinued in 2008 as a result of the credit crisis, First National’s relationships with mortgage brokers and underwriting systems allowed it to seamlessly relaunch the product this year. To start, the product will be originated for placement with institutional investors and the Company will earn a one-time placement fee and servicing income over the term of the mortgages. The Excalibur relaunch was rolled out gradually starting with select brokers in Ontario. Currently the program has been opened to include all Ontario brokers with a potential expansion to Western Canada in 2019.

Raising Capital for Operations

Bank Credit Facility

In the second quarter of 2018, the Company increased its revolving line of credit with a syndicate of banks from \$1.06 billion to \$1.25 billion. This facility enables the Company to fund the large amounts of mortgages accumulated for securitization. At the same time, the Company extended the term of the facility by about one year such that the maturity is now March 2023. The facility bears interest at floating rates. The Company has elected to undertake this debt for a number of reasons: (1) the facility provides the amount of debt required to fund mortgages originated for securitization purposes; (2) the debt is revolving and can be used and repaid as the Company requires, providing more flexibility than the senior unsecured notes, which are fully drawn during their term; (3) the five-year remaining term gives the Company a committed facility for the medium term; and (4) the cost of borrowing reflects the Company’s BBB issuer rating.

Preferred Share Issuance

Commencing on April 1, 2016, the Company reset the dividend rate on the 2,887,147 Class A Series 1 preference shares issued in 2011 which did not elect to convert to Class A Series 2 preference shares. The Series 1 shares provide an annual dividend rate of 2.79%. Also effective April 1, 2016, 1,112,853 Class A Series 2 were issued on the conversion from Series 1 shares. These bear a floating rate dividend calculated quarterly based on the 90 day T-Bill rate. Both the Series 1 and Series 2 shares pay quarterly dividends, subject to Board of Director approval and are redeemable at the discretion of the Company such that after the five-year term ending on March 31, 2021, the Company can choose to extend the shares for another five-year term at a fixed spread (2.07%) over the relevant index (five-year Government of Canada bond yield for any Series 1 shares or the 90-day T-Bill rate for any Series 2 shares). While the investors in these shares have an option on each five-year anniversary to convert their Series 1 preference shares into Series 2 preference shares (or vice versa), there is no provision of redemption rights to these shareholders. As such, the Company considers these shares to represent a permanent source of capital and classifies the shares as equity on its balance sheet. Management believes this capital has provided the Company with the opportunity to pursue its strategy of increased securitization, which requires upfront investment.

Employing Securitization Transactions to Minimize Funding Costs

Approval as both an Issuer of NHA-MBS and Seller to the Canada Mortgage Bonds Program

The Company has been involved in the issuance of NHA-MBS as an administrator since 1995. In December 2007, the Company was approved by Canada Mortgage and Housing Corporation (“CMHC”) as an issuer of NHA-MBS and as a seller into the CMB program. Issuer status has provided the Company with direct and independent access to reliable and low-cost funding.

Mortgage spreads can be illustrated by comparing posted five-year fixed single-family mortgage rates to a similar-term Government of Canada bond as listed in the table below.

Period	Average five-year Mortgage Spread for the Period
2006	1.12%
2007	1.50%
2008	2.68%
2009 - 2013	1.79%
2014	1.57%
2015	1.87%
2016	1.76%
2017	1.36%
Q1 2018	1.27%
Q2 2018	1.27%
Q3 2018	1.10%

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels; however, in 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. This trend continued into 2016, as optimism about the economy was mixed such that spreads remained at levels in excess of 1.8% until the third quarter when increased competition made for tighter spreads. With the recent strength in the economy and tougher mortgage rules, competition has further increased and spreads have tightened significantly. While funding spreads have also improved, generally the advantage of securitization compared to placement with investors is not as distinct as it was in the previous 10-year period. In the third quarter of 2018, the Company originated and renewed for securitization purposes approximately \$2.8 billion of single-family mortgages and \$0.2 billion of multi-unit residential mortgages. In the quarter, the Company securitized through NHA-MBS approximately \$2.6 billion of single-family mortgages and \$0.1 billion of multi-unit residential mortgages.

In August 2013, CMHC announced that it would be limiting the amount of guarantees it would provide on NHA-MBS pools created for sale to the “market”. CMHC indicated that the amount of guarantees it was providing for such market pools (generally any pool not sold to the Canada Housing Trust (“CHT”) for the CMB) was growing significantly. To better control the absolute amount of risk that it takes on in this respect, CMHC has implemented policies to allocate the amount of guarantees to issuers. The maximum amount allocated under the process has exceeded First National’s requirements in every quarter since inception. The process was amended in July 2016 to combine both NHA MBS for sale to the market and to CHT under one allocation. The available guarantees to be allocated were increased to accommodate issuance to CHT and continue to exceed the Company’s current needs.

Canada Mortgage Bonds Program

The CMB program is an initiative sponsored by CMHC whereby the CHT issues securities to investors in the form of semi-annual interest-yielding five- and 10-year bonds. Pursuant to the Company's approval as a seller into the CMB, the Company is able to make direct sales into the program. The ability to sell into the CMB has given the Company access to lower costs of funds on both single-family and multi-family mortgage securitizations. Because of the effectiveness of the CMB, many institutions have indicated their desire to participate. As a result, CHT has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is subject to these limitations. Beginning in July 2016, CHT effectively increased the price of the timely payment guarantees which CMB participants are required to purchase with the issuance of each CMB transaction. Although nominally CMB fees were decreased, these rules require guarantee fees to be levied on the creation of NHA MBS pools being sold to the CMB. Prior to this rule change, the NHA MBS pools to be sold into the CMB were exempt from such fees. In aggregate, guarantee fees have increased between 25% and 50% for CMB participants. This increase translates to approximately five basis points of cost over the term of the securitization. Since 2016, CMHC also modified the tiered NHA MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees from \$7.5 billion to \$9.0 billion. In the second quarter of 2018, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), issued its first NHA MBS pool for \$25 million and securitized the pool in the 5 year CMB issued by CHT in June 2018.

Adoption of New IFRS Accounting Standards

IFRS 9 – Financial Instruments

On January 1, 2018 the Company adopted the International Accounting Standard Board's ["IASB"] new standard - IFRS 9 – *Financial Instruments*, which replaced IAS 39. IFRS 9 includes a model for classification and measurement, a single, forward-looking "expected loss" impairment model and a substantially reformed approach to hedge accounting. Under this standard, financial assets are classified and measured based on the business model in which they are held and the characteristics of their contractual cash flows. The accounting model for financial liabilities is largely unchanged from IAS 39, except for the presentation of the impact of own credit risk on financial liabilities, which will be recognized in other comprehensive income ["OCI"], rather than in profit and loss as under IAS 39. The new general hedge accounting principles under IFRS 9 are aimed to align hedge accounting more closely with risk management. This new standard does not fundamentally change the types of hedging relationships or the requirement to measure and recognize ineffectiveness; however, it has provided more hedging strategies that are used for risk management to qualify for hedge accounting and these introduce more judgment to assess the effectiveness of a hedging relationship. All of the changes as a result of adopting IFRS 9 have been accounted for on a prospective basis by the Company so that there are no adjustments to the opening equity of the Company.

Classifications and Measurement

IFRS 9 requires that all financial assets are to be measured at either at FVTPL, fair value through OCI ["FVOCI"], or amortized cost. Based on its business models, the Company has determined which measurement convention is most appropriate for its mortgage assets as summarized below with a comparison to the classification and measurement under IAS 39:

	IAS 39	IFRS 9
Mortgages accumulated for securitization	Loans and Receivable	Amortized Cost
Mortgages accumulated for sale	FVTPL	FVTPL
Mortgages pledged under securitization	FVTPL or Loan and Receivables	Amortized Cost
Mortgage and loan investments	Loans and Receivable	FVTPL

As at December 31, 2017, the mortgages pledged under securitization which were classified as FVTPL had a mark to market discount to par of \$1,683.

Impairment

IFRS 9 introduces an expected credit loss ["ECL"] model applicable to all debt instruments within financial assets classified as amortized cost or FVOCI and certain off-balance sheet loan commitments. The model has three stages: Stage 1 – the credit risk has not increased significantly since initial recognition such that an allowance for credit loss is recognized and maintained equal to 12 months of expected credit loss; Stage 2 – the credit risk has increased significantly since initial recognition, and the allowance for credit loss is increased to cover full lifetime expected credit loss; and Stage 3 – a financial asset is considered credit-impaired and the allowance for credit loss continues to be the full lifetime expected credit loss, with interest revenue calculated on the carrying amount (net of the allowance for credit loss), rather than the gross carrying value of the financial assets.

The key inputs in the measurement of ECL include Probability of Default, Loss Given Default and forecast of future economic conditions which involves significant judgment. Upon application of the impairment portion of IFRS 9, there has been no impact on the Company's earnings due to the high proportion of government insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends.

Hedge Accounting

The Company has adopted hedge accounting for a portion of its mortgage commitments and virtually all of its fixed rate funded mortgages accumulated for securitization.

For multi-unit residential commercial segment mortgages, the Company has applied "cash flow" hedge accounting by hedging the anticipated future debt to be arranged through securitization on these mortgages. Effective January 1, 2018 the Company commenced designating the short sales of Government of Canada bonds at the time of mortgage commitment as hedging instruments. When effective hedging is achieved, any gains or losses will be recorded in OCI and amortized into interest expense over the term of the hedged debt. Under ordinary market conditions, this accounting should remove some of the volatility related to marking to market hedging instruments from the Company's regular income.

For residential mortgages accumulated for securitization, the Company has applied "fair value" hedge accounting to minimize the exposure to changing interest rates by selling short Government of Canada bonds at the time these mortgages are funded. The Company will re-balance and evaluate the hedge effectiveness on an ongoing basis. For an effective hedge, the gains or losses on the hedging instrument should be offset by the losses or gains of value on the hedged mortgages. At the termination of the hedging relationship of an effective hedge, the changes in the value of the hedging instrument will be adjusted to the carrying value of the hedged mortgages, and amortized into interest revenue over the term of the hedged mortgages. Any changes in the market value of an ineffective hedge will be immediately recorded in the Company's regular income.

IFRS 15 – Revenue from Contracts with Customers

On January 1, 2018 the Company adopted IASB issued IFRS 15 – *Revenue from Contracts* with Customers. The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step

revenue recognition process to determine the nature, amount, timing and uncertainty of revenue and cash flows from the contracts with customers.

The Company has applied the standard on January 1, 2018, using the modified retrospective approach. The main revenue stream that has been affected by IFRS 15 is mortgage servicing revenue, including the ongoing measurement of servicing liabilities. Because of the immaterial impact of applying this standard, there has been no significant effect on the Company's first, second or third quarter 2018 consolidated financial statements and there has not been any required restatement of comprehensive income for prior years.

Key Performance Indicators

The principal indicators used to measure the Company's performance are:

- Earnings before income taxes, depreciation, and losses and gains on financial instruments with the exception of any losses related to mortgage investments ("Pre-FMV EBITDA" ⁽¹⁾); and
- Dividend payout ratio.

Pre-FMV EBITDA is not a recognized measure under IFRS. However, management believes that Pre-FMV EBITDA is a useful measure that provides investors with an indication of income normalized for capital market fluctuations. Pre-FMV EBITDA should not be construed as an alternative to net income determined in accordance with IFRS or to cash flows from operating, investing and financing activities. The Company's method of calculating Pre-FMV EBITDA may differ from other issuers and, accordingly, Pre-FMV EBITDA may not be comparable to measures used by other issuers.

	Quarter ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
For the Period	(\$ 000's)			
Revenue	321,835	284,315	869,471	808,753
Income before income taxes	71,078	80,009	183,367	222,244
Pre-FMV EBITDA ⁽¹⁾	62,990	51,826	169,406	173,185
At Period end				
Total assets	35,597,827	31,548,130	35,597,827	31,548,130
Mortgages under administration	105,032,062	100,176,720	105,032,062	100,176,720

Note:

- (1) This non-IFRS measure adjusts income before income taxes by adding back expenses for depreciation of capital assets, but it also eliminates the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) used in and deducting gains on the valuation of financial instruments.

Since going public in 2006, First National has been considered a high-yielding dividend paying company. With a large MUA which generates continuing income and cash flow and a business model which is designed to make efficient use of capital, the Company has been able to pay distributions to its shareholders which represent a relatively large ratio of its earnings. The Company calculates the dividend payout ratio as dividends declared on common shares over net income attributable to common shareholders. This measure is useful to shareholders as it indicates the percentage of earnings which have been paid out in dividends. Similar to the performance measure for earnings, the Company also calculates the dividend payout ratio on a basis using after-tax Pre-FMV EBITDA.

Determination of Common Share Dividend Payout Ratio

	Quarter ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
For the Period	((\$000s))			
Net income attributable to common shareholders	51,216	57,789	132,034	160,359
Total dividends paid or declared on common shares	27,735	27,735	83,205	81,706
Total Common Share Dividend Payout Ratio	54%	48%	63%	51%
After-tax Pre-FMV Dividend Payout Ratio ⁽¹⁾	63%	77%	70%	67%

Note:

- (1) This non-IFRS measure adjusts the net income used in the calculation of the dividend payout ratio to after tax Pre-FMV earnings so as to eliminate the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments. The Company uses its aggregate effective tax rate to tax affect the impact of the valuation of financial instruments on this ratio.

For the quarter ended September 30, 2018, the common share payout ratio was 54% compared to 48% in the 2017 quarter. In both the 2018 and 2017 quarters, the Company recorded gains on account of changes in the fair value of financial instruments. These revenues are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact will likely be reflected in narrower spreads in the future once the mortgages are pledged for securitization. Accordingly, management does not consider this revenue to increase the ability of the Company to pay dividends. If the gains on financial instruments in the two quarters are excluded from the above calculations, the dividend payout ratio for the 2018 third quarter would have been 63% compared to 77% in the 2017 quarter.

The Company also paid \$0.7 million of dividends on its preferred shares in both the third quarter of 2018 and the third quarter of 2017.

Revenues and Funding Sources

Mortgage Origination

The Company derives a significant amount of its revenue from mortgage origination activities. Most mortgages originated are funded either by placement with institutional investors or through securitization conduits, in each case with retained servicing. Depending upon market conditions, either an institutional placement or a securitization conduit may be the most cost-effective means for the Company to fund individual mortgages. In general, originations are allocated from one funding source to another depending on market conditions and strategic considerations related to maintaining diversified funding sources. The Company retains servicing rights on virtually all of the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the quarter ended September 30, 2018, new origination volume increased from \$4.9 billion to \$5.4 billion, or about 10%, compared to the 2017 third quarter.

Securitization

The Company securitizes a portion of its origination through various vehicles, including NHA-MBS, CMB and Asset-backed Commercial Paper ("ABCP"). Although legally these transactions represent sales of mortgages, for accounting purposes they do not meet the requirements for sale recognition and instead are accounted for as secured financings. These mortgages remain as mortgage assets of the Company for the full term and are funded with securitization-related debt. Of the Company's \$7.5 billion of new originations and renewals for the quarter ended September 30, 2018, \$3.0 billion was originated for its own securitization programs.

Placement Fees and Gain on Deferred Placement Fees

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as “placement fees”. The present value of additional amounts expected to be received over the remaining life of the mortgage sold (excluding normal market-based servicing fees) is recorded as a “deferred placement fee”. A deferred placement fee arises when mortgages with spreads in excess of a base spread are sold. Normally the Company would earn an upfront cash placement fee, but investors prefer paying the Company over time as they earn net interest margin on such transactions. Upon the recognition of a deferred placement fee, the Company establishes a “deferred placement fee receivable” that is amortized as the fees are received by the Company. Of the Company's \$7.5 billion of new originations and renewals in the third quarter of 2018, \$4.3 billion was placed with institutional investors.

For all institutional placements and mortgages sold to institutional investors for the NHA-MBS market, the Company earns placement fees. Revenues based on these originations are equal to either (1) the present value of the excess spread, or (2) an origination fee based on the outstanding principal amount of the mortgage. This revenue is received in cash at the time of placement. In addition, under certain circumstances, additional revenue from institutional placements and NHA-MBS may be recognized as “gain on deferred placement fees” as described above.

Mortgage Servicing and Administration

The Company services virtually all mortgages generated through its mortgage origination activities on behalf of a wide range of institutional investors. Mortgage servicing and administration is a key component of the Company's overall business strategy and a significant source of continuing income and cash flow. In addition to pure servicing revenues, fees related to mortgage administration are earned by the Company throughout the mortgage term. Another aspect of servicing is the administration of funds held in trust, including borrowers' property tax escrows, reserve escrows and mortgage payments. As acknowledged in the Company's agreements, any interest earned on these funds accrues to the Company as partial compensation for administration services provided. The Company has negotiated favourable interest rates on these funds with the chartered banks that maintain the deposit accounts, which has resulted in significant additional servicing revenue.

In addition to the interest income earned on securitized mortgages and deferred placement fees receivable, the Company also earns interest income on mortgage-related assets, including mortgages accumulated for sale or securitization, mortgage and loan investments and purchased mortgage servicing rights.

The Company provides underwriting and fulfilment processing services to a mortgage originator using the mortgage broker distribution channel. The Company earns a fee based on the dollar value of funded mortgages. These fees are recognized at the time a mortgage funds and is included in “Mortgage servicing income” in the consolidated statement of income.

Results of Operations

The following table shows the volume of mortgages originated by First National and mortgages under administration for the periods indicated:

	Quarter ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Mortgage Originations by Segment				
New single-family residential	3,878	3,157	9,471	8,346
New multi-unit and commercial	1,478	1,720	4,389	4,125
Sub-total	5,356	4,877	13,860	12,471
Single-family residential renewals	1,829	1,734	4,761	4,095
Multi-unit and commercial renewals	295	313	746	870
Total origination and renewals	7,480	6,924	19,367	17,436
Mortgage Originations by Funding Source				
Institutional investors – new residential	2,126	1,858	4,049	4,986
Institutional investors – renew residential	685	1,016	1,862	2,124
Institutional investors – multi/commercial	1,505	1,703	4,084	4,071
NHA-MBS/ CMB/ABCP securitization	2,984	2,158	8,750	5,750
Internal Company resources/CMBS	180	189	622	505
Total	7,480	6,924	19,367	17,436
Mortgages under Administration				
Single-family residential	78,780	77,123	78,780	77,213
Multi-unit residential and commercial	26,252	23,054	26,252	23,054
Total	105,032	100,177	105,032	100,177

Total new mortgage origination volumes increased in the third quarter of 2018 compared to 2017 by 10%. Single-family volumes increased by 23% but commercial segment volumes decreased by 14% year over year. The increase in the single-family segment is evident across the country except for the Company's Calgary and Vancouver offices, which had volumes similar to the 2017 third quarter. When combined with renewals, total production increased from \$6.9 billion in the 2017 third quarter to \$7.5 billion in the third quarter of 2018, or by 8%. The Company believes higher new single-family origination is partially the result the relaunch of its Excalibur program which has added origination volume where there was none in 2017. Overall volumes were also affected favorably by a 54% increase in the Quebec market. Some of the mortgage rate pressure in this region subsided so as to make the Company's products more competitive. The Company's expertise in mortgage underwriting drove higher commercial segment origination volumes higher by 6% for the nine months to September 2018 despite the 14% decrease evidenced in the 2018 third quarter. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of \$3.0 billion in the third quarter of 2018. The Company used such securitization funding to a greater degree than institutional placements in 2018. Generally, the Company maintained a balance between these funding sources so as to support its long-term strategy to maintain diverse funding sources.

Net Interest - Securitized Mortgages

Comparing the quarter ended September 30, 2018 to the quarter ended September 30, 2017, “net interest – securitized mortgages” decreased by 7% to \$34.1 million from \$36.5 million. The decrease was due to a tighter weighted-average spread on the portfolio offset by a larger portfolio of securitized mortgages year over year. The portfolio of securitized mortgages increased by 15% from \$26.2 billion at September 30, 2017 to \$30.2 billion by the end of September 2018. The increase in the securitized portfolio has been offset by tighter securitization spreads as mortgage spreads to risk-free Government of Canada have decreased by about 0.66% since 2016. The impact of accounting for financial instruments has also impacted these earnings. Large gains recognized in 2017 and 2016 are effectively amortizing into securitization as the resultant tighter securitization spreads produce net securitization margin.

Placement Fees

Placement fee revenue increased by 35% to \$42.0 million from \$31.2 million in 2018. The increase is explained largely by the impact of changing interest rates and a change in accounting policy for the Company’s interest rate hedging program. As described previously in the third quarter 2017 MD&A, management determined that because of rising interest rates, the Company recorded about \$14.4 million of gains on financial instruments in the second quarter of 2017 related to short bonds used to mitigate interest rate risk associated with a pool of specific mortgages. The pool of mortgages declined in value by a similar amount; however because the Company’s interest risk mitigation program did not qualify for hedge accounting, the offsetting financial impact was only realized when the pool was placed with investors in the third quarter of 2017. Accordingly, third quarter placement fees were lower by approximately \$14.4 million. If this amount is added back to 2017 placement fees revenues to normalize, 2018 third quarter placement fees would have decreased by 8% in comparing the two quarters. This decrease results from lower placement fees per unit which were 11% lower in the 2018 quarter. The decline is the result of tightening mortgage spreads which reduced the value of placement with a portion of the Company’s institutional investors. Excalibur placement fees have offset this decrease to some extent as there was no comparative revenue in 2017. Commercial placement fees were lower in the quarter due to the decrease in origination volume.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue increased 36% to \$3.0 million from \$2.2 million. The gains relate to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Volumes for these transactions increased by 37% from 2017 and spreads on these transactions were consistent between the quarters.

Mortgage Servicing Income

Mortgage servicing income increased 10% to \$42.7 million from \$38.7 million. This increase was largely due to the third party underwriting business which experienced an increase in the volume of mortgages processed and with the benefits associated with higher MUA.

Mortgage Investment Income

Mortgage investment income increased 24% to \$23.1 million from \$18.6 million. The increase is due primarily to an increase in market interest rates providing more investment income. The Company recorded mark to market losses of \$1.0 million (2017 – credit losses of \$1.5 million) regarding four non-performing properties in the commercial bridge portfolio in the 2018 third quarter. These are recorded as losses on financial instruments in 2018. In addition, the interest rates associated with the Company’s mortgages warehoused prior to securitization were higher this quarter such that more interest income was earned during the warehousing period.

Realized and Unrealized Gains (Losses) on Financial Instruments

In previous periods, this financial statement line item has typically consisted of two components: (1) gains and losses related to the Company's economic hedging activities using short bonds, and (2) gains and losses related to holding term assets derived using discounted cash flow methodology. Under previous IFRS accounting standards, the company's use of short Government of Canada bonds together with repurchase agreements to create synthetic forward interest rate contracts to hedge interest rate risk, did not qualify as hedges for accounting purposes. The result was large gains and losses related to changes in the fair value of these instruments. The gains or losses were recorded in earnings in the period in which the bond prices changed. With the adoption of IFRS 9, these instruments can now qualify as hedges for accounting purposes with the proper documentation and oversight. The Company has elected to document hedging relationships for virtually all of the multi-residential commitments and mortgages it originates for its own securitization programs. It has also done the same for the funded single-family mortgages and the swaps used in its ABCP programs. This decision will likely reduce the volatility of gains and losses on financial instruments seen in the last several fiscal years as gains and losses on these hedged items are generally deferred and amortized into income over the term of the related mortgage. The Company has not documented a hedging relationship for the short bonds used to economically hedge commitments on single-family mortgages. The Company believes given the optional nature of these commitments it is difficult to establish a valid hedging relationship. For financial reporting purposes, this means that there will still be gains and losses on financial instruments in the years after 2017, but these should be limited to those on the short bonds used to mitigate the interest rate risk associated with single-family commitments. The Company has recorded most of the mortgages held as assets on its balance sheet at amortized cost. Accordingly, there should be much lower fair value gains or losses associated with "mortgages held at fair value" compared to the past several years. The following table summarizes these gains and losses by category in the periods indicated:

Summary of realized and unrealized gains (losses) on financial instruments	Quarter ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	(\$000s)			
Gains on short bonds used for the economic hedging program	10,716	17,916	20,106	34,084
Losses on mortgages held at fair value	(1,000)	(11,814)	(3,000)	(18,140)
Gains (losses) on interest rate swaps	(1,322)	23,272	(2,229)	36,690
Other losses	—	(1,167)	—	(1,167)
Net gains on financial instruments	<u>8,394</u>	<u>29,374</u>	<u>14,877</u>	<u>52,634</u>

In the third quarter of 2017, economic data turned positive and interest rates jumped higher with the expectations of a Bank of Canada increase in overnight rates. This meant that 5-year bond prices decreased so that generally the Company recorded large gains on its hedging program. In the third quarter of 2018, bond yields also increased; however by adopting hedge accounting a portion of the gains have been removed from the Company's statement of income.

In the third quarter of 2018, the Company recorded gains on these instruments of \$10.7 million (2017 - \$17.9 million). On its commercial segment hedges, the value of the Company's hedges increased by \$4.3 million; however because of the designation of a hedge relationship, the amount was recorded in Other Comprehensive Income. This amount will be amortized into the Company's regular income over the terms of the related securitization and placement transactions. For the residential segment, the Company has designated hedge relationships to protect the fair value of funded mortgages prior to securitization or placement. The \$10.7 million gain above reflects the increase in value of short bonds used to hedge the Company's commitments for which the Company does not attempt to document a hedge relationship. The change in value of the mortgages that were hedged effectively in the quarter has been deferred on the Company's balance sheet.

Brokerage Fees Expense

Brokerage fees expense decreased 4% to \$23.8 million from \$24.7 million. This decrease is explained by lower per unit broker fees for single family mortgages. In the third quarter of 2017, broker compensation for insured mortgages was abnormally high as the market competed for such mortgages. In 2018 fees returned to 2016 levels such that third quarter 2018 per unit broker fees are generally 12% lower than in the 2017 comparative quarter. Although origination volumes of Excalibur mortgages are still less than 5% of total origination, these mortgages are generally for 1 year terms and accordingly have a significantly lower broker fee cost which also reduces average per unit broker fees. Origination volumes of single-family mortgages for institutional investors, including Excalibur loans, increased by 14% comparing the third quarter of 2018 to 2017. The related increase in broker fees was offset by about \$1.0 million of savings in lower commercial segment fees, portfolio insurance costs and other costs accounted for in broker fees.

Salaries and Benefits Expense

Salaries and benefits expense decreased by less than 1% to \$24.1 million from \$24.2 million. Salaries were higher by 1% despite overall headcount increasing by 4% (921 employees as at September 30, 2017 and 962 at September 30, 2018). Although overall headcount rose and salaries expenses increased by standard cost of living increases, these increases were offset by \$1.4 million of lower compensation earned by commercial sales staff on the lower origination volumes recorded in the quarter. Management salaries were paid to the two senior executives (Co-founders) who together control about 74% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO") in 2006.

Interest Expense

Interest expense increased 44% to \$19.2 million from \$13.3 million. As discussed in the "Liquidity and Capital Resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the investor or funding with a securitization vehicle. The Company used the senior unsecured notes together with a \$1.25 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense has increased from the prior period due to higher short-term interest rates pursuant to Bank of Canada announcements which have increased short-term borrowing rates by 0.75% beginning in the third quarter of 2017. The Company also held higher balances of mortgages accumulated for securitization and mortgage and loan investments in the 2018 quarter, which required greater use of the Company's credit facilities.

Other Operating Expenses

Other operating expenses increased by 7% to \$15.2 million from \$14.2 million. Other operating expenses increased by \$1.5 million related to higher hedge expenses which increased in step with higher bond yields and a larger hedge book. Because of more mortgages originated for securitization, the Company carried notional hedges of approximately \$2.0 billion during the 2018 third quarter. In addition, the rising interest rate environment has created a steeper yield curve which makes it more expensive to carry the short bonds the Company employs to mitigate interest rate risk associated with the Company's commitment and funded warehouse pipeline. The offsetting decrease in other operating expenses of \$0.5 million reflects reductions in costs for information technology and mortgage servicing.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes decreased by 11% to \$71.1 million from \$80.0 million. This decrease was affected by changing capital markets. In the third quarter of 2018, the Company recorded \$9.4 million of gains on financial instruments (excluding \$1.0 million of losses related to mortgage and loan investments). In the 2017 comparative quarter, the Company recorded \$29.4 million of gains on financial instruments. The change in these values accounts for a \$20.0 million decrease in comparative income before income taxes. Pre-FMV EBITDA, which eliminates the impact of gains and losses on financial instruments, increased by 22% to \$63.0 million from \$51.8 million. The increase was due largely to the effect of fair value accounting on placement fee revenues in the third quarter of 2017. Because of a rising interest rate environment and the inability of the Company to apply hedge accounting at that time, large gains on financial instruments were recognized in the 2017 second quarter to the detriment of related mortgage assets which were subsequently placed with institutional investors in the third quarter of 2017. Effectively \$14.4 million of revenue was recognized in the second quarter of 2017 within gains on financial instruments detracting from placement fees subsequently earned on the related mortgages in the third quarter of 2017. If the 2017 third quarter is “normalized” for this circumstance, Pre-FMV EBITDA would have been \$66.2 million in that quarter or 5% higher than the same measure in the third quarter of 2018. The decrease in this earning measure is a result of Company’s increased securitization program. By securitizing mortgages instead of placing them with institutional investors, the Company delays the earning’s process: placement fee revenues are reduced and the costs of hedging and interest during the warehousing period are increased. In addition, tight mortgage spreads have reduced the profitability of securitization such that net interest – securitization mortgages has not grown in step with the growth in mortgages pledged for securitization.

Provision for Income Taxes

The provision for taxes decreased by 10% to \$19.1 million from \$21.2 million. The provision decreased proportionately with net income before income taxes. The overall effective tax rate is a marginally higher in 2018 as a provincial tax rate increased by 1% at the start of 2018.

Other Comprehensive Income

Beginning January 1, 2018, the Company adopted IFRS 9. As a part of this transition the Company began accounting for some of its interest rate risk mitigation strategies as hedges for reporting purposes. For the commercial segment, the Company hedges the interest rate risk associated with insured multi-residential mortgages. This hedging begins on commitment and ends when the Company either securitizes the mortgages (primarily through CMB funding) or places the mortgage with an institutional investor. As the Company has determined that these hedges were effective, the Company recorded \$4.3 million of gains on such hedges in the third quarter of 2018 that would have been recorded in gains on financial instruments under the previous IFRS standard. During the third quarter, the Company amortized \$1.3 million of such gains earned year to date into its Net Income. The remaining OCI amount has been tax affected at the Company’s effective tax rate.

Operating Segment Review

The Company aggregates its business from two segments for financial reporting purposes: (i) Residential (which includes single-family residential mortgages); and (ii) Commercial (which includes multi-unit residential and commercial mortgages), as summarized below:

Operating Business Segments				
	Residential		Commercial	
	(\$000s except percent amounts)			
For the quarter ended	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Originations and renewals	5,707,374	4,891,266	1,772,694	2,033,216
<i>Percentage change</i>	<i>17%</i>		<i>(13%)</i>	
Revenue	255,608	220,692	66,227	63,623
<i>Percentage change</i>	<i>16%</i>		<i>4%</i>	
Income before income taxes	54,572	62,695	16,506	17,314
<i>Percentage change</i>	<i>(13%)</i>		<i>(5%)</i>	
As at	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
Identifiable assets	28,425,609	25,653,160	7,142,442	7,093,342
Mortgages under administration	78,780,450	77,422,655	26,251,612	24,166,498

Residential Segment

Overall residential origination including renewals increased by 17% between the 2018 and 2017 third quarters while residential revenues increased by about 16%. Revenues in both quarters were affected by large gains of fair value associated with rising interest rates. If such revenues are excluded from both quarters, revenue increased by 18%. Revenue growth exceeded the growth in origination as the Company's revenue from securitized mortgages in this segment increased by 27% as mortgage interest rates increased in the market. Net income before tax was also affected by fair value related amounts. Without the impact of these revenues (including \$10.9 million related to lower placement fees the result of large fair value gains in the 2017 second quarter), net income before tax decreased from \$50.6 million to \$46.2 million or by 9%. This is also the result of the Company's decision to securitize as opposed to placing a larger portion of its residential origination in the quarter. The costs of underwriting, hedging and warehousing these mortgages are significant and there is an only marginal amount to earnings on new transactions in the quarter. Net securitization margin also suffered from tighter securitization spreads the result of a competitive marketplace as well as the amortization of large debt discounts created by interest rate movements in 2016 and 2017. Identifiable assets increased from December 31, 2017, as the Company increased its investment in mortgages pledged under securitization by about \$2.0 billion and mortgages accumulated for securitization by \$0.9 billion. The growth was offset by lower amounts of bonds purchased under resale agreements for hedging purposes as a bigger portion of the mortgages accumulated for securitization are now floating rate mortgages that do not require interest rate hedging.

Commercial Segment

Third quarter 2018 commercial revenues increased by about 4% compared to 2017. Without the impact of gains and losses on account of fair value, revenue increased by 9% year over year despite decreased origination. This reflects interest revenue on securitized mortgages which increased by 15% year over year as the average mortgage rate in the securitized portfolio increased with the higher interest rate environment. Income before income taxes was also affected by fair value considerations. By excluding fair value gains and losses, this measure would have increased by 14% year over year as the 20% increase in origination evidenced in 2017 and the first 6 months of 2018, created higher net securitization and servicing income which more than offset lower placement fees on decreased origination. Identifiable

assets increased from those at December 31, 2017, as the Company increased its investment mortgages pledged for securitization by \$628 million but reduced its investment in mortgage investments, hedging assets and mortgages accumulated for securitization by almost the same amount within the nine month period.

Liquidity and Capital Resources

The Company's fundamental liquidity strategy has been to invest in prime Canadian mortgages. Management's belief has always been that these mortgages are considered "AAA" by investors and should always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, when capital markets faltered and only the highest-quality assets were bid. As the Company's results in those years demonstrated, First National had little trouble finding investors to purchase its mortgage origination at profitable margins. Originating prime mortgages also allows the Company to securitize in the capital markets; however, this activity requires significant cash resources to purchase and hold mortgages prior to arranging for term debt through the securitization markets. For this purpose, the Company uses the combination of the \$175 million unsecured notes and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) the origination costs associated with securitization, and (3) mortgage and loan investments. The Company has a credit facility with a syndicate of ten financial institutions for a total credit of \$1.25 billion. This facility was extended in May 2018 for a five-year term maturing in March 2023. At September 30, 2018, the Company entered into repurchase transactions with financial institutions to borrow \$1.5 billion related to \$1.6 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At September 30, 2018, outstanding bank indebtedness was \$1,028.8 million (December 31, 2017 - \$643.8 million). Together with the unsecured notes of \$175 million (December 31, 2017 - \$175 million), this "combined debt" was used to fund \$1,025.7 million (December 31, 2017 - \$556.1 million) of mortgages accumulated for sale or securitization. At September 30, 2018, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$41.6 million (December 31, 2017 - \$41.3 million) and (2) mortgage and loan investments of \$264.7 million (December 30, 2017 - \$379.7 million). The difference between "combined debt" and the mortgages accumulated for sale or securitization funded by it, which the Company considers a proxy for "true leverage", has increased between December 31, 2017 and September 30, 2018, and now stands at \$178.1 million (December 31, 2017 - \$262.4 million). This represents a debt-to-equity ratio of approximately 0.30:1. This has decreased from December 31, 2017 when the ratio was also 0.48:1. In general, in the nine month period to September 30, 2018, the Company used the cash from repayment of \$115 million of mortgage and loan investments to (1) invest in \$31 million of broker fees related to securitized mortgages and, (2) to pay down debt by \$84 million. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

The Company funds a portion of its mortgage originations for institutional placement on the same day as the advance of the related mortgage. The remaining originations are funded by the Company on behalf of institutional investors or pending securitization by the Company. On specified days, the Company aggregates all mortgages warehoused to date for an institutional investor and transacts a settlement with that institutional investor. A similar process occurs prior to arranging for funding through securitization. The Company uses a portion of the committed credit facility with the banking syndicate to fund the mortgages during this warehouse period. The credit facility is designed to be able to fund the highest balance of warehoused mortgages in a month and is normally only partially drawn.

The Company also invests in short-term mortgages, usually for six- to 18-month terms, to bridge existing borrowers in the interim period between long-term financing solutions. The banking syndicate has provided credit facilities to partially fund these investments. As these investments return cash, it will be used to pay down this bank indebtedness. The syndicate has also provided credit to finance a portion of the Company's deferred placement fees receivable and the origination costs associated with securitization as well as other miscellaneous longer-term financing needs.

The Company has used ABCP as an efficient source of funding primarily for short-term insured mortgages. In the May 2013 federal budget, the government announced it was going to take steps to limit the securitization of government insured mortgages to CMHC sponsored programs. As ABCP is not sponsored by CMHC, such a limitation would impact the Company. Almost two years after the announcement, legislation was passed and detailed transition information was published. With the change in the federal government, the legislation was reconfirmed in February 2016 with some delayed application dates. Generally, the regulations make mortgage default insurance invalid for any single-family mortgages with maturity dates beyond December 31, 2021 in a non-CMHC sponsored securitization vehicle. Accordingly, existing single-family mortgages in ABCP conduits can be funded by ABCP until their maturity, not to exceed 5 years and new insured single-family mortgages can be sold in as long as the maturity date of the mortgage is prior to January 1, 2022. As this date approaches, the Company must find other funding sources for the insured mortgages it has historically funded with ABCP. The Company is considering various alternatives including whole loan sales and selling short-term NHA-MBS pools to ABCP conduits. The Company may also adjust its renewal offering to provide incentives to borrowers to select five year terms as opposed to shorter terms. These alternatives may not be as economical to the Company as ABCP. A portion of the Company's capital has been employed to support its ABCP and NHA-MBS programs, primarily to provide credit enhancements as required by rating agencies. The most significant portion of cash collateral is the investment made on behalf of the Company's ABCP programs. As at September 30, 2018, the investment in cash collateral was \$69.5 million (December 31, 2017 - \$66.4 million).

The Company's Board of Directors has elected to pay dividends, when declared, on a monthly basis on the outstanding common shares and on a quarterly basis on the outstanding preference shares. For purposes of the enhanced dividend tax credit rules contained in the *Income Tax Act* (Canada) and any corresponding provincial and territorial tax legislation, all dividends (and deemed dividends) paid by the Company to Canadian residents on both common and preference shares after December 31, 2010, are designated as "eligible dividends". Unless stated otherwise, all dividends (and deemed dividends) paid by the Company hereafter are designated as "eligible dividends" for the purposes of such rules. For the preference shares, the Company has elected to pay any tax under Part VI.1 of the *Income Tax Act*, such that corporate holders of the shares will not be required to pay tax under Part VI.1 of the *Income Tax Act* on dividends received on such shares.

Financial Instruments and Risk Management

The Company has recorded mortgages accumulated for sale and mortgage and loan investments, as financial assets measured at "fair value through profit or loss" such that changes in market value are recorded in the consolidated statement of income. The mortgages accumulated for sale are held for very short periods and any change in value due to changing interest rates is the obligation of the ultimate institutional investor. Accordingly the Company believes there will be little, if any, effect on its income related to the change in fair value of these mortgages. The majority of mortgages in mortgage and loan investments are uninsured commercial segment bridge loans. These are primarily floating rate loans that have mortgage terms of eighteen months or less. As the mortgages do not conform to conventional mortgage lending, there are few active quoted markets available to determine the fair value of these assets. The Company estimates fair value based upon: benchmark interest rates, credit spreads for similar products, creditworthiness and status of the borrower, valuation of the underlying real property, payment history, and other conditions specific to the rationale for the loan. Any favourable or unfavourable amounts will be recorded in the statement of income each quarter.

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. Prior to 2018, the Company did not attempt to adopt hedge accounting; however with the introduction of IFRS 9 on January 1, 2018, the Company began designating hedging relationships such that the results of any effective hedging will not affect the Company's statement of income. See previous discussion in this MD&A under "Realized and Unrealized Gains (Losses) on Financial Instruments". As at September 30, 2018, the Company had more than \$1.1 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund, and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages to be sold to the Company's other securitization vehicles. As at September 30, 2018, the Company had entered into \$0.2 billion of notional value forward bond sales for this segment.

The Company is party to four interest rate swaps that economically hedge the interest rate exposure related to certain CMB transactions in which the Company has replacement obligations. As at September 30, 2018, the aggregate notional value of these swaps, maturing between June 2021 and September 2026, was \$57.3 million. During the third quarter of 2018, the value of these swaps decreased by \$1.3 million.

As described above, the Company employs various strategies to reduce interest rate risk. In the normal course of business, the Company takes some credit spread risk. This is the risk that the credit spread at which a mortgage is originated changes between the date of commitment of that mortgage and the date of sale or securitization. This can be illustrated by the Company's experience with commercial mortgages originated for the CMBS market in the spring of 2007. These mortgages were originated at credit spreads designed to be profitable to the Company when sold to a bank-sponsored CMBS conduit. Unfortunately for the Company, when these mortgages funded, the CMBS market had shut down. The alternative to this channel was more expensive, as credit spreads elsewhere in the marketplace for this type of mortgage had widened. The Company adjusted for market-suggested increases in credit spreads in 2007 and 2008, adjusting the value of the mortgages downward. In 2009, the economic environment remained weak but did not worsen from what it was at the end of 2008. Overall credit spreads stopped widening such that the Company applied the same spreads to these mortgages and the Company did not record any additional unrealized losses or gains related to credit spread movement. Despite entering into effective economic interest rate hedges, the Company's exposure to credit spreads remained. This risk is inherent in the Company's business model and cannot be economically hedged.

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of June 2011 and continuing through the current period, it was priced at a discount to BAs. At the same time the Company has leveraged on changing credit spreads. The success of this approach has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages. As at September 30, 2018, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost \$2.5 billion of mortgages that are susceptible to some degree of changing credit spreads.

Capital Expenditures

A significant portion of First National's business model consists of the origination and placement or securitization of financial assets. Generally, placement activities do not require much capital investment as the Company acts primarily in the capacity of a broker. On the other hand, the undertaking of securitization transactions may require significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. For fixed assets, the business requires capital expenditures on technology (both software and

hardware), leasehold improvements, and office furniture. During the quarter ended September 30, 2018, the Company purchased new computer equipment and software. In the long term, the Company expects capital expenditures on fixed assets will be approximately \$5.0 million annually.

Summary of Contractual Obligations

The Company's long-term obligations include five- to 10-year leases of premises for its six offices across Canada, and its obligations for the ongoing servicing of mortgages sold to securitization conduits and mortgages related to purchased servicing rights. The Company sells its mortgages to securitization conduits on a fully-serviced basis, and is responsible for the collection of the principal and interest payments on behalf of the conduits, including the management and collection of mortgages in arrears.

Critical Accounting Policies and Estimates

The Company prepares its financial statements in accordance with IFRS, which requires management to make estimates, judgments and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and other assumptions that it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. The significant accounting policies of First National are described in Note 2 to the Company's annual consolidated financial statements as at December 31, 2017. The policies which First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

The Company uses estimates in valuing its gain or loss on the sale of its mortgages placed with institutions earning a deferred placement fee. Under IFRS, valuing a gain on deferred placement fees requires the use of estimates to determine the fair value of the retained interest (derived from the present value of expected future cash flows) in the mortgages. These retained interests are reflected on the Company's balance sheet as deferred placement fees receivable. The key assumptions used in the valuation of gains on deferred placement fees are prepayment rates and the discount rate used to present value future expected cash flows. The annual rate of unscheduled principal payments is determined by reviewing portfolio prepayment experience on a monthly basis. The Company assumes there is virtually no prepayment on multi-unit residential fixed-rate mortgages. Currently there are no deferred placement fees related to single-family mortgages.

On a quarterly basis, the Company reviews the estimates used to ensure their appropriateness and monitors the performance statistics of the relevant mortgage portfolios to adjust and improve these estimates. The estimates used reflect the expected performance of the mortgage portfolio over the lives of the mortgages. The method of determining the assumptions underlying the estimates used for the quarter ended September 30, 2018 continue to be consistent with those used for the year ended December 31, 2017 and the quarters ended March 31, 2018 and June 30, 2018.

Effective January 1, 2018, the Company has elected to treat certain of its financial assets and liabilities, including mortgages accumulated for sale, mortgage and loan investments and bonds sold short, at fair value through profit or loss. Essentially, this policy requires the Company to record changes in the fair value of these instruments in the current period's earnings. If the bonds sold short are designated as an effective hedge, a portion of the change in the short bonds fair value may be recorded in Other Comprehensive Income or deferred against hedge assets. This accounting should reduce the volatility in current earnings as changes in the value on short bonds should be better matched to the change in value of the hedged items (mortgages). The Company's assets and liabilities are such that the Company must use valuation techniques based on assumptions that are not fully supported by observable market prices or rates in most cases. Much like the valuation of deferred placement fees receivable described above, the Company's method of determining the fair value of the assets listed above are subject to Company

estimates. The most significant would be implicit in the valuation of mortgage and loan investments. These are generally non-homogeneous mortgages and other loans where it is difficult to find independent valuation comparatives. The Company uses information in its underwriting files, regional real estate information and other internal measures to determine the fair value of these assets.

As a mortgage lender, the Company invests in uninsured mortgages. When it funds these mortgages through securitization debt, it continues to be liable for any credit losses. The key inputs in the measurement of any ECL include Probability of Default, Loss Given Default and forecast of future economic conditions which involves significant judgment. Upon application of IFRS 9 with respect to impairment, there has been no impact on the Company's earnings. Because of the high proportion of government insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends, ECL has been determined to be insignificant.

Future Accounting Changes

The following accounting pronouncements issued by the IASB, although not yet effective, may have a future impact on the Company:

IFRS 16 – Leases

In January 2016, the IASB issued IFRS 16 – Leases, replacing IAS 17 – Leases. IFRS 16 requires lessees to recognize assets and liabilities for most leases instead of previous categories of finance leases, which are reported on the balance sheet, or operating leases, which are disclosed only in the notes to the financial statements, under IAS 17. IFRS 16 is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted for companies that also adopt IFRS 15. The Company is currently assessing the impact of this standard on the Company's consolidated financial statements.

Disclosure Controls and Internal Controls Over Financial Reporting

The Company's disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company in reports filed under Canadian securities laws is recorded, processed, summarized and reported within the time periods specified under those laws, and include controls and procedures that are designed to ensure that information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

Management is responsible for establishing and maintaining adequate 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 for external purposes in accordance with reporting standards; however, because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements on a timely basis.

No changes were made in the Company's internal controls over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Risks and Uncertainties Affecting the Business

The business, financial condition and results of operations of the Company are subject to a number of risks and uncertainties, and are affected by a number of factors outside the control of management of the Company. In addition to the risks addressed elsewhere in this discussion and the financial statements, these risks include: ability to sustain performance and growth, reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, changes in interest rates, repurchase obligations and breach of representations and warranties on mortgage sales, risk of servicer termination events and trigger events on cash collateral and retained interests, reliance on multi-

unit residential and commercial mortgages, general economic conditions, legislation and government regulation (including regulations imposed by the Department of Finance, CMHC and the policies set by and for mortgage default insurance companies), potential for losses on uninsured mortgages, competition, reliance on mortgage insurers, reliance on key personnel and the ability to attract and retain employees and executives, conduct and compensation of independent mortgage brokers, failure or unavailability of computer and data processing systems and software, insufficient insurance coverage, change in or loss of ratings, impact of natural disasters and other events, unfavorable litigation, and environmental liability. In addition, there are risks associated with the structure of the Company including: those related to the dependence on FNFLP, leverage and restrictive covenants, dividends which are not guaranteed and could fluctuate with the Company's performance, restrictions on potential growth, the market price of the Company's shares, statutory remedies, control of the Company, and contractual restrictions. The Company is subject to Canadian federal and provincial income and commodity tax laws and pays such taxes as it determines are compliant with such legislation. Among the risks of all potential tax matters, there is a risk that tax legislation changes are detrimental to the Company or that Canadian tax authorities interpret tax legislation differently than the Company's filing positions. Risk and risk exposure are managed through a combination of insurance, a system of internal controls and sound operating practices. The Company's key business model is to originate primarily prime mortgages and find funding through various channels to earn ongoing servicing or spread income. For the single-family residential segment, the Company relies on independent mortgage brokers for origination and several large institutional investors for sources of funding. These relationships are critical to the Company's success. For a more complete discussion of the risks affecting the Company, reference should be made to the Company's Annual Information Form.

Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "intend", "estimate", "predict", "potential", "continue" or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management's future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the "Risk and Uncertainties Affecting the Business" section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the "Risk and Uncertainties Affecting the Business" section, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management's expectations as of October 30, 2018, and is subject to change after such date. However, management and the Company disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Outlook

Management is pleased with the results of the third quarter of 2018. Despite additional government regulation introduced in 2018, B-20 guidelines, on top of the existing October 2016 mortgage insurance rules announced by the Department of Finance, the Company's single-family origination increased by 23%. Although commercial mortgage origination was lower in the quarter, for the year to date, this segment's origination increased by 6% compared to the same period in 2017. Including renewals, origination was up 11% for the nine months to September 30, 2018. While earnings, adjusted for fair value considerations, were lower by 5%, a large part of this was the outcome of shifting mortgages to the securitization programs from placement transactions. By securitizing mortgages instead of placing them with institutional investors, the Company delays the earning's process: placement fee revenues are reduced and the costs of hedging during the warehousing period are increased. A second drag on earnings in the quarter is the result of the accounting used for interest rate hedges prior to 2018. In fiscal 2017, the Company recognized \$56 million related to the change in fair value of financial instruments. Some of the offsetting loss in value implicit in the hedged mortgages was realized in 2017, but the majority of the value will be recognized in tighter securitization spreads over the terms of these mortgages.

Going into the fourth quarter of 2018, the Company is optimistic that the trend established in the first three quarters will continue. The 13% year to date increase experienced in new single-family origination represents a return to more normalized markets after the disruption in 2017 resulting from the change to mortgage insurance rules announced in October 2016. Despite the impact of these new qualifying mortgage rules under B-20 and higher interest rates, the Company is confident that its strong relationships with mortgage brokers and diverse funding sources will continue to set First National apart from its competition. It also expects a tight interest spread environment similar to what has existed for most of 2018.

The Company will continue to generate income and cash flow from its \$30 billion portfolio of mortgages pledged under securitization and \$72 billion servicing portfolio, and focus on the value inherent in its significant single-family renewal book.

Interim condensed consolidated financial statements

First National Financial Corporation

[Unaudited]

Third quarter 2018

First National Financial Corporation

Interim condensed consolidated statements of financial position

[Unaudited – in thousands of Canadian dollars]

As at

	September 30, 2018	December 31, 2017
	\$	\$
Assets		
Restricted cash <i>[note 3]</i>	614,898	561,470
Cash held as collateral for securitization <i>[note 3]</i>	69,486	66,413
Accounts receivable and sundry	157,013	144,159
Securities purchased under resale agreements	1,564,003	2,185,362
Mortgages accumulated for sale or securitization <i>[note 5]</i>	2,588,310	1,789,765
Mortgages pledged under securitization <i>[note 3]</i>	30,247,162	27,566,677
Deferred placement fees receivable <i>[note 4]</i>	41,589	41,273
Mortgage and loan investments <i>[note 6]</i>	264,714	379,713
Income taxes recoverable	10,818	—
Other assets	39,834	41,446
Total assets	35,597,827	32,776,278
Liabilities and equity		
Liabilities		
Bank indebtedness <i>[note 8]</i>	1,028,751	643,828
Obligations related to securities and mortgages sold under repurchase agreements	1,508,961	1,200,135
Accounts payable and accrued liabilities	129,476	118,081
Securities sold short	1,561,383	2,180,253
Debt related to securitized and participation mortgages <i>[note 9]</i>	30,508,336	27,834,080
Senior unsecured notes	174,795	174,693
Income taxes payable	—	7,191
Deferred tax liabilities	88,000	74,750
Total liabilities	34,999,702	32,233,011
Equity attributable to shareholders		
Common shares <i>[note 10]</i>	122,671	122,671
Preferred shares <i>[note 10]</i>	97,394	97,394
Retained earnings	372,031	323,202
Accumulated other comprehensive income	6,029	—
Total equity	598,125	543,267
Total liabilities and equity	35,597,827	32,776,278

See accompanying notes

On behalf of the Board:



John Brough



Robert Mitchell

First National Financial Corporation

Interim condensed consolidated statements of income

[Unaudited – in thousands of Canadian dollars]

	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	\$	\$	\$	\$
Revenue				
Interest revenue – securitized mortgages	202,634	164,296	577,045	483,884
Interest expense – securitized mortgages	(168,537)	(127,835)	(469,135)	(375,831)
Net interest – securitized mortgages <i>[note 3]</i>	34,097	36,461	107,910	108,053
Placement fees	41,996	31,194	92,697	110,769
Gains on deferred placement fees <i>[note 4]</i>	3,042	2,186	8,894	8,318
Mortgage investment income	23,063	18,550	65,248	48,606
Mortgage servicing income	42,706	38,715	110,710	104,542
Realized and unrealized gains on financial instruments	8,394	29,374	14,877	52,634
	153,298	156,480	400,336	432,922
Expenses				
Brokerage fees	23,818	24,667	45,041	66,976
Salaries and benefits	24,076	24,238	73,234	72,301
Interest	19,165	13,344	50,335	32,711
Other operating	15,161	14,222	48,359	38,690
	82,220	76,471	216,969	210,678
Income before income taxes	71,078	80,009	183,367	222,244
Income tax expense	19,120	21,200	49,160	58,540
Net income for the period	51,958	58,809	134,207	163,704
Net income attributable to				
Shareholders	51,958	58,475	134,207	162,405
Non-controlling interests	—	334	—	1,299
	51,958	58,809	134,207	163,704
Earnings per share				
Basic <i>[note 10]</i>	0.85	0.96	2.20	2.67

See accompanying notes

First National Financial Corporation

Interim condensed consolidated statements of comprehensive income

[Unaudited – in thousands of Canadian dollars]

	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	\$	\$	\$	\$
Net income for the period	51,958	58,809	134,207	163,704
Other comprehensive income items that may be subsequently reclassified to income				
Net unrealized gains from change in fair value of cash flow hedges	4,309	—	14,741	—
Reclassification of net gains to income	(1,266)	—	(6,522)	—
	3,043	—	8,219	—
Income tax expense	(810)	—	(2,190)	—
Total other comprehensive income	2,233	—	6,029	—
Total comprehensive income	54,191	58,809	140,236	163,704

See accompanying notes

First National Financial Corporation

Interim condensed consolidated statements of changes in equity

[Unaudited – in thousands of Canadian dollars]

	Common shares	Preferred shares	Retained earnings	Accumulated other comprehensive income	Total equity
	\$	\$	\$	\$	\$
Balance as at January 1, 2018	122,671	97,394	323,202	—	543,267
Net income	—	—	134,207	—	134,207
Other comprehensive income, net of tax	—	—	—	6,029	6,029
Dividends paid or declared	—	—	(85,378)	—	(85,378)
Balance as at September 30, 2018	122,671	97,394	372,031	6,029	598,125

	Common shares	Preferred shares	Retained earnings	Non- controlling interests	Total equity
	\$	\$	\$	\$	\$
Balance as at January 1, 2017	122,671	97,394	302,271	27,961	550,297
Net income	—	—	162,405	1,299	163,704
Dividends paid or declared	—	—	(83,752)	(1,281)	(85,033)
Redemption by non-controlling interests	—	—	—	(4,260)	(4,260)
Balance as at September 30, 2017	122,671	97,394	380,924	23,719	624,708

See accompanying notes

First National Financial Corporation

Interim condensed consolidated statements of cash flows

[Unaudited – in thousands of Canadian dollars]

	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	\$	\$	\$	\$
Operating activities				
Net income for the period	51,958	58,809	134,207	163,704
Add (deduct) items				
Deferred income taxes	5,540	5,000	11,060	9,400
Non-cash portion of gains on deferred placement fees	(2,983)	(2,073)	(8,540)	(7,916)
Decrease (increase) in restricted cash	164,806	16,858	(53,428)	86,188
Net investment in mortgages pledged under securitization	(992,960)	(171,940)	(2,680,485)	(76,133)
Net increase (decrease) in debt related to securitized mortgages	819,255	144,640	2,674,282	(14,515)
Provision for loan loss	—	1,500	—	3,500
Amortization of deferred placement fees receivable	2,845	2,872	8,224	8,484
Amortization of purchased mortgage service rights	—	—	—	664
Amortization of property, plant and equipment	1,305	1,191	3,915	3,575
Unrealized gains on financial instruments	(3,383)	(10,663)	(17,121)	(27,908)
	46,383	46,194	72,114	149,043
Net change in non-cash working capital balances related to operations	(139,199)	(168,426)	(818,365)	(459,858)
Cash used in operating activities	(92,816)	(122,232)	(746,251)	(310,815)
Investing activities				
Additions to property, plant and equipment	(264)	(371)	(2,303)	(3,481)
Repayment of (Investment in) cash held as collateral for securitization	12,463	(15,657)	(3,073)	(16,434)
Investment in mortgage and loan investments	(278,540)	(47,433)	(641,972)	(302,421)
Repayment of mortgage and loan investments	345,329	92,281	753,971	224,721
Cash provided by (used in) investing activities	78,988	28,820	106,623	(97,615)
Financing activities				
Dividends paid	(28,463)	(28,819)	(85,339)	(84,283)
Obligations related to securities and mortgages sold under repurchase agreements	48,882	106,207	308,826	338,789
Decrease in debt related to participation mortgages	(9)	(2,781)	(26)	(5,767)
Securities purchased under resale agreements and owned, net	1,085,732	(424,225)	621,359	(617,839)
Securities sold under repurchase agreements and sold short, net	(1,070,947)	443,120	(590,115)	630,959
Redemption by non-controlling interests	—	—	—	(4,260)
Cash provided by financing activities	35,195	93,502	254,705	257,599
Net increase in bank indebtedness during the period	21,367	90	(384,923)	(150,831)
Bank indebtedness, beginning of period	(1,050,118)	(779,443)	(643,828)	(628,522)
Bank indebtedness, end of period	(1,028,751)	(779,353)	(1,028,751)	(779,353)
Supplemental cash flow information				
Interest received	242,338	200,498	689,825	585,596
Interest paid	173,228	121,173	483,434	370,069
Income taxes paid	16,066	15,856	56,109	69,606

See accompanying notes

First National Financial Corporation

Notes to interim condensed consolidated financial statements

[Unaudited – in thousands of Canadian dollars, except per share amounts or unless otherwise noted]

September 30, 2018

1. General organization and business of First National Financial Corporation

First National Financial Corporation [the “Corporation” or “Company”] is the parent company of First National Financial LP [“FNFLP”], a Canadian-based originator, underwriter and servicer of predominantly prime single-family, multi-residential and commercial mortgages. With over \$105 billion in mortgages under administration as at September 30, 2018, FNFLP is an originator and underwriter of mortgages and a significant participant in the mortgage broker distribution channel.

The Corporation is incorporated under the laws of the Province of Ontario, Canada and has its registered office and principal place of business located at 100 University Avenue, Toronto, Ontario. The Corporation’s common and preferred shares are listed on the Toronto Stock Exchange under the symbols FN, FN.PR.A and FN.PR.B, respectively.

2. Significant accounting policies

Basis of preparation

The interim condensed consolidated financial statements have been prepared in accordance with IAS 34 – *Interim Financial Reporting* under International Financial Reporting Standards, as issued by the International Accounting Standards Board. Except as indicated below, the interim condensed consolidated financial statements have been prepared using the same accounting policies used in the preparation of the audited annual consolidated financial statements for the year ended December 31, 2017.

These interim condensed consolidated financial statements should be read in conjunction with the audited annual consolidated financial statements and are presented in Canadian dollars with all values rounded to the nearest thousand, except when otherwise indicated. The interim condensed consolidated financial statements were authorized for issue by the Board of Directors on October 30, 2018.

Changes in accounting policies

IFRS 9 – *Financial Instruments*

On January 1, 2018, the Company adopted IFRS 9 – *Financial Instruments* [“IFRS 9”]. As permitted by the transition provisions of IFRS 9, the Company elected not to restate comparative period results. All comparative period information is presented in accordance with the accounting policies as described in the annual consolidated financial statements for the year ended December 31, 2017.

Classification and measurement of financial assets

IFRS 9 requires that all financial assets are measured at either fair value through profit or loss [“FVTPL”], fair value through OCI [“FVOCI”], or amortized cost.

The Company originates and underwrites single-family residential mortgages and multi-unit residential commercial mortgages. Subsequent to origination, the mortgages are either placed with third party investors [mortgages accumulated for sale] or securitized through various securitization vehicles [mortgages accumulated for securitization]. When mortgages are securitized, typically they do not meet de-recognition criteria, and continue to be held on the Company’s balance sheet. The Company presents these mortgages as mortgages

First National Financial Corporation

Notes to interim condensed consolidated financial statements

[Unaudited – in thousands of Canadian dollars, except per share amounts or unless otherwise noted]

September 30, 2018

pledged under securitization on the balance sheet and continues to classify the mortgages at amortized cost, earning “interest revenue – securitized mortgages” over their term to maturity.

The Company also invests in commercial bridge mortgages and other miscellaneous loans using its own internal funding sources. These assets are classified as FVTPL and are presented as mortgage and loan investments on its balance sheet.

Based on its business models as described above, the Company has determined the classification of its financial assets as below:

	IAS 39	IFRS 9
Mortgages accumulated for securitization	Loans and Receivables	Amortized Cost
Mortgages accumulated for sale	FVTPL	FVTPL
Mortgages pledged under securitization	FVTPL or Loan and Receivables	Amortized Cost
Mortgage and loan investments	Loans and Receivable	FVTPL
Deferred placement fees receivable	FVTPL	Amortized Cost

As at December 31, 2017, the difference resulting from the change in accounting classification of the assets was insignificant; accordingly, no adjustment to opening retained earnings was recorded.

Classifications and measurement of financial liabilities

The Company classifies its financial liabilities as either amortized cost or at FVTPL as summarized below:

	IAS 39	IFRS 9
Securities sold short	FVTPL	FVTPL
Debt related to securitized mortgages	Amortized Cost	Amortized Cost
Servicing liabilities	Amortized Cost	Amortized Cost
Senior unsecured notes	Amortized Cost	Amortized Cost

Impairment

IFRS 9 introduces an expected credit loss [“ECL”] model applicable to all debt instruments within financial assets classified as amortized cost or FVOCI, as well as certain off-balance sheet loan commitments. The model has three stages: Stage 1 – the credit risk has not increased significantly since initial recognition such that an allowance for credit loss is recognized and maintained equal to 12 months of expected credit loss; Stage 2 – the credit risk has increased significantly since initial recognition, and the allowance for credit loss is increased to cover full lifetime expected credit loss; and Stage 3 – a financial asset is considered credit-impaired and the allowance for credit loss continues to be the full lifetime expected credit loss, with interest revenue calculated on the carrying amount [net of the allowance for credit loss], rather than the gross carrying value of the financial assets.

The Company assesses the credit risk of the mortgages based on the expected repayments of principal and interest. All mortgages with arrears that are less than 30 days past due are included in Stage 1 whereas mortgages with principal in arrears between 31 to 90 days are included in Stage 2. Mortgages in these two

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stages are not considered to be impaired, and the Company recognizes a 12-month ECL for Stage 1 mortgages and a lifetime ECL for Stage 2 mortgages. When a mortgage is in arrears for over 90 days or has a legal demand for repayment, there is an expectation of a detrimental impact on the estimated cash flows and, therefore, the Company considers the mortgages as impaired and includes in Stage 3.

The Company's ECL model is built on an unbiased and probability-weighted method, determined by evaluating a range of possible outcomes and discounted to reflect the time value of money. The key inputs in the measurement of ECL include Probability of Default, Loss Given Default and forecast of future economic conditions which involves significant judgment.

Hedge accounting

On January 1, 2018, the Company adopted hedge accounting within IFRS 9 for certain mortgage commitments and funded mortgages. Hedge accounting is applied prospectively.

The Company uses a combination of short Government of Canada bonds and bond repo agreements to manage exposure to interest rate risk. The Company documents a hedging relationship between the hedging instrument and the hedged item at inception when the relationship is established. The Company also assesses the effectiveness of the hedges at both the hedge inception and on an ongoing basis. Any ineffectiveness of any hedging relationship is recognized immediately in the interim condensed consolidated statements of income.

Cash flow hedges

The Company applies cash flow hedge accounting for the anticipated funding of its multi-unit residential commercial segment mortgages. At the time of mortgage commitment, the Company shorts Government of Canada bonds as the hedging instrument to hedge the cash flows on the anticipated future debt to be arranged through securitization on these mortgages obtained through the Canada Mortgage Bond Program ["CMB"] disclosed as debt related to securitized mortgages. The effective portion of the change in the fair value of the designated hedging instrument qualifying as a cash flow hedge is recognized in other comprehensive income ["OCI"] in the interim condensed consolidated statements of comprehensive income. When the hedge relationship is terminated, the cumulative amounts recognized in OCI are amortized into interest expense – securitized mortgages over the term of the securitized debt. Any change in fair value of the hedge determined as ineffective is recognized immediately in regular income.

Fair value hedges

The Company enters into interest rate swaps to protect against changes in the fair value of fixed rate mortgages funded by Asset-backed Commercial Paper ["ABCP"] debt. The Company also shorts Government of Canada bonds to manage interest rate exposure for a portion of single-family mortgage commitments and funded residential mortgages accumulated for securitization. The Company applies hedge accounting for the swaps. For the short bond hedges, the Company documents a hedging relationship during the period when the mortgages are funded until the date they are securitized or placed with an arm's length investor. The Company does not apply hedge accounting to the short bonds used to mitigate interest risk on single-family mortgage commitments.

In the case of the swaps and short bonds used to hedge funded mortgages, changes in fair value of the hedged item, to the extent that the hedging relationship is effective, are offset by changes in the fair value of the hedging

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instrument, both of which are recognized in regular income. At hedge unwind, the realized change in the value of the hedging instrument is adjusted to the carrying value of the hedged mortgages, and amortized into interest revenue over the term of the hedged mortgages. Any changes in the fair value of an ineffective hedge will be immediately recorded in regular income.

IFRS 15 – Revenue from Contracts with Customers

On January 1, 2018, the Company adopted International Accounting Standards Board issued IFRS 15 – *Revenue from Contracts with Customers*. The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step revenue recognition process to determine the nature, amount, timing and uncertainty of revenue and cash flows from the contracts with customers.

The Company has applied the standard on January 1, 2018, using the modified retrospective approach. The main revenue stream that has been affected by IFRS 15 is mortgage servicing revenue, including the ongoing measurement of servicing liabilities. Because of the immaterial impact of applying this standard, there has been no significant effect on the Company's interim condensed consolidated financial statements for the first three quarters in 2018 and there has not been any required restatement of comprehensive income for prior years.

3. Mortgages pledged under securitization

The Company securitizes residential and commercial mortgages in order to raise debt to fund these mortgages. Most of these securitizations consist of the transfer of fixed and floating rate mortgages into securitization programs, such as ABCP, NHA-MBS, and CMB programs. In these securitizations, the Company transfers the assets to structured entities for cash, and incurs interest-bearing obligations typically matched to the term of the mortgages. These securitizations do not qualify for derecognition, although the structured entities and other securitization vehicles have no recourse to the Company's other assets for failure of the mortgages to make payments when due.

As part of the ABCP transactions, the Company provides cash collateral for credit enhancement purposes as required by the rating agencies. Credit exposure to securitized mortgages is generally limited to this cash collateral. The principal and interest payments on the securitized mortgages are paid to the Company by the structured entities monthly over the term of the mortgages. The full amount of the cash collateral is recorded as an asset and the Company anticipates full recovery of these amounts. NHA-MBS securitizations may also require cash collateral in some circumstances. As at September 30, 2018, the cash held as collateral for securitization was \$69,486 [December 31, 2017 – \$66,413].

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The following table compares the carrying amount of mortgages pledged for securitization and the associated debt:

	September 30, 2018		December 31, 2017	
	Carrying amount of securitized mortgages \$	Carrying amount of associated liabilities \$	Carrying amount of securitized mortgages \$	Carrying amount of associated liabilities \$
Securitized mortgages	30,074,155	30,621,167	27,427,239	27,914,097
Capitalized origination costs	173,007	—	139,438	—
Debt discounts	—	(113,128)	—	(80,340)
	30,247,162	30,508,039	27,566,677	27,833,757
Add				
Principal portion of payments held in restricted cash	561,942	—	514,793	—
Participation debt	—	297	—	323
	30,809,104	30,508,336	28,081,470	27,834,080

The principal portion of payments held in restricted cash represents payments on account of mortgages pledged under securitization which have been received at period end but have not been applied to reduce the associated debt. This cash is applied to pay down the debt in the month subsequent to period end. In order to compare the components of mortgages pledged under securitization to securitization debt, this amount is added to the carrying value of mortgages pledged under securitization in the above table.

Mortgages pledged under securitization have been classified as amortized cost and are carried at par plus adjustment for unamortized origination costs.

The changes in capitalized origination costs for the three months ended September 30, 2018 are as follows:

	2018 \$	2017 \$
Opening balance, June 30	158,753	130,707
Add: new origination costs capitalized in the period	33,537	18,847
Less: amortization in the period	(19,283)	(17,981)
Ending balance, September 30	173,007	131,573

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The following table summarizes the mortgages pledged under securitization that are past due:

	September 30, 2018	December 31, 2017
	\$	\$
Arrears days		
31 to 60	11,779	35,652
61 to 90	7,170	5,841
Greater than 90	23,640	28,707
	42,589	70,200

All the mortgages listed above are insured, except for three mortgages which are uninsured and have a principal balance of \$188 as at September 30, 2018 [December 31, 2017 – \$289]. Within mortgages pledged under securitization, the Company's exposure to credit loss is limited to uninsured mortgages with principal balances totalling \$1,264,472 [December 31, 2017 – \$1,106,796], before consideration of the value of underlying collateral. All such mortgages are conventional prime single-family mortgages, with an 80% or less loan to value ratio at origination, and verified borrower income. Accordingly, the expected credit loss related to these mortgages is insignificant.

Allowance for expected credit losses

The following table illustrates the movement in ECL changes related to mortgages pledged under securitization:

	Stage 1	Stage 2	Stage 3	Total
	\$	\$	\$	\$
Balance as at June 30, 2018	—	—	116	116
ECL transfers from Stage 2 to Stage 3	—	—	—	—
Balance as at September 30, 2018	—	—	116	116

4. Deferred placement fees receivable

The Company enters into transactions with institutional investors to sell primarily fixed rate mortgages in which placement fees are received over time as well as at the time of the mortgage placement. These mortgages are derecognized when substantially all of the risks and rewards of ownership are transferred and the Company has minimal exposure to the variability of future cash flows from these mortgages. The investors have no recourse to the Company's other assets for failure of mortgagors to make payments when due.

During the three months ended September 30, 2018, \$642,944 [2017 – \$469,241] of mortgages were placed with institutional investors which created gains on deferred placement fees of \$3,042 [2017 – \$2,186]. Cash receipts on deferred placement fees receivable for the three months ended September 30, 2018 were \$3,343 [2017 – \$3,295].

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Deferred placement fees receivable is classified as amortized cost, and has been calculated initially based on the present value of the anticipated future stream of placement fees. An assumption of no credit losses was used, commensurate with the credit quality of the investors. An assumption of no prepayment for the commercial segment was used, as borrowers cannot refinance for financial advantage without paying the Company a fee commensurate with its investment in the mortgage. The effect of variations, if any, between actual experience and assumptions will be recorded in future statements of income.

5. Mortgages accumulated for sale or securitization

Mortgages accumulated for sale or securitization consist of mortgages the Company has originated for its own securitization programs, together with mortgages funded in advance of settlement with institutional investors.

Mortgages originated for the Company's own securitization programs are classified as amortized cost and are recorded at par plus adjustment for unamortized origination costs. Mortgages funded for placement with institutional investors are designated as FVTPL and are recorded at fair value. The fair values of mortgages classified as FVTPL approximate their carrying values as the time period between origination and sale is short. The following table summarizes the components of mortgages according to their classification:

	September 30, 2018	December 31, 2017
	\$	\$
Mortgages accumulated for securitization	2,480,606	1,770,275
Mortgages accumulated for sale	107,704	19,490
	2,588,310	1,789,765

The Company's exposure to credit loss is limited to \$412,623 [December 31, 2017 – \$569,571] of principal balances of uninsured mortgages within mortgages accumulated for sale or securitization, before consideration of the value of underlying collateral. These are conventional prime single-family mortgages similar to the mortgages described in note 3. Accordingly the expected credit loss related to these mortgages is insignificant.

6. Mortgage and loan investments

Mortgage and loan investments consist primarily of commercial first and second mortgages held for various terms, the majority of which mature within one year.

The portfolio contains \$13,039 [December 31, 2017 – \$15,145] of insured mortgages and \$251,675 [December 31, 2017 – \$364,568] of uninsured mortgage and loan investments as at September 30, 2018. Of the uninsured mortgages, approximately \$47,930 [December 31, 2017 – \$49,693] have principal balance in arrears. Three of these mortgages are non-performing and the Company has stopped interest on accrual. These mortgages had a total original principal balance of \$46,115 and are recorded at fair value of \$31,446 as at September 30, 2018 [December 31, 2017 – four mortgages, original principal balance of \$48,600, and fair value of \$32,001].

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Mortgage and loan investments are classified as FVTPL and are recorded on a fair value basis. Any changes in fair value are immediately recognized in income. The Company recorded a fair value loss of \$1,000 for the quarter ended September 30, 2018. The mortgages were classified as loans and receivables prior to the adoption of IFRS 9, such that for the quarter ended September 30, 2017, a \$1,500 credit loss was recorded as an offset to mortgage investment income on the consolidated statement of income.

7. Mortgages under administration

As at September 30, 2018, the Company managed mortgages under administration of \$105,032,062 [December 31, 2017 – \$101,589,153], including mortgages held on the Company's interim condensed consolidated statements of financial position. Mortgages under administration are serviced for financial institutions such as banks, insurance companies, pension funds, mutual funds, trust companies, credit unions and securitization vehicles. As at September 30, 2018, the Company administered 304,948 mortgages [December 31, 2017 – 301,492] for 109 institutional investors [December 31, 2017 – 103] with an average remaining term to maturity of 40 [December 31, 2017 – 41 months].

Mortgages under administration are serviced as follows:

	September 30, 2018	December 31, 2017
	\$	\$
Institutional investors	58,669,818	59,601,263
Mortgages accumulated for sale or securitization and mortgage and loan investments	2,805,540	2,190,393
Deferred placement investors	12,311,323	11,125,228
Mortgages pledged under securitization	30,074,155	27,427,239
CMBS conduits	1,171,226	1,245,030
	105,032,062	101,589,153

The Company's exposure to credit loss is limited to mortgage and loan investments as described in note 6, securitized mortgages as described in note 3 and uninsured mortgages held in mortgages accumulated for securitization as described in note 5. As at September 30, 2018, the Company has included in accounts receivable and sundry \$85 [December 31, 2017 – \$86] of uninsured non-performing mortgages.

The Company maintains trust accounts on behalf of the investors it represents. The Company also holds municipal tax funds in escrow for mortgagors. Since the Company does not hold a beneficial interest in these funds, they are not presented on the interim condensed consolidated statements of financial position. The aggregate of these accounts as at September 30, 2018 was \$599,003 [December 31, 2017 – \$670,259].

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8. Bank indebtedness

Bank indebtedness includes a revolving credit facility of \$1,250,000 [December 31, 2017 – \$1,060,000] maturing in March 2023. At September 30, 2018, \$1,028,751 [December 31, 2017 – \$643,828] was drawn against which the following have been pledged as collateral:

- [a] a general security agreement over all assets, other than real property, of the Company; and
- [b] a general assignment of all mortgages owned by the Company.

The credit facility bears a variable rate of interest based on prime and bankers' acceptance rates.

9. Debt related to securitized and participation mortgages

Debt related to securitized mortgages represents the funding for mortgages pledged under the NHA-MBS, CMB and ABCP programs. As at September 30, 2018, debt related to securitized mortgages was \$30,508,039 [December 31, 2017 – \$27,833,757], net of unamortized discounts of \$113,128 [December 31, 2017 – \$80,340]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

As at September 30, 2018, debt related to participation mortgages was \$297 [December 31, 2017 – \$323].

Debt related to securitized and participation mortgages is reduced on a monthly basis when the principal payments received from the mortgages are applied. Debt discounts and premiums are amortized over the term of each debt on an effective yield basis. Debt related to securitization mortgages had a similar contractual maturity profile as the associated mortgages in mortgages pledged under securitization.

10. Shareholders' equity

[a] Authorized

Unlimited number of common shares

Unlimited number of cumulative 5-year rate reset preferred shares, Class A Series 1

Unlimited number of cumulative 5-year rate reset preferred shares, Class A Series 2

[b] Capital stock activities

	Common shares		Preferred shares	
	#	\$	#	\$
Balance, December 31, 2017 and September 30, 2018	59,967,429	122,671	4,000,000	97,394

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[c] Earnings per share

	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	\$	\$	\$	\$
Net income and comprehensive income	51,958	58,475	134,207	162,405
Less: dividends declared on preferred shares	(739)	(685)	(2,173)	(2,046)
Net earnings attributable to common shareholders	51,219	57,790	132,034	160,359
Number of common shares outstanding	59,967,429	59,967,429	59,967,429	59,967,429
Basic earnings per common share	0.85	0.96	2.20	2.67

Basic earnings per common share for the three months ended September 30, 2018 is calculated on earnings that are affected by the adoption of hedge accounting under IFRS 9 on January 1, 2018. Hedge accounting is applied prospectively.

11. Financial instruments and risk management

Fair value measurement

The Company uses the following hierarchy for determining and disclosing the fair value of financial instruments recorded at fair value in the interim condensed consolidated statements of financial position:

- Level 1 quoted market price observed in active markets for identical instruments;
- Level 2 quoted market price observed in active markets for similar instruments or other valuation techniques for which all significant inputs are based on observable market data; and
- Level 3 valuation techniques in which one or more significant inputs are unobservable.

Valuation methods and assumptions

The Company uses valuation techniques to estimate fair values, including reference to third-party valuation service providers using proprietary pricing models and internal valuation models such as discounted cash flow analysis. The valuation methods and key assumptions used in determining fair values for the financial assets and financial liabilities are as follows:

[a] Mortgage and loan investments

The fair value of mortgage and loan investments is determined by either projected cash flows using market industry pricing practices or external or internal appraised value, where applicable.

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[b] Securities sold short

The fair values of securities sold short used by the Company to hedge its interest rate exposure are determined by quoted prices.

[c] Servicing liabilities and deferred placement fees receivables

The fair values of the servicing liability and deferred placement fees receivable are determined by internal valuation models using market data inputs, where possible. The fair values are determined by discounting the expected future cost related to the servicing or deferred placement fees of explicit mortgages at market interest rates. The expected future cash flows are estimated based on certain assumptions which are not supported by observable market data.

[d] Mortgages pledged under securitization

The fair value of mortgages pledged under securitization is determined by discounting projected cash flows using market industry pricing practices. Discount rates used are determined by comparison to similar term loans made to borrowers with similar credit. This methodology will reflect changes in interest rates which have occurred since the mortgages were originated. Impaired mortgages are recorded at net realizable value.

[e] Other financial assets and financial liabilities

The fair values of mortgages accumulated for sale or securitization, cash held as collateral for securitization, restricted cash and bank indebtedness correspond to the respective outstanding amounts due to their short-term maturity profiles.

Carrying value and fair value of selected financial instruments

The fair value of the financial assets and financial liabilities of the Company approximates its carrying value, except for mortgages pledged under securitization, which has a carrying value of \$30,247,162 [December 31, 2017 – \$27,566,677] and a fair value of \$30,566,946 [December 31, 2017 – \$27,557,542], debt related to securitized and participation mortgages, which has a carrying value of \$30,508,336 [December 31, 2017 – \$27,834,080] and a fair value of \$30,129,062 [December 31, 2017 – \$27,748,498], and senior unsecured notes, which have a carrying value of \$174,795 [December 31, 2017 – \$174,693] and a fair value of \$175,508 [December 31, 2017 – \$176,372]. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3].

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The following tables represent the Company's financial instruments measured at fair value on a recurring basis:

	September 30, 2018			
	Level 1	Level 2	Level 3	Total
	\$	\$	\$	\$
Financial assets				
Mortgages accumulated for sale	—	107,704	—	107,704
Mortgage and loan investments	—	—	264,714	264,714
Interest rate swaps	—	69,439	—	69,439
Total financial assets	—	177,143	264,714	441,857

Financial liabilities				
Securities sold short	—	1,561,383	—	1,561,383
Interest rate swaps	—	8,354	—	8,354
Total financial liabilities	—	1,569,737	—	1,569,737

	December 31, 2017			
	Level 1	Level 2	Level 3	Total
	\$	\$	\$	\$
Financial assets				
Mortgages accumulated for sale	—	19,490	—	19,490
FVTPL mortgages	—	—	2,986,097	2,986,097
Deferred placement fees receivable	—	—	41,273	41,273
Interest rate swaps	—	63,689	—	63,689
Total financial assets	—	83,179	3,027,370	3,110,549

Financial liabilities				
Securities sold short	—	2,180,253	—	2,180,253
Interest rate swaps	—	6,124	—	6,124
Total financial liabilities	—	2,186,377	—	2,186,377

In estimating the fair value of financial assets and financial liabilities using valuation techniques or pricing models, certain assumptions are used including those that are not fully supported by observable market prices or rates [Level 3]. The amount of the change in fair value recognized by the Company in net income for the three months ended September 30, 2018 that was estimated using a valuation technique based on assumptions that are not fully supported by observable market prices or rates, was a loss of \$1,000 [2017 – loss of \$11,184]. Although the Company's management believes that the estimated fair values are appropriate as at the date of the interim condensed consolidated statements of financial position, those fair values may differ if other reasonably possible alternative assumptions are used.

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Transfers between levels in the fair value hierarchy are deemed to have occurred at the beginning of the period in which the transfer is made. Transfers between levels can occur as a result of additional or new information regarding valuation inputs and changes in their observability. During the quarter, there were no transfers between levels.

The following table presents changes in the fair values including realized gains of \$1,968 [2017 – gain of \$18,711] of the Company's financial assets and financial liabilities for the three months ended September 30, 2018 and 2017, all of which have been classified as FVTPL:

	Three months ended September 30		Nine months ended September 30	
	2018	2017	2018	2017
	\$	\$	\$	\$
FVTPL mortgages	(1,000)	(11,814)	(3,000)	(18,141)
Deferred placement fees receivable	—	(1,167)	—	(1,167)
Securities owned and sold short	10,716	17,916	20,106	34,085
Interest rate swaps	(1,322)	24,439	(2,229)	37,857
	8,394	29,374	14,877	52,634

The above table includes the unrealized fair value loss on the mortgage and loan investments. These mortgages were classified as loan and receivables under IAS 39, but have now been classified as FVTPL under IFRS 9. The mortgages pledged under securitization that were classified as FVTPL in 2017 have now been classified as amortized cost with the transition to IFRS 9. Accordingly, there is no gain or loss reported in the table above.

Movement in Level 3 financial instruments measured at fair value

The following tables show the movement in Level 3 financial instruments in the fair value hierarchy for the three months ended September 30, 2018 and 2017, including changes due to reclassification following the adoption of IFRS 9. The Company classifies financial instruments as Level 3 when there is reliance on at least one significant unobservable input in the valuation models.

	Fair value as at June 30, 2018	Investments	Unrealized losses recorded in income	Payment and amortization	Fair value as at September 30, 2018
	\$	\$	\$	\$	\$
Financial assets					
Mortgage and loan investments	332,503	51,847	(1,000)	(118,636)	264,714

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	Fair value as at June 30, 2017 \$	Investments \$	Unrealized losses recorded in income \$	Payment and amortization \$	Fair value as at September 30, 2017 \$
Financial assets					
FVTPL mortgages	2,619,563	449,639	(11,814)	(392,133)	2,665,255
Deferred placement fees receivable	44,164	2,073	(1,167)	(2,872)	42,198
Mortgage and loan investments	36,710	2,105	—	(7,314)	31,501
	<u>2,700,437</u>	<u>453,817</u>	<u>(12,981)</u>	<u>(402,319)</u>	<u>2,738,954</u>

12. Capital management

The Company's objective is to maintain a strong capital base so as to maintain investor, creditor and market confidence and sustain future development of the business. Management defines capital as the Company's equity, long-term debt and retained earnings. The Company has a minimum capital requirement as stipulated by its bank credit facility. The agreement limits the debt under bank indebtedness together with the unsecured notes to four times FNFLP's equity. As at September 30, 2018, the ratio was 1.87:1 [December 31, 2017 – 1.39:1]. The Company was in compliance with the bank covenant throughout the period.

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13. Earnings by business segment

The Company operates principally in two business segments, Residential and Commercial. These segments are organized by mortgage type and contain revenue and expenses related to origination, underwriting, securitization and servicing activities. Identifiable assets are those used in the operations of the segments.

	Three months ended September 30, 2018			Nine months ended September 30, 2018		
	Residential	Commercial	Total	Residential	Commercial	Total
	\$	\$	\$	\$	\$	\$
Revenue						
Interest revenue – securitized mortgages	156,077	46,557	202,634	442,937	134,108	577,045
Interest expense – securitized mortgages	(130,442)	(38,095)	(168,537)	(358,500)	(110,635)	(469,135)
Net interest – securitized mortgages	25,635	8,462	34,097	84,437	23,473	107,910
Placement and servicing	72,660	15,084	87,744	167,622	44,679	212,301
Mortgage investment income	17,477	5,586	23,063	45,162	20,086	65,248
Realized and unrealized gains (losses) on financial instruments	9,394	(1,000)	8,394	17,888	(3,011)	14,877
	125,166	28,132	153,298	315,109	85,227	400,336
Expenses						
Amortization	1,101	204	1,305	3,302	613	3,915
Interest	16,007	3,158	19,165	39,053	11,282	50,335
Other operating costs	53,486	8,264	61,750	135,228	27,491	162,719
	70,594	11,626	82,220	177,583	39,386	216,969
Income before income taxes	54,572	16,506	71,078	137,526	45,841	183,367
Identifiable assets	28,425,609	7,142,442	35,568,051	28,425,609	7,142,442	35,568,051
Goodwill	—	—	29,776	—	—	29,776
Total assets	28,425,609	7,142,442	35,597,827	28,425,609	7,142,442	35,597,827
Capital expenditures	185	79	264	1,612	691	2,303

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	Three months ended September 30, 2017			Nine months ended September 30, 2017		
	Residential \$	Commercial \$	Total \$	Residential \$	Commercial \$	Total \$
Revenue						
Interest revenue – securitized mortgages	123,863	40,433	164,296	367,748	116,136	483,884
Interest expense – securitized mortgages	(94,854)	(32,981)	(127,835)	(280,429)	(95,402)	(375,831)
Net interest – securitized mortgages	29,009	7,452	36,461	87,319	20,734	108,053
Placement and servicing	59,715	12,380	72,095	182,529	41,100	223,629
Mortgage investment income	14,143	4,407	18,550	34,427	14,179	48,606
Realized and unrealized gains on financial instruments	22,971	6,403	29,374	40,017	12,617	52,634
	125,838	30,642	156,480	344,292	88,630	432,922
Expenses						
Amortization	999	192	1,191	2,996	579	3,575
Interest	10,957	2,387	13,344	27,207	5,504	32,711
Other operating costs	51,187	10,749	61,936	144,095	30,297	174,392
	63,143	13,328	76,471	174,298	36,380	210,678
Income before income taxes	62,695	17,314	80,009	169,994	52,250	222,244
Identifiable assets	25,443,255	6,075,099	31,518,354	25,443,255	6,075,099	31,518,354
Goodwill	—	—	29,776	—	—	29,776
Total assets	25,443,255	6,075,099	31,548,130	25,443,255	6,075,099	31,548,130
Capital expenditures	260	111	371	2,437	1,044	3,481

First National Financial Corporation

Notes to interim condensed consolidated financial statements

[Unaudited – in thousands of Canadian dollars, except per share amounts or unless otherwise noted]

September 30, 2018

14. Related party and other transactions

The Company has servicing contracts in connection with several originated commercial mezzanine mortgages subsequently sold to various entities controlled by a senior executive and shareholder of the Company. The Company services these mortgages during their terms at market commercial servicing rates. During the quarter, the Company originated \$1,700 of new mortgages for the related parties. The related parties also funded several progress draws totalling \$3,192 on existing mortgages originated by the Company. All such mortgages, which are administered by the Company, have a balance of \$104,864 as at September 30, 2018 [December 31, 2017 – \$61,034]. As at September 30, 2018, three of the mortgages are secured by real estate in which the Company is also a subordinate mortgage lender.

A senior executive and shareholder of the Company has a significant investment in a mortgage default insurance company. In the ordinary course of business, the insurance company provides insurance policies to the Company's borrowers at market rates. In addition, the insurance company has also provided the Company with portfolio insurance at market premiums. The total bulk insurance premium paid by the Company during the three months ended September 30, 2018 was \$1,470 [2017 – nil], net of third-party investor reimbursement. The insurance company has also engaged the Company to service a portfolio of mortgages at market servicing rates. As at September 30, 2018, the portfolio's balance was \$3,709 [December 31, 2017 – \$3,822].

15. Comparative unaudited interim condensed consolidated financial statements

The comparative unaudited interim condensed consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2018 unaudited interim condensed consolidated financial statements.

First National Financial Corporation

Shareholder Information

Corporate Office

100 University Avenue
North Tower, Suite 700
Toronto, Ontario
M5J 1V6
Phone: 416-593-1100
Fax: 416-593-1900

Transfer Agent and Registrar

Computershare Investor Services Inc.
Toronto, Ontario
Phone: 1-800-564-6253

Auditors

Ernst & Young LLP
100 Adelaide Street West
Toronto, Ontario
M5H 0B3

TSX Symbols

FN, FN.PR.A, FN.PR.B

Investor Relations

Rob Inglis
Chief Financial Officer
First National Financial LP
Tel: 416-593-1100
Email: rob.inglis@firsnational.ca

Ernie Stapleton
President
Fundamental Creative Inc.
Tel: 905.648.9354
Email: ernie@fundamental.ca