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 February 24, 2020. This discussion should be read in conjunction with the audited consolidated financial statements and accompanying notes of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the year ended December 31, 2019. The audited 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 $111 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.

2019 Results Summary

Management is very pleased with the results of 2019. After a slow start to the year, single-family origination increased 11% year over year and the commercial segment produced record origination volumes which increased 19% over 2018. On a consolidated basis, total new origination was higher by 13% compared to 2018. Higher volume had a favorable impact as normalized earnings grew 12%.

- MUA grew to $111.4 billion at December 31, 2019 from $106.2 billion at December 31, 2018, an increase of 5%; the growth from September 30, 2019, when MUA was $110.6 billion, was 3% on an annualized basis.
- Total new single-family mortgage origination was $13.5 billion in 2019 compared to $12.2 billion in 2018, an increase of 11%. The Company attributes this to a strong economy, lower mortgage rates and First National's market share in the mortgage broker channel. Commercial segment origination of $7.4 billion was 19% more than the $6.2 billion originated in 2018. Overall new origination increased by 13% in 2019 compared to 2018.
- The Company took advantage of opportunities in the year to renew $5.5 billion of single-family mortgages ($6.1 billion a year ago). For the commercial segment, renewals increased to $2.0 billion from $1.3 billion.
- Revenue for 2019 increased by 12% to $1.3 billion from $1.2 billion in 2018. The increase reflected the growth in mortgage origination in the year and a change in the funding mix, which featured more placement with institutional investors as opposed to securitization. The volume of origination for institutions increased by 24% compared to 2018, which contributed to an increase of $63.6 million in placement fee revenue. In addition, the comparatively higher interest rate environment, which began in mid-2017, had an impact. Because of higher interest rates in recent years, mortgages added to the portfolio of securitized mortgages in those years have higher interest rates than the average rates of the mortgages maturing in the securitized portfolio. Interest revenue on securitized mortgages increased by $87.5 million between the years.
- Income before income taxes increased to $241.7 million in 2019 from $227.4 million in 2018. The increase was the result of strong mortgage origination, wider mortgage spreads in 2019, and a shift in funding from securitization to institutional placement. The pace of growth was affected by changing capital market conditions. In aggregate, the impact from financial instruments decreased pre-tax income by $12.5 million, comparing 2019 to 2018.
- The Company's earnings before income taxes, depreciation and amortization, and gains and losses on financial instruments ("Pre-FMV EBITDA") for 2019 increased by 12% to $251.3 million from $225.2 million in 2018. The increase is the result of increased origination, but also of the Company's decision to shift its funding from securitization to institutional placement. By placing mortgages with institutions, most of the economics of the transaction are recognized in the current period. Using securitization funding, the value inherent in the mortgages is realized over the term of the mortgages – typically five years. By increasing funding through institutional placement by approximately $1.3 billion as opposed to securitization, First National has accelerated the recognition of earnings into the current period. The Company has also benefited from comparatively wider mortgage spreads, which prevailed for most of 2019.

The Company's Board of Directors increased the regular monthly dividend from $1.90 to $1.95 per common share on an annualized basis effective with the dividend paid on December 16, 2019, and declared a special common share dividend in the amount of $0.50 per share, which was also paid on December 16, 2019. The special dividend reflects the Board's determination that the Company has generated excess capital in the past year 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
2019					
Fourth quarter	$342,138	$48,993	$61,766	$0.80	$37,685,593
Third quarter	$362,833	$60,578	$80,772	$1.00	$37,249,143
Second quarter	$335,241	$44,164	$68,522	$0.72	$37,229,876
First quarter	$286,311	$23,478	$40,225	$0.38	$36,193,793
2018					
Fourth quarter	$312,039	$32,220	$55,780	$0.53	$36,037,127
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

(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.

In the past eight quarters, the Company has experienced a relatively volatile economic environment. In most of 2018, the economic outlook was positive and there was a surplus of liquidity for investment in financial assets. This bred a very competitive marketplace such that mortgage funding spreads tightened to levels not seen since 2007. This reduced the profitability of the Company's operations. However, toward the end of 2018, economic worries resurfaced, and interest rates fell. Mortgage lenders pulled back and mortgage spreads widened by about 0.30%. This had a significant positive effect on the value of the Company's operations. This trend is evident in the Pre-FMV EBITDA figures above. In the first quarter of 2019, Pre-FMV EBITDA was at its lowest in the two-year period, as tighter spread 2018 originated mortgages were securitized and placed. Combined with lower origination volumes typically experienced in the first quarter of each year, profitability was low. This trend reversed in the second quarter of 2019, as the Company was able to take advantage of wider mortgage spreads and increased profitability. In the third quarter of 2019, the Company shifted its mortgage funding strategy to use more institutional placements instead of securitization, which accelerated the recognition of the value inherent in the mortgages originated, leading to the large increase in earnings in the quarter.

Outstanding Securities of the Corporation

At December 31, 2019, and February 24, 2020, 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; 175,000 April 2020 senior unsecured notes: and 200,000 November 2024 senior unsecured notes outstanding.

Selected Annual Financial Information and Reconciliation to Pre-FMV EBITDA(1)

($000s, except per share amounts)

	2019	2018	2017
For the Year Ended December 31, Income Statement Highlights			
Revenue	1,326,523	1,181,510	1,078,768
Interest expense – securitized mortgages	(739,071)	(646,069)	(511,939)
Brokerage fees	(102,596)	(75,354)	(83,260)
Salaries, interest and other operating expenses	(238,926)	(227,739)	(193,032)
Add (deduct): realized and unrealized losses (gains) on financial instruments	9,655	(3,162)	(56,259)
Deduct: unrealized losses regarding mortgage investments	(4,300)	(4,000)	—
Pre-FMV EBITDA(1)	251,285	225,186	234,278
Amortization of intangible and capital assets	(4,217)	(4,931)	(5,135)
Add: realized and unrealized gains on financial instruments excluding those on mortgage investments	(5,355)	7,162	56,259
Provision for income taxes	(64,500)	(60,990)	(75,750)
Net income	177,213	166,427	209,652
Common share dividends declared	144,421	171,407	184,400
Per Share Highlights			
Net income per common share	2.90	2.73	3.42
Dividends per common share	2.40	2.86	3.08
At Year End Balance Sheet Highlights Total assets	37,685,593	36,037,127	32,776,278
Total long-term financial liabilities	374,025	174,829	174,693

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 December 31, 2019, MUA totalled $111.4 billion, up from $106.2 billion at December 31, 2018, an increase of 5%. The growth of MUA in the fourth quarter of 2019 from September 30, 2019, on an annualized basis was 3%.

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 2019, the Company's single-family origination increased across most of the country. The Company believes this is the result of a strong economy coupled with lower mortgage rates and First National's market share in the mortgage broker distribution channel. All of the Company's sales offices experienced growth: Toronto (17%), Vancouver (1%), Calgary (2%) and Montreal (6%). In aggregate, the Company's single-family origination grew by 11% in 2019. The commercial segment had a record year in 2019, increasing volume by 19% to $7.4 billion in 2019 compared to $6.2 billion in the 2018. Together, overall new origination for 2019 increased 13% 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. In late 2019, the Company entered into a similar agreement with another Canadian bank.

Relaunch of Excalibur Mortgage Products

In April 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 in the spring of 2018. The product has been originated primarily for placement with institutional investors but beginning in April 2019, the Company finalized an agreement with a bank-sponsored securitization conduit to fund a portion of the Excalibur origination. The Excalibur relaunch was rolled out gradually, beginning in Ontario. Currently the program is open to include all Ontario brokers with a potential expansion to western Canada later in 2020.

Raising Capital for Operations

Bank Credit Facility

The Company has a revolving line of credit with a syndicate of banks of $1.25 billion. This facility enables the Company to fund the large amounts of mortgages accumulated for securitization. In the second quarter of 2019, the Company extended the term of the facility by one year such that the maturity is now March 2024. 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.

Note Issuance

On November 25, 2019, the Company issued 200,000 3.582% Series 2 senior unsecured Notes for a 5-year term pursuant to a private placement under an offering memorandum. The net proceeds of the offering, after broker commissions, of $199.3 million were loaned to FNFLP. On settlement, the proceeds were used to pay down a portion of the indebtedness under the bank credit facility. The Company plans to draw on the bank credit facility to repay the existing 4.01% $175 million Series 1 note when it matures in April 2020. Effectively the new note issuance has increased the Company's leverage by $25 million, as $175 million has been earmarked for paying off the older note on maturity.

Preferred Share Issuance

Effective April 1, 2016, the Company reset the dividend rate on the 2,887,147 Class A Series 1 preference shares issued in 2011 that 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.

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 served as an issuer and administrator of NHA-MBS 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 Canada Mortgage Bonds ("CMB") program. Issuer status provides 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%
2009–2016	1.77%
2017–2018	1.36%
2019	1.42%

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%. In 2017 and 2018, economic information was favourable, and competition was strong such that spreads were the tightest seen in the past decade, falling to 1.10% in the third quarter of 2018. With renewed worries about global economics, interest rates on government debt decreased rapidly at the end of 2018 and the first quarter of 2019. Despite the lower funding rates in the first quarter of 2019, mortgage rates did not fall, as lenders delayed reducing profit margins in an unsettled economy. With competitive pressures in the second and third quarter of 2019, spreads tightened but remained relatively wider than spreads in 2018. In 2019, the Company originated and renewed for securitization purposes approximately $7.2 billion of single-family mortgages and $1.7 billion of multi-unit residential mortgages. In 2019, the Company securitized through NHA-MBS approximately $6.6 billion of single-family mortgages and $0.9 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 pools 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. CMHC also modified the tiered NHA-MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees to $9.0 billion. The tiered limit of $9.0 billion remains unchanged for 2020. On December 31, 2019, CMHC announced that for NHA-MBS pools issued after July 1, 2020, guarantee fees will be increased. The Company estimates that the increase translates to an additional annual cost of funding of 0.05% per year for its NHA-MBS program.

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. In 2019, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), also took advantage of funding provided by the CMB, issuing 12 NHA-MBS pools totalling $131 million and securitizing those pools in the CMB program.

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		**Year Ended**	
	December 31, 2019	**December 31, 2018**	**December 31, 2019**	**December 31, 2018**
For the Period		**($000s)**		
Revenue	342,138	312,039	1,326,523	1,181,510
Income before income taxes	66,593	44,050	241,713	227,417
Pre-FMV EBITDA (1)	61,766	55,780	251,285	225,186
At Period End				
Total assets	37,685,593	36,038,527	37,685,593	36,038,527
Mortgages under administration	111,378,891	106,151,363	111,378,891	106,151,363

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 that generates continuing income and cash flow and a business model that is designed to make efficient use of capital, the Company has been able to pay distributions to its shareholders that 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 paid out as dividends. Similar to the performance measurement 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		Year Ended	
	December 31, 2019	December 31, 2018	December 31, 2019	December 31, 2018
For the Period		($000s)		
Net income attributable to common shareholders	48,230	31,465	174,156	163,499
Total dividends paid or declared on common shares	58,968	88,202	144,421	171,407
Dividends paid or declared on common shares, excluding special dividends	28,984	28,235	114,437	111,440
Total common share dividend payout ratio	122%	280%	83%	105%
Regular common share dividend payout ratio (1)	60%	90%	66%	68%
After-tax Pre-FMV dividend payout ratio (2)	66%	72%	64%	70%

Note:

(1) This ratio is calculated by excluding the payment of the special dividends declared at the end of each year.

(2) This non-IFRS measure adjusts the net income used in the calculation of the "Regular common share 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 year ended December 31, 2019, the common share payout ratio was 83% compared to 105% in 2018. However, in November of both 2019 and 2018, the Company declared a special dividend, which represented the distribution of excess retained earnings not required for Company growth initiatives. Including such dividends distorts the payout ratios. If the special dividends are excluded from the calculation, the payout ratios would have been 66% in 2019 and 68% in 2018. In both 2019 and 2018, the Company recorded gains and losses on account of the changes in fair value of financial instruments. The gains and losses are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact is largely to be reflected in narrower/wider spreads in the future from the mortgages pledged for securitization. Accordingly, management does not consider this revenue to be available for dividend payment. If the gains and losses on financial instruments in the two years are excluded from the above calculations, the dividend payout ratio for 2019 would have been 64% compared to 70% in 2018.

The Company also paid $3.1 million of dividends on its preferred shares in 2019 compared to $2.9 million in 2018.

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 the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2019, new origination volume increased from $18.5 billion to $21.0 billion, or about 13%, compared to 2018.

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 $28.5 billion of new originations and renewals in 2019, $8.9 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 placed. 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 $28.5 billion of new originations and renewals in 2019, $18.6 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 are 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		Year Ended	
	December 31, 2019	December 31, 2018	December 31, 2019	December 31, 2018
	($ millions)			
Mortgage Originations by Segment				
New single-family residential	3,624	2,760	13,523	12,231
New multi-unit and commercial	2,226	1,848	7,431	6,237
Sub-total	5,850	4,608	20,954	18,468
Single-family residential renewals	1,409	1,322	5,504	6,083
Multi-unit and commercial renewals	603	592	1,996	1,338
Total origination and renewals	7,862	6,522	28,454	25,889
Mortgage Originations by Funding Source				
Institutional investors – new residential	2,140	2,446	8,223	6,495
Institutional investors – renew residential	201	628	3,204	2,490
Institutional investors – multi/commercial	1,994	1,873	7,153	5,957
NHA-MBS/CMB/ABCP securitization	3,185	1,359	8,887	10,109
Internal Company resources/CMBS	342	216	987	838
Total	7,862	6,522	28,454	25,889
Mortgages under Administration				
Single-family residential	80,709	79,166	80,709	79,166
Multi-unit residential and commercial	30,670	26,985	30,670	26,985
Total	111,379	106,151	111,379	106,151

Total new mortgage origination volumes increased in 2019 compared to 2018 by 13%. Single-family volumes increased by 11% and commercial segment volumes increased by 19% year over year. Management believes the increase in the single-family segment is due to a strong economy coupled with low mortgage rates and the Company's position in the mortgage broker distribution channel. With lower risk-free interest rates, mortgage rates offered by the Company have decreased since December 31, 2018. Accordingly, despite new stress tests implemented as part of revised B-20 guidelines effective in 2019, lower mortgage rates make it comparatively easier for borrowers to qualify for similar mortgage amounts between the years. The Company believes that its strong market share in the mortgage broker channel has also led to increased origination. All the Company's regional offices experienced growth, particularly in Ontario and the Maritimes, which increased by 17% over comparative volumes in 2018. When combined with renewals, total production increased from $25.9 billion in 2018 to $28.5 billion in 2019, or by 10%. One part of the strength in eastern Canada for new single-family origination is partially the result of the relaunch of its Excalibur program. Because of the successful launch of the product in 2018, the Company was able to quickly establish new origination volume. In 2019, growth for this program was similar to that of the overall single-family segment. The Company's expertise in mortgage underwriting drove commercial segment origination (including renewals) higher by 24% in 2019. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of $8.9 billion in 2019.

Net Interest – Securitized Mortgages

Comparing the year ended December 31, 2019 to the year ended December 31, 2018, "net interest – securitized mortgages" decreased by about 4% to $138.6 million from $144.1 million. The decrease was largely due to the accounting for financial instruments. Prior to adopting hedge accounting in 2018, the Company recorded gains and losses on financial instruments in its current earnings and earned tighter or wider securitization spreads in future periods. In both 2017 and 2016, the Company recorded very large gains as interest rates began to climb. The offset to these gains is generally more expensive debt raised on the securitized mortgages. As the securitization transactions related to these debts performs, a lower net securitization margin is recorded. The Company estimates that the impact of this accounting treatment has decreased net interest on securitized mortgages in 2019 by about $8.3 million year over year. Without this amount, net interest on securitized mortgages increased by 2% between 2018 and 2019, as the Company increased the amount of mortgages pledged under securitization.

Placement Fees

Placement fee revenue increased by 45% to $205.5 million from $141.9 million in 2018. The increase was the result of a changing funding mix between the years. In 2019, the Company placed about $18.6 billion of volume with institutional investors compared to $14.9 billion in 2018. The increase of 25% drove most of the increase in placement fees. In 2018, a greater proportion of mortgage origination volume was securitized by the Company such that the value is now being recognized over time through net securitization margin. Placement fees on both newly originated and renewed single-family mortgages also benefited from the interest rate environment. As described previously, the Company does not apply any hedge accounting for the interest rate risk program related to its single-family mortgage commitment pipeline. Accordingly, any gains or losses related to the financial instruments used for this program are recorded in the Company's current period net income. To the extent that these mortgage commitments became funded mortgages, the mortgages may be more or less valuable given changes in the interest rate environment during the commitment period. In the first six months of 2019, bond yields dropped significantly, creating large losses on the financial instruments used to economically hedge these commitments. The Company expensed these losses. However, when the mortgage commitments related to these financial instruments transformed into funded mortgages, the mortgage rates on these mortgages were significantly higher than mortgage rates currently being offered at the time. The Company was able to immediately crystallize the value of such mortgages through placement transactions. Effectively the Company recouped a portion of the losses on financial instruments recorded in the first two quarters of 2019 in third-quarter placement fees. The commercial segment was able to increase placement fees with increased pricing given demand from its customers. Single-family renewals while lower than a year before, were comparatively more valuable to the Company than those in 2018.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue decreased 1% to $11.6 million from $11.7 million. The gains related to multi-unit residential mortgages originated and sold to institutional investors. Volumes for these transactions decreased by 6% from 2018, but spreads on these transactions widened year over year.

Mortgage Servicing Income

Mortgage servicing income increased 7% to $156.7 million from $146.2 million. This increase was largely due to the benefits associated with higher MUA and the funding shift from securitization to institutional placements, which effectively moves revenues from net securitization margin to servicing income.

Mortgage Investment Income

Mortgage investment income decreased 4% to $84.7 million from $88.3 million. The decrease was due primarily to lower mortgage rates which prevailed in 2019 compared to 2018. Generally, five-year closed single-family mortgage rates fell by about 1% from the peak in 2018 to 2019's low.

Realized and Unrealized Gains (Losses) on Financial Instruments

This financial statement line item typically consists of three components: (1) gains and losses related to the Company's economic hedging activities of single-family commitments, (2) gains and losses related to holding a portfolio of mortgage and loan investments at fair value, and (3) gains and losses on interest rate swaps used to mitigate interest rate risk associated with its CMB activity. With the adoption of IFRS 9 in 2018, a significant portion of the Company's interest rate management program qualifies as hedging for accounting purposes. 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 has reduced the volatility of gains and losses on financial instruments otherwise recorded in the Company's regular earnings, as gains and losses on hedged items are generally deferred and amortized into income over the term of the related mortgages. The Company has not documented a hedging relationship for its interest mitigation program 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, but these should be limited to those on the bonds sold short used to mitigate such risk. The Company has recorded mortgage and loan investments at fair value on its balance sheet. Accordingly, there are fair value gains or losses associated with these mortgages. The following table summarizes these gains and losses by category in the periods indicated:

	Quarter Ended		**Year Ended**	
Summary of Realized and Unrealized Gains (Losses) on Financial Instruments	**December 31, 2019**	**December 31, 2018**	**December 31, 2019**	**December 31, 2018**
	($000s)			
Gains (losses) on short bonds used for the economic hedging program	5,931	(14,285)	(8,269)	5,822
Losses on mortgages held at fair value	(700)	(1,000)	(4,300)	(4,000)
Gains (losses) on interest rate swaps	244	3,569	2,914	1,340
Net gains (losses) on financial instruments	5,475	(11,716)	(9,655)	3,162

In 2018, economic data was generally positive and interest rates began the year climbing slowly higher. However, in the fourth quarter of 2018, poor economic data moved rates lower. Together with the adoption of hedge accounting by the Company in 2018, which removes some of the volatility from its earnings, First National recorded gains on financial instruments of about $5.8 million related to its short bond hedging program in 2018. In 2019, economic concerns had a significant impact on the bond market, as bond prices rose in the first eight months of the year until receding toward year end. Overall, the Company experienced losses of $36.5 million on its total short bond book during the year ended December 31, 2019; however, about $28.2 million of these losses pertained to mortgages to which the Company was able to apply hedge accounting. This left losses on account of financial instruments in earnings of $8.3 million. These losses largely reflect the decrease in the value of short bonds used to mitigate interest rate risk related to the Company's single-family mortgage commitments. The Company does not attempt to document a hedge relationship on such commitments.

Brokerage Fees Expense

Brokerage fees expense increased 36% to $102.6 million from $75.4 million. This increase is explained by higher origination volumes of prime single-family mortgages for institutional investors which increased by 32% year over year, excluding Excalibur product. Broker fees on a per unit basis were higher in 2019 compared to 2018 by about 6%, as the Company increased broker loyalty programs. Commercial segment broker fees were 15% higher in 2019 when compared to 2018.

Salaries and Benefits Expense

Salaries and benefits expense increased 18% to $117.6 million from $99.7 million. Salaries were higher as overall headcount increased by 7% (987 employees as at December 31, 2018 and 1,058 at December 31, 2019). The increase was also the result of $9.2 million of higher compensation earned by commercial sales staff pursuant to increased origination in 2019. Management salaries were paid to the two senior executives (co-founders) who together control about 71% 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 11% to $77.7 million from $69.9 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 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 increased from the prior year due to higher short-term interest rates in 2019 and increased mortgage origination, which required higher levels of warehouse debt.

Other Operating Expenses

Other operating expenses decreased by 24% to $47.9 million from $63.0 million. The primary change in other operating expenses was lower hedge expenses, which were $15.9 million less than in 2018. The expense decreased as bond yields moved downward in 2019. With 30-day interest rates remaining relatively static, it became cheaper to borrow the short bonds that the Company uses to hedge interest rate exposure. As interest rates fell to start 2019, the yield curve became inverted such that short-term interest rates exceeded longer-term rates for much of the year. Accordingly, there was only $2.8 million of costs related to hedging in 2019. Without these costs, other operating expenses increased by $0.8 million, reflecting costs to support the growth of the business and MUA.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes increased by 6% to $241.7 million from $227.4 million. This increase was the result of higher origination and a shift in funding strategy to a higher proportion of institutional placement. These results were affected by changing capital markets. In 2019, the Company recorded $5.4 million of losses on financial instruments (excluding $4.3 million of losses related to mortgage and loan investments). Comparatively, in 2018, the Company recorded $7.2 million of gains on financial instruments (excluding the impact of $4.0 million of losses related to mortgage and loan investments). The change in these values, excluding the losses on mortgage investments, accounted for a $12.5 million decrease in comparative income before income taxes. Pre-FMV EBITDA, which eliminates the impact of such gains and losses on financial instruments, increased by 12% to $251.3 million from $225.2 million. As described previously in this MD&A, not only did the Company increase new origination volumes by 13%, but it also increased the amount of mortgages placed with institutional investors. By placing mortgages with investors as opposed to using securitization, the Company effectively accelerates the recognition of the value inherent in the mortgages to the current accounting period. With wider mortgage spreads prevalent for much of 2019, the per unit values of the placements were more favourable than in 2018. Placement fee revenue was also affected favourably by a falling interest rate environment. As the Company committed to mortgages in the first six months of the year, funding costs decreased, and the value of the mortgages placed increased significantly. The Company had programs to mitigate the effect of changing interest rates on programs. The losses related to these instruments were recorded in the first two quarters of 2019. All together, the value of higher placement fee revenue net of the cost of the related broker fees and additional commercial compensation, increased earnings by about $27 million year over year, accounting for most of the increase in Pre-FMV EBITDA.

Income Tax Expense

The provision for taxes increased by 6% to $64.5 million from $61.0 million. The provision increased proportionately with net income before income taxes. The overall effective tax rate was consistent between the two years.

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 determined that these hedges were effective, the Company recorded $25.1 million of pre-tax net losses on such hedges in 2019 that would have been recorded as losses on financial instruments under the previous IFRS standard. In the year, the Company amortized these losses and a portion of opening accumulated OCI into regular earnings. In 2019, $24.7 million of pre-tax OCI was amortized into the Company’s net income. The remaining OCI amount will be amortized into net income in future periods.

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 ($000s except percent amounts)			
	Residential		**Commercial**	
For the Year Ended	**December 31, 2019**	**December 31, 2018**	**December 31, 2019**	**December 31, 2018**
Originations and renewals	19,026,919	18,314,129	9,427,357	7,574,443
Percentage change	*4%*		*24%*	
Revenue	1,008,013	913,301	318,510	268,209
Percentage change	*10%*		*19%*	
Income before income taxes	171,423	164,897	70,290	62,517
Percentage change	*4%*		*12%*	
As at	**December 31, 2019**	**December 31, 2018**	**December 31, 2019**	**December 31, 2018**
Identifiable assets	28,535,288	27,719,231	9,120,529	8,289,520
Mortgages under administration	80,709,370	79,165,363	30,669,521	26,985,711

Residential Segment

Overall residential origination volumes including renewals increased by 4% between 2019 and 2018, while residential revenues increased by 10%. Revenues in both years were affected by gains and losses on fair value associated with changing interest rates. If revenues are normalized for these gains and losses, revenue would have increased by 12%. Revenue growth exceeded the growth in origination, as the Company placed a higher portion of its origination with institutional investors as opposed to using securitization. Placement transactions accelerate the recognition of the value inherent in a mortgage. Together with a wider spread environment, which increased the value of placement fees on a per unit basis, residential placement fee revenue increased by 46% year over year. Net income before tax was also affected by fair value related amounts. Without the impact of these revenues, net income before tax increased from $157.7 million in 2018 to $176.8 million in 2019, or by 12%. This was the result of higher placement fees as described above. The cost of originating mortgages on a per unit basis was similar year over year such that the additional placement revenue flowed through to increase net income. Identifiable assets increased from 2018 to 2019, as the Company increased its investment in mortgages pledged under securitization by about $450 million, restricted cash by about $100 million and hedging related assets by about $215 million.

Commercial Segment

2019 commercial revenues increased by about 19% compared to 2018. This increase was the result of higher origination and interest revenue on the securitized mortgage portfolio that grew by 15% year over year. Income before income taxes for this segment was not affected by fair value considerations. This measure increased by 12% year over year. The increase is due to the higher revenue offset by higher compensation payable to the Company's commercial origination employees. Identifiable assets increased from those at December 31, 2018, as the Company increased its investment in mortgages pledged for securitization by $975 million and mortgage and loan investments by $150 million. This increase was offset by a decrease in mortgages accumulated for securitization of $315 million.

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 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 financial institutions for a total credit of $1.25 billion. This facility was extended in May 2019 for a five-year term maturing in May 2024. At December 31, 2019, the Company entered into repurchase transactions with financial institutions to borrow $1.1 billion related to $1.1 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At December 31, 2019, outstanding bank indebtedness was $797.8 million (December 31, 2018 – $918.3 million). Together with the unsecured notes of $375 million (December 31, 2018 – $175 million), this "combined debt" was used to fund $817.5 million (December 31, 2018 – $902.0 million) of mortgages accumulated for sale or securitization. At December 30, 2019, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $42.0 million (December 31, 2018 – $41.6 million) and (2) mortgage and loan investments of $370.4 million (December 31, 2018 –- $188.7 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, 2018, and December 31, 2019, and now stands at $353.3 million (December 31, 2018 – $191.1 million). This represents a debt-to-equity ratio of approximately 0.63:1. This ratio increased from 0.36:1 at December 31, 2018. In general, the increase is due to the Company's investment in commercial bridge loans. Toward year end, a number of the Company's large customers required financing to transition their real estate portfolios between traditional mortgage financing solutions. In the month of December alone, the Company loaned about $150 million on such opportunities. 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 does impact the Company. Almost two years after the announcement, legislation was passed, and detailed transition information was published. 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 five-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 December 31, 2019, the investment in cash collateral was $83.6 million (December 31, 2018 – $75.9 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 March 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.

Financial Instruments and Risk Management

Commencing January 1, 2018, 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 mortgages terms of 18 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 December 31, 2019, the Company had about $1.5 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 December 31, 2019, the Company had entered into $0.5 billion of notional value forward bond sales for this segment. The Company is also a 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 December 31, 2019, the aggregate notional value of these swaps, maturing between June 2021 and September 2026, was $68.4 million. During 2019, the value of these swaps increased by $2.9 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 by adjusting the value of the mortgages downward. In 2009, the economic environment remained weak but did not worsen from 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 December 31, 2019, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost $1.9 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. The business requires capital expenditures on technology (both software and hardware), leasehold improvements, and office furniture. During the year ended December 31, 2019, the Company purchased new computer equipment, software and made leasehold improvements. In the long term, the Company expects capital expenditures on fixed assets will be approximately $6.0 million annually.

Summary of Contractual Obligations

The Company's long-term obligations include five- to 10-year leases of premises for its 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.

	Payments Due by Period				
	Total	0-1 Years	1-3 Years ($000s)	4-5 Years	After 5 Years
Lease Obligations	29,086	7,484	21,602	—	—

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, 2019. The policies that 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 December 31, 2019, continue to be consistent with those used for the year ended December 31, 2018, and the quarters ended September 30, June 30, and March 31, 2019.

Effective January 1, 2018, the Company 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 expected credit loss ("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.

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.

As of December 31, 2019, management evaluated, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, management concluded that the Company's disclosure controls and procedures, as defined by National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings, were effective as of December 31, 2019.

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.

Management evaluated, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's internal control over financial reporting based on the criteria set forth in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and, based on that evaluation, concluded that the Company's internal control over financial reporting was effective as of December 31, 2019, and that no material weaknesses have been identified in the Company's internal control over financial reporting as of December 31, 2019. No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2019, 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 including third-party servicing customers, reliance on independent mortgage brokers, changes in interest rates, repurchase obligations and breach of representations and warranties on mortgage sales, risk of servicer termination including the impact of 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, unfavourable 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 that 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. In October 2019, the sale transaction involving an institution for which the Company administers a large portfolio of third-party originated mortgages, was completed. The new owners of the institution may decide not to renew the existing contract with First National or to exercise termination clauses within the agreement. In the event of non-renewal or termination, the Company's MUA will decrease. 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 February 24, 2020, 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

2019 results exceeded management's expectations, as single-family origination increased by 11% from the comparative amount in 2018 and commercial segment origination increased by 19%. Management remains optimistic about 2020, as single-family mortgage commitments have continued to outpace commitments at the same time in 2019. The commercial segment also anticipates a strong start to 2020, as borrower appetite continues to be strong following the record fourth quarter of 2019. Despite these favourable indications, the Company will continue to be faced with uncertain securitization margins, as mortgage spreads have tightened toward the end of 2019 and have not widened in early 2020. The effect of pre-2018 fair value accounting conventions will continue to have a negative impact on income in 2020, albeit for a slightly lower amount than in 2019.

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. The Company will continue to generate income and cash flow from its $32 billion portfolio of mortgages pledged under securitization and $77 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.