FIRST NATIONAL

FINANCIAL CORPORATION

# Report to Shareholders

# Period Ended September 30, 2020

100 University Avenue, Suite 700, North Tower, Toronto, ON M5J 1V6
www.firstnational.ca

FIRST NATIONAL

FINANCIAL CORPORATION

**Fellow Shareholders:**

In a year marked by the pandemic, First National has delivered strong results for customers, partners and shareholders through the committed efforts of our 1,131 employees from coast to coast. In the third quarter ended September 30, 2020:

- Mortgages under administration increased 6% to a record $117.1 billion compared to $110.6 billion at September 30, 2019 and increased 8% annualized during the quarter
- Total mortgage originations (including renewals) grew 30% year over year to $9.97 billion
- Revenue increased 3% to $373.8 million from $362.8 million in Q3 2019
- Pre-FMV Income, a non-IFRS measure, increased 25% to $99.6 million from $79.8 million in Q3 2019
- Net income was $72.5 million ($1.20 per common share) compared to net income of $60.6 million ($1.00 per common share) in Q3 2019
- Common share dividends were declared at the annualized rate of $1.95 per share for a payout ratio of 41%.

**Dividend Increase and Special Dividend**

We are very pleased that the performance trend over the past year led the Company's Board of Directors to increase the common share dividend rate to $2.10 per share on an annualized basis effective with the payment on December 15, 2020. This is the 13th time since the Company's 2006 IPO that distributions to shareholders have increased. Furthermore, the Board determined that over the past year, First National has generated excess capital and can continue to fund its near-term growth opportunities from operations. Accordingly, the Board voted to pay a special common share dividend of $0.50 per share on December 15th to holders of record on November 30th. This is the fourth consecutive year a special dividend has been declared.

**Looking Forward**

COVID-19 uncertainties are still prevalent. However, management is very positive about the fourth quarter and the start of 2021. Expectations for the fourth quarter include: substantially higher seasonal residential origination; commercial segment success in growing origination at higher spreads; and employee productivity from the Company's work-from-home strategy. Details may be found in the Company's MD&A for the three and nine months ended September 30, 2020.

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 27, 2020. 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, 2020. 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 Income" 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 $117 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 2020 Results Summary

Management is very pleased with the performance of the Company during the third quarter of 2020 particularly given the widespread financial crisis which commenced with COVID-19 related employment loss. First National's employees worked from home throughout the third quarter and remained productive and efficient. Supported by a resilient housing market across Canada, the Company increased single-family origination 42% year over year. The commercial segment had good results given the economic environment and a challenging period for non-residential real estate. Commercial origination for the third quarter increased by 18%. Total combined new origination was higher by 36% compared to 2019. Earnings were strong as the Company benefited from strong origination and wider mortgage spreads.

- MUA grew to $117.1 billion at September 30, 2020 from $110.6 billion at September 30, 2019, an increase of 6%; the growth from June 30, 2020, when MUA was $114.9 billion, was 8% on an annualized basis.
- Total new single-family mortgage origination was $5.9 billion in the third quarter of 2020 compared to $4.2 billion in the 2019 comparative quarter, an increase of 42%. The Company attributes this to an increasing market share in the mortgage broker distribution channel. The Company believes that the value of its long-time broker relationships and effective technology may be a significant advantage during the pandemic. Commercial segment origination of $1.7 billion was 18% higher than the $1.4 billion originated in the third quarter of 2019. Overall new origination increased by 36% in the third quarter of 2020 compared to the third quarter of 2019.
- The Company took advantage of opportunities in the quarter to renew over $1.9 billion of single-family mortgages ($1.7 billion a year ago). For the commercial segment, renewals increased to $406 million from $343 million.
- Revenue for the third quarter of 2020 increased by 3% to $373.8 million from $362.8 million in the third quarter of 2019. The increase included changes in fair market value gains and losses related to interest rate movements in the quarters. Excluding such amounts, revenue grew from $360.9 million in the 2019 quarter to $375.2 million in the 2020 quarter or 4%. This growth was largely a function of higher mortgage origination which fueled an increase in placement fee revenue of 41%.
- Income before income taxes increased by 19% to $98.8 million in the third quarter of 2020 from $82.8 million in the third quarter of 2019. A portion of the increase was the result of changing capital market conditions. Excluding the gains and losses related to these conditions, the Company's earnings before income taxes and gains and losses on financial instruments ("Pre-FMV Income") for the third quarter of 2020 increased by 25% to $99.6 million from $79.8 million in the 2019 quarter. The increase is largely the result of higher origination and wider mortgage spreads which both had favorable impacts on placement fee revenue.

The Company's Board of Directors announced both an increase to the regular monthly dividend from $1.95 to $2.10 per common share on an annualized basis effective with the dividend payable on December 15, 2020; and a special common share dividend in the amount of $0.50 per share, payable on December 15, 2020 to shareholders of record on November 30, 2020. This payment 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 (loss) for the Period | Pre-FMV Income for the Period (1) | Net Income (loss) per Common Share | Total Assets |
|---|---|---|---|---|---|
| **2020** | | | | | |
| Third quarter | $373,760 | $72,517 | $99,644 | $1.20 | $38,314,904 |
| Second quarter | $344,581 | $50,844 | $75,506 | $0.84 | $39,040,298 |
| First quarter | $274,650 | ($2,255) | $52,921 | ($0.05) | $39,203,792 |
| **2019** | | | | | |
| Fourth quarter | $342,138 | $48,993 | $60,418 | $0.80 | $37,685,593 |
| Third quarter | $362,833 | $60,578 | $79,816 | $1.00 | $37,249,143 |
| Second quarter | $335,241 | $44,164 | $67,565 | $0.72 | $37,229,876 |
| First quarter | $286,311 | $23,478 | $39,269 | $0.38 | $36,193,793 |
| **2018** | | | | | |
| Fourth quarter | $312,039 | $32,220 | $54,765 | $0.53 | $36,037,127 |

(1) This non-IFRS measure adjusts income before income taxes by eliminating 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 figures presented for 2018 and 2019 had been restated to conform to 2020's presentation.

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. Recently MUA has increased, and revenue has followed. 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 Income, 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 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. Toward the end of 2018, economic worries resurfaced, and interest rates fell and mortgage spreads widened by about 0.30%. This had a significant positive effect on the value of the Company's operations. In the first quarter of 2019, Pre-FMV Income was at its lowest in the two-year period prior to the COVID-19 pandemic, as tighter spread 2018 originated mortgages were securitized and placed. Combined with lower origination volumes than 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. To start 2020, COVID-19 related financial turmoil meant that the Company reported a small loss. In the third quarter of 2020, the Company benefited from abnormally wide mortgage spreads which were the result of the aftermath of COVID-19 related financial crisis which began at the end of the 2020 first quarter. These spreads were the basis for growth in Pre-FMV Income in the quarter.

## Outstanding Securities of the Corporation

At September 30, 2020, and October 27, 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; and 200,000 November 2024 senior unsecured notes outstanding.

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

($000s, except per share amounts)

| | 2019 | 2018 | 2017 |
|---|---|---|---|
| **For the Year Ended December 31,**<br>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 | (243,143) | (232,670) | (198,167) |
| 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 Income(1) | 247,068 | 220,255 | 229,143 |
| Add (deduct): realized and unrealized gains (losses) 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 | 2.41 | 2.86 | 3.08 |
| **At Year End**<br>Balance Sheet Highlights<br>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 Income is not a recognized earnings measure under IFRS and does not have a standardized meaning prescribed by IFRS. Therefore, Pre-FMV Income may not be comparable to similar measures presented by other issuers. Investors are cautioned that Pre-FMV Income 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. The figures in the chart have been restated to conform to 2020's presentation.

## 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, 2020, MUA totalled $117.1 billion, up from $110.6 billion at September 30, 2019, an increase of 6%. The growth of MUA in the third quarter of 2020 from June 30, 2020, on an annualized basis, was 8%.

## 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 2020, the Company's single-family origination increased across most of the country. The Company believes this is the result of its strong broker relationship and technology which have both been significant benefits in the pandemic period. All of the Company's sales offices experienced double digit growth: Toronto (+37%), Vancouver (+61%), Calgary (+22%) and Montreal (+69%). In aggregate, the Company's single-family origination grew by 42% in the third quarter of 2020 compared to the third quarter 2019. The commercial segment had higher origination as its CMHC business thrived with volumes increasing by 18% to $1.7 billion in 2020 compared to $1.4 billion in the 2019 quarter. Investor appetite for non-residential mortgages remained low, however the Company saw growth in origination of its uninsured products. Together, overall new origination for the third quarter 2020 increased 36% 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.

### *Excalibur Mortgage Products*

The Company originates 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. First National's relationships with mortgage brokers and underwriting systems allow for cost effective origination of significant volumes. The product is 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. In early 2020 another agreement was entered into with another bank-sponsored conduit to providing additional funding for this product. The Excalibur relaunch was rolled out gradually, beginning in Ontario. Currently the program is open to include all Ontario brokers. In the third quarter of 2020, the Company began testing the product selectively in the BC region.

## 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 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 four-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*

In November 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 drew on the bank credit facility to repay the all of the 4.01% $175 million Series 1 notes when they matured in early April 2020. Effectively the new note issuance has increased the Company's leverage by $25 million, as $175 million was used to pay off the older notes 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% |
| 2020 first quarter | 2.24% |
| 2020 second quarter | 1.87% |
| 2020 third quarter | 1.54% |

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 2019, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads tightened in the ten-year period as shown above, falling to a low of 1.10% in the third quarter of 2018. In the middle of the first quarter of 2020, fears of a global pandemic related to COVID-19 led to a dramatic and sudden decrease in bond yields as central banks cut overnight rates significantly. Although much of the quarter evidenced tighter spreads, by the end of the quarter, mortgage rates had moved up and the wide spread of 2.24% was the mark at quarter end. Like the credit crisis in 2008, spreads subsequently tightened as financial institutions reduced rates to attract volume. These spreads had positive impacts on third quarter results, and will increase the profitability of the Company's securitization portfolio in future periods. In the third quarter of 2020, the Company originated and renewed for securitization purposes approximately $2.5 billion of single-family mortgages and 0.3 billion of multi-unit residential mortgages. In the quarter, the Company securitized approximately $1.7 billion of NHA-MBS pools.

In August 2013 and subsequently amended in July 2016, CMHC put in place regulations to limit the amount of guarantees it would provide on NHA-MBS pools created for the "market" as well as for CMB purposes. CMHC designed a system to allocate guarantees to issuers. The maximum amount allocated under the process has exceeded First National's requirements in every quarter since inception. 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. In 2020 CMHC also announced the relaunch of the Insured Mortgage Purchase Plan which it last used in the 2008 credit crisis to provide liquidity to the insured mortgage market. The Plan will enable NHA-MBS issuers like First National to issue, in aggregate, up to $150 billion of NHA-MBS to the government. The Company has not taken part in this program. In early June 2020, CMHC announced several changes to its insurance rules for single family home buyers. The rules, effective July 1, 2020, increase the required credit score and debt service ratios for potential borrowers. The other mortgage default insurers have not changed their policies. The Company has relationships with all three insurers, so that it does not anticipate much, if any, impact to its business.

### *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 2020, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), also took advantage of funding provided by the CMB, issuing NHA-MBS pools totalling $8.3 million and securitizing those pools in the CMB program. Pursuant to the COVID-19 crisis, CHT announced that the 2020 CMB program will be increased from a target of $40 billion to $60 billion. The Company hopes to use any additional funding allocated to it throughout the remainder of 2020.

## Key Performance Indicators

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

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

- Dividend payout ratio.

Since 2012 the Company used Pre-FMV EBITDA as a key performance measure. This non-IFRS measure was used to adjust the Company's earnings by excluding gains and losses related to the fair value of financial instruments and adding back depreciation and amortization. The addbacks of amortization ended in 2016 when IPO related intangible assets were fully amortized. Accordingly, effective January 1, 2020 the Company has elected to simplify the non-IFRS measure it presents to adjust only for fair value related gains and losses. This measure will be reported as "Pre-FMV Income". Measures prior to 2020 will be restated in accordance with this revised calculation. Pre-FMV Income is not a recognized measure under IFRS. However, management believes that Pre-FMV Income is a useful measure that provides investors with an indication of income normalized for capital market fluctuations. Pre-FMV Income 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 Income may differ from other issuers and, accordingly, Pre-FMV Income may not be comparable to measures used by other issuers.

| | Quarter ended | | Nine months ended | |
|---|---|---|---|---|
| | **September 30, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| **For the Period** | | | ($000s) | |
| Revenue | 373,760 | 362,833 | 992,991 | 984,385 |
| Income before income taxes | 98,767 | 82,778 | 164,456 | 175,120 |
| Pre-FMV Income (1) | 99,644 | 79,816 | 228,071 | 186,650 |
| **At Period End** | | | | |
| Total assets | 38,314,904 | 37,249,143 | 38,314,904 | 37,249,143 |
| Mortgages under administration | 117,116,971 | 110,601,875 | 117,116,971 | 110,601,875 |

Note:

(1) This non-IFRS measure adjusts income before income taxes by eliminating 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 2019 comparative figure has been revised to conform to the 2020 presentation.

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 Income.

*Determination of Common Share Dividend Payout Ratio*

| | Quarter ended | | Nine months ended | |
|---|---|---|---|---|
| | **September 30, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| **For the Period** | | **($000s)** | | |
| Net income attributable to common shareholders | 71,851 | 59,811 | 118,918 | 125,926 |
| Total dividends paid or declared on common shares | 29,234 | 28,484 | 87,702 | 85,453 |
| Total common share dividend payout ratio | 41% | 48% | 74% | 68% |
| After-tax Pre-FMV dividend payout ratio (1) | 40% | 49% | 53% | 64% |

Note:

(1) 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 income 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, 2020, the common share payout ratio was 41% compared to 48% in the 2019 third quarter. In both 2020 and 2019 quarters, 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 generally reflected in narrower or wider spreads in the future once the mortgages have been pledged for securitization. Accordingly, management does not consider these losses to affect its dividend payment policy. If the gains and losses on financial instruments in the two quarters are excluded from the above calculations, the dividend payout ratio for the 2020 third quarter would have been 40% compared to 49% in 2019 third quarter.

The Company also paid $0.7 million of dividends on its preferred shares in the third quarter of 2020 compared to $0.8 million in 2019 third quarter.

## 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 quarter ended September 30, 2020, new origination volume increased from almost $5.6 billion to $7.6 billion, or about 36%, compared to the 2019 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 $10.0 billion of new originations and renewals in the third quarter of 2020, $2.8 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 $10.0 billion of new originations and renewals in the third quarter 2020, $6.9 billion was placed with institutional investors.

For all institutional placements, 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 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 two mortgage originators 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 | | Nine months ended | |
|---|---|---|---|---|
| | September 30, 2020 | September 30, 2019 | September 30, 2020 | September 30, 2019 |
| | ($ millions) | | | |
| **Mortgage Originations by Segment** | | | | |
| New single-family residential | 5,925 | 4,179 | 13,203 | 9,899 |
| New multi-unit and commercial | 1,697 | 1,441 | 6,389 | 5,205 |
| Sub-total | 7,622 | 5,620 | 19,592 | 15,104 |
| Single-family residential renewals | 1,948 | 1,709 | 5,020 | 4,095 |
| Multi-unit and commercial renewals | 406 | 343 | 1,404 | 1,393 |
| Total origination and renewals | 9,976 | 7,672 | 26,016 | 20,592 |
| **Mortgage Originations by Funding Source** | | | | |
| Institutional investors – new residential | 4,006 | 2,681 | 8,449 | 6,083 |
| Institutional investors – renew residential | 1,196 | 1,685 | 2,718 | 3,003 |
| Institutional investors – multi/commercial | 1,727 | 1,492 | 5,841 | 5,159 |
| NHA-MBS/CMB/ABCP securitization | 2,832 | 1,640 | 8,489 | 5,702 |
| Internal Company resources/CMBS | 215 | 174 | 519 | 645 |
| Total | 9,976 | 7,672 | 26,016 | 20,592 |
| **Mortgages under Administration** | | | | |
| Single-family residential | 83,028 | 80,855 | 83,028 | 80,855 |
| Multi-unit residential and commercial | 34,089 | 29,747 | 34,089 | 29,747 |
| Total | 117,117 | 110,602 | 117,117 | 110,602 |

Total new mortgage origination volumes increased in the third quarter of 2020 compared to 2019 by 36%. Single-family volumes increased by 42% and commercial segment volumes increased by 18% year over year. Management believes the increase in the single-family segment is due to its strong broker and investor relationships and its MERLIN technology and operating systems which support physical distancing and have allowed the Company to continue to underwrite efficiently during the pandemic. Lower risk-free interest rates have also encouraged home purchasing across the country as lower mortgage rates make it comparatively easier for borrowers to qualify for mortgages. The Quebec and British Columbia regions had the most success with increases of 69% and 61%, respectively over comparative volumes in 2019's third quarter. However, both Ontario and Calgary achieved double digit growth. In the commercial segment, the Company shifted its emphasis to insured multi-unit origination and was able to increase origination of this product by 18%. Despite a more challenging market, the Company increased production of uninsured mortgages by 15% over 2019. The commercial segment's expertise in underwriting insured and uninsured mortgages was fundamental to growth. When combined with renewals, total production for both business segments increased from $7.7 billion in the 2019 third quarter to almost $10.0 billion in 2020's third quarter, or by 30%. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of $2.8 billion in the third quarter of 2020.

### *Net Interest – Securitized Mortgages*

Comparing the quarter ended September 30, 2020 to the quarter ended September 30, 2019, "net interest – securitized mortgages" decreased by about 3% to $34.9 million from $35.9 million. The small decrease was largely due to the indirect consequences of the financial crisis that accompanied the COVID-19 pandemic. In March 2020, the Bank of Canada cut overnight interest rates by 1.5% and the ensuing financial turmoil affected securitization margins in the first and second quarters. By the third quarter, financial market conditions had normalized and mortgages with wider spreads were being securitized by the Company. Together with a growing securitization portfolio, the Commercial segment earned $2.4 million more securitization income than in the 2019 third quarter. The residential earned similar income in 2020 compared to 2019 thanks to a larger Excalibur securitization program. This program produced income that offset lower earnings on the prime securitization portfolio that were negatively affected by tighter spread business put on in 2018 and 2019. However, the additional combined spread of $2.4 million was offset by the significant impact from the cost of indemnities payable to debtholders when mortgages prepay prior to their scheduled maturity date. The indemnities are calculated to make whole NHA MBS debtholders who are assumed to reinvest the prepayment principal at risk free reinvestment rates. With the recent decrease in interest rates, the cost of such indemnities has increased significantly. The Company calculates that because of the increase in indemnity costs, Interest Expense – Securitized Mortgage is higher by about $3.4 million comparing 2020 and 2019 third quarters.

### *Placement Fees*

Placement fee revenue increased by 41% to $98.4 million from $69.8 million in the comparative quarter. The increase was the result of increased mortgage volume with institutional investors which increased by 48% year over year. This growth was offset by a decrease of placements related to renewed mortgages. Although the volume of renewals increased, the Company elected to securitize a greater portion of these mortgages. Placement volume in the commercial segment grew by 16% but because of wider mortgage spreads which were about double what they were in the 2019 quarter, placement fees for this segment were 133% greater than in the comparative quarter.

### *Gains on Deferred Placement Fees*

Gains on deferred placement fees revenue increased 258% to $12.9 million from $3.6 million. The gains related to multi-unit residential mortgages originated and sold to institutional investors. Volumes for these transactions increased by 47% from the 2019 third quarter and, as described above, mortgage spreads on commercial segment mortgages widened significantly year over year.

### *Mortgage Servicing Income*

Mortgage servicing income increased 5% to $46.0 million from $43.9 million. This increase was due to the Company's third-party underwriting business unit. Much like the Company's experience in single-family origination, mortgage brokers referring mortgages to First National's third-party customers have embraced the MERLIN technology. The Company believes the technology has been advantageous during the pandemic-related lockdown period and led to increased origination volumes. The growth in this division has offset decreases in revenue in the Company's servicing business related to lower administration fees, particularly on mortgages on deferred payment plans, and lower interest rates earned on escrow deposits.

### *Mortgage Investment Income*

Mortgage investment income decreased 31% to $15.5 million from $22.5 million. The decrease was due primarily to the interest rate environment as short term rates fell significantly in March as the Bank of Canada cut its overnight rate by 1.5%. The decrease was also a function of lower balances of mortgage and loan investments which was largely the result of slowing the Company's commercial bridge loan program in order to conserve cash flow for pandemic-related requirements.

### *Realized and Unrealized Gains (Losses) on Financial Instruments*

This financial statement line item typically consists of three primary 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** | | **Nine months ended** | |
|---|---|---|---|---|
| **Summary of Realized and Unrealized Gains (Losses) on Financial Instruments** | **September 30, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| | **($000s)** | | | |
| Gains (losses) on short bonds used for the economic hedging program | (1,127) | 3,508 | (75,803) | (14,200) |
| Losses on mortgages held at fair value | (600) | (1,000) | (4,000) | (3,600) |
| Gains (losses) on interest rate swaps | 250 | (546) | 12,188 | 2,670 |
| Net gains (losses) on financial instruments | (1,477) | 1,962 | 67,615 | (15,130) |

In the first quarter of 2020, financial repercussions related to COVID-19 were very severe. With rapid unemployment and liquidity fears, the Bank of Canada reduced its overnight lending rate by 1.50% and bond yields plummeted as concerns over a global pandemic and recession increased. The lower yields had a significant impact on the Company's short bond positions. This contrasts with the third quarter of 2020, when sentiment turned more optimistic and bond yields declined only nominally over the quarter. The Company recorded net losses of $1.1 million on short bonds in the third quarter of 2020 due to the trading activity on the portion of short bonds used to mitigate interest rate risk on single-family mortgages commitments. The Company does not attempt to document a hedge relationship on such commitments.

### *Brokerage Fees Expense*

Brokerage fees expense increased 39% to $46.8 million from $33.6 million. This increase is explained by higher origination volumes of single-family mortgages for institutional investors which increased by 49% year over year. Although per unit broker fees increased by about 2% year over year, the Company paid less for commercial segment fees, Excalibur-related fees and portfolio insurance in the 2020 quarter. The growth in broker fees was also moderated by increased amounts of internal refinance transactions that were brokered by inhouse employees which do not require payment of a broker fee.

### *Salaries and Benefits Expense*

Salaries and benefits expense increased 26% to $36.5 million from $29.0 million. Salaries were higher as overall headcount increased by 10% (1,028 employees as at September 30, 2019 and 1,131 at September 30, 2020). The increase was also the result of $4.8 million of higher compensation earned by commercial sales staff and $0.7 million to increase bonus provisions for residential underwriting staff pursuant to increased origination levels reached in the 2020 third quarter. 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 decreased 49% to $10.6 million from $20.8 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 decreased from the prior year due to the significant decrease in short term lending rates pursuant to the Bank of Canada’s 1.5% rate cut in March 2020.

### *Other Operating Expenses*

Other operating expenses increased by 20% to $13.6 million from $11.3 million. The primary change in other operating expenses was higher hedging costs which increased $2.1 million between the quarters. The expense increased as 30-day interest rates moved down significantly relatively to five and 10 year bond yields making it expensive to borrow the short bonds that the Company uses to hedge interest rate exposure. Without these costs, other operating expenses increased by $0.2 million, reflecting costs to support the growth of the business and MUA particularly information technology costs. Discretionary costs, including promotion, travel and entertainment were lower as a result of the pandemic.

### *Income before Income Taxes and Pre-FMV Income*

Income before income taxes increased by 19% to $98.8 million from $82.8 million in the 2019 third quarter. This increase was partially the result of changing capital markets. As described previously in this MD&A, there are always movements in gains and losses on account of financial instruments. In the 2020 third quarter, the Company recorded $0.9 million of losses on financial instruments (excluding $0.6 million of losses related to mortgage and loan investments). Comparatively, in the 2019 third quarter, the Company recorded $3.0 million of gains on financial instruments (excluding the impact of $1.0 million of losses related to mortgage and loan investments). The change in these values, excluding the losses on mortgage investments, accounted for a $3.9 million decrease in comparative income before income taxes. Pre-FMV Income, which eliminates the impact of such gains and losses on financial instruments, increased by 25% to $99.6 million from $79.8 million. This growth was largely the result of increased origination and higher per unit placement fee revenue such that placement fee revenues net of brokerage fees increased by $24.7 million.

### *Income Tax Expense*

The provision for taxes increased by 18% to $26.3 million from $22.2 million. The provision increased proportionately with net income before income taxes. The overall effective tax rate was slightly lower in 2020 as one of the provinces where the Company operates, reduced its corporate tax rate during the year.

*Other Comprehensive Income*

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 cash flow hedges were effective, the Company recorded \$0.9 million of pre-tax net losses on such hedges in OCI in the third quarter of 2020. These losses would have been recorded as losses on financial instruments under the previous IFRS standard. In the quarter, the Company amortized a portion of these losses and a portion of opening accumulated OCI into regular earnings. In the third quarter of 2020, \$8.1 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 | | | |
|---|---|---|---|---|
| | Residential | | Commercial | |
| | ($000s except percent amounts) | | | |
| **For the Period Ended** | **September 30, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| Originations and renewals | 7,873,360 | 5,888,293 | 2,103,442 | 1,784,388 |
| *Percentage change* | *34%* | | *18%* | |
| Revenue | 258,503 | 281,332 | 115,257 | 81,501 |
| *Percentage change* | *(8%)* | | *41%* | |
| Income before income taxes | 53,957 | 62,920 | 44,810 | 19,858 |
| *Percentage change* | *(14%)* | | *126%* | |
| **As at** | **September 30, 2020** | **December 31, 2019** | **September 30, 2020** | **December 31, 2019** |
| Identifiable assets | 28,876,604 | 28,535,288 | 9,408,524 | 9,120,529 |
| Mortgages under administration | 83,028,219 | 80,709,370 | 34,088,752 | 30,669,521 |

## Residential Segment

Overall residential origination volumes including renewals increased by 34% between the third quarters of 2020 and 2019, while residential revenues decreased by 8%. Revenue growth lagged the growth in origination, due to the reduction in short term interest rates which followed the Bank of Canada's overnight rate cut of 1.5%. This negatively affected both interest revenue – securitized mortgages, and mortgage investment income. Net income before tax was affected by fair value related amounts. Without the impact of these revenues, net income before tax decreased from $60.0 million in the third quarter of 2019 to $54.8 million in 2020, or by 9%. This was largely the result of increased interest expense – securitized mortgages as described earlier in this MD&A which reduced net margin from securitization by approximately $3.3 million. The Company also securitized a higher proportion of its single-family mortgage origination than in the 2019 quarter which slows down the earnings process. Identifiable assets increased from December 31, 2019, as the Company increased its investment in mortgages pledged for securitization by about $570 million and mortgages accumulated for securitization by $480 million. This growth was offset by lower hedging related assets of about $650 million.

## Commercial Segment

Third quarter 2020 commercial revenues increased by about 41% compared to 2019. This increase was the result of higher spread origination which drove a 133% increase in placement fees. Interest revenue on the securitized mortgage portfolio also grew by 13% year over year. Income before income taxes for this segment was not affected by fair value considerations. This measure increased by 126% year over year. The increase is due to the higher revenues offset partially by higher compensation payable to the Company's commercial origination employees. Identifiable assets increased from those at December 31, 2019, as the Company increased its investment in mortgages pledged for securitization by $1.2 billion. These increases were offset by a decrease in mortgage and loan investments of approximately $180 million and hedging related assets of about $700 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, and once again in the COVID-19 crisis, when capital markets were disrupted and only the highest-quality assets were bid. As the Company's results in those years demonstrated, First National was able to attract 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 September 30, 2020, the Company had entered into repurchase transactions with financial institutions to borrow $1.5 billion related to $1.5 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At September 30, 2020, outstanding bank indebtedness was $1,015.1 million (December 31, 2019 – $797.8 million). Together with the unsecured notes of $199 million (December 31, 2019 – $375 million), this "combined debt" was used to fund $809.0 million (December 31, 2019 – $817.5 million) of mortgages accumulated for sale or securitization. At September 30, 2020, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $57.2 million (December 31, 2019 – $42.0 million) and (2) mortgage and loan investments of $213.2 million (December 31, 2019 - $370.4 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 decreased between December 31, 2019, and September 30, 2020, and now stands at $334.1 million (December 31, 2019 – $353.3 million). This represents a debt-to-equity ratio of approximately 0.59:1. This ratio is similar to the ratio of 0.63:1 at December 31, 2019. Despite the small movement between the period end ratios, there were significant movements during the nine-month period. In general, the Company funded large losses on financial instruments, which including OCI, totaled more than $110 million. It also increased its net investment in mortgages pledged under securitization by $100 million in the period. These investments were offset by repayments of $157 million of mortgage and loan investments, primarily related to the Company's commercial bridge loan portfolio, and retained earnings. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

Since being approved as an issuer of NHA-MBS, the Company has funded the difference between the mortgages it uses to create NHA-MBS and the debt obligations it assumes upon issuance. In recent years this requirement has generally been limited to mortgages in arrears where First National does not receive payments from the borrower but is obliged to pay the interest and amortizing principal on the NHA-MBS debt. However, due to the rapid rise in national unemployment pursuant to the COVID-19 pandemic, this funding requirement have increased as more borrowers were unable to make their mortgage payments. From mid March 2020 into June many of the borrowers in the Company's MUA requested payment deferrals. In such situations, the Company determined to grant mortgage payment deferrals. Qualifying borrowers receive three months of payment deferral. In cases of extended hardship, the Company has provided a second three-month deferral after the initial deferral period ends. During this deferral period, a significant portion of such mortgages ceased to amortize and interest otherwise payable will be capitalized to the principal of the mortgage. The three mortgage default insurers have approved these steps, permitting the deferrals to occur without any impact on subsequent claims under the mortgage insurance policies. In turn, First National has been required to make "timely payments" on the NHA-MBS securities. This means that despite not receiving payments from borrowers on the mortgages that support the NHA-MBS, the Company has been required to pay the interest and amortizing principal on the debt. In effect, the Company de-leveraged its balance sheet by paying off the debt while the related mortgages did not as amortize as quickly. At September 30, 2020, the Company estimates that it had reduced its NHA MBS debt by approximately $61 million because of the impact of deferred payments. This has been funded by cash received from the repayment of mortgage and loan investments

Management believes that at its peak the Company granted deferrals to as much as 14% of its single-family borrowers. There have been no significant deferral requests granted to the multi-family segment of borrowers. The Company has significant credit lines and prime mortgage assets that continue to be liquid in turbulent economic times. Such facilities will provide the cash needed to fund this investment in 'timely payments.' For non-securitized MUA, the Company's institutional investors will be required to fund any deferred payments which First National grants to borrowers in that investor's portfolio. The Company's current deferral program ended on September 30, 2020.

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 September 30, 2020, the investment in cash collateral was $94.2 million (December 31, 2019 – $83.6 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 June 30, 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 mortgage 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 September 30, 2020, the Company had over $0.8 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, 2020, the Company had entered into $0.1 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 September 30, 2020, the aggregate notional value of these swaps, maturing between June 2021 and September 2026, was $68.4 million. During the 2020 third quarter, the value of these swaps increased by $0.3 million.

As described above, the Company employs various strategies to reduce interest rate risk. In the normal course of business, the Company also takes on 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 ultimate date of placement or securitization. If credit spreads widen during this holding period, this is unfavorable for the Company. It means that the Company cannot fund the mortgages originated with a funding source as effective as originally intended. Despite entering into effective interest rate hedges, the Company's exposure to credit spreads will remain. This risk is inherent in the Company's business model and the Company believes cannot be economically hedged. As at September 30, 2020, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost $2.2 billion of mortgages that were 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 quarter ended September 30, 2020, 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.

## 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 September 30, 2020, continue to be consistent with those used for the year ended December 31, 2019, and the quarters ended March 31 and June 30, 2020.

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 $1.1 million for the third quarter of 2020.

### *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, 2020, 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.

It became clear to the Company in mid March 2020 that the COVID-19 was highly contagious and it executed its business continuity plan. In this case, the plan called for a "working from home" contingency. Within about one week, approximately 95% of the Company's staff across the country transitioned to "working from home". The COVID-19 crisis has been the cause of significant unemployment across the country and widespread economic hardship. During the duration of this crisis, the probability of the risks listed above having a negative impact on the Company has increased. Related losses could be material.

## 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 27, 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

The 2020 third quarter results exceeded management's expectations. Single-family origination increased by 42% from the comparative volume in 2019 and commercial segment origination increased by 18% despite the pandemic related slowdown in demand for uninsured commercial product. With COVID-19 uncertainties still prevalent, it is difficult to look too far ahead. However, management's outlook turned positive in the second quarter. With the results of the third quarter of 2020 and the short-term view forward, management continues to be very positive about the fourth quarter and the start of 2021. The expectation for the fourth quarter includes: substantially higher seasonal residential origination, commercial segment success in growing origination at higher spreads, and employee productivity from the Company's work from home strategy. During the third quarter, the value of First National's business model was further demonstrated. By designing systems that do not rely on face-to-face interactions, the Company's business practices resonated with mortgage brokers and borrowers alike during the pandemic period. In the third quarter, the commercial segment benefited from reduced competition and First National increased its market share while experiencing wider spreads. Although more and more of the Company's competitors are returning to the market, wider mortgage spreads are persisting. The residential segment is experiencing substantial growth in originations in part due to the disruption that COVID-19 has meant for the traditional bank origination channels. On the funding side, there continues be strong demand from institutional investors as a result of the substantial amount of liquidity in the financial system. Securitization markets have normalized after a period of disruption at the beginning of the crisis. Much like its experience in 2009 coming out of the credit crisis, the Company is now benefiting from the wider mortgage coupons relative to funding costs on new originations. If the wider spreads persist, the Company will continue to benefit from such a period.

While it is not early in the crisis, there is still significant uncertainty about its duration and the extent of repercussions. The outbreak of COVID-19 has resulted in governments worldwide enacting emergency measures to combat the spread of the virus. These measures, which include the implementation of travel bans, self-imposed quarantine periods and physical distancing, have caused material disruption to businesses globally resulting in an economic recession. Global equity markets have experienced significant volatility. Governments and central banks have reacted with significant monetary and fiscal interventions designed to stabilize economic conditions. The duration and impact of the COVID-19 outbreak is unknown at this time, as is the long-term efficacy of the government and central bank interventions. It is not possible to reliably estimate the length and severity of these developments and the impact on the financial results and condition of the Company and its operating subsidiaries in future periods.

When we reported for the second quarter, management described the nature of deferred mortgage payments and the need for cash resources to fund these assets. As of May 11, 2020, the Company had approved mortgage payment deferrals for approximately 13.9% of the Company's single-family mortgages under administration eligible for such an approval. As at October 23, 2020 this number had fallen significantly to stand at approximately 0.7% of the relevant MUA.

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 $34 billion portfolio of mortgages pledged under securitization and $81 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 2020

**First National Financial Corporation**

# Interim condensed consolidated statements of financial position

[Unaudited – in thousands of Canadian dollars]

As at

| | September 30, 2020 | December 31, 2019 |
|---|---|---|
| | $ | $ |
| **Assets** | | |
| Restricted cash *[note 3]* | **598,299** | 681,596 |
| Cash held as collateral for securitization *[note 3]* | **94,163** | 83,587 |
| Accounts receivable and sundry | **125,115** | 131,042 |
| Mortgages accumulated for sale or securitization *[note 5]* | **2,325,793** | 1,918,581 |
| Mortgages pledged under securitization *[note 3]* | **33,785,385** | 31,995,424 |
| Deferred placement fees receivable *[note 4]* | **57,152** | 42,046 |
| Mortgage and loan investments *[note 6]* | **213,170** | 370,414 |
| Securities purchased under resale agreements | **1,074,955** | 2,414,835 |
| Other assets *[note 7]* | **40,872** | 48,068 |
| **Total assets** | **38,314,904** | 37,685,593 |
| **Liabilities and equity** | | |
| **Liabilities** | | |
| Bank indebtedness *[note 9]* | **1,015,081** | 797,758 |
| Obligations related to securities and mortgages sold under repurchase agreements | **1,417,404** | 1,072,062 |
| Accounts payable and accrued liabilities | **133,773** | 149,906 |
| Securities sold short | **1,072,487** | 2,397,325 |
| Debt related to securitized mortgages *[note 10]* | **33,847,014** | 32,245,793 |
| Senior unsecured notes | **199,204** | 374,025 |
| Income taxes payable | **2,104** | 4,764 |
| Deferred income tax liabilities | **66,100** | 82,300 |
| **Total liabilities** | **37,753,167** | 37,123,933 |
| **Equity attributable to shareholders** | | |
| Common shares *[note 11]* | **122,671** | 122,671 |
| Preferred shares *[note 11]* | **97,394** | 97,394 |
| Retained earnings | **376,245** | 345,029 |
| Accumulated other comprehensive loss | **(34,573)** | (3,434) |
| **Total equity** | **561,737** | 561,660 |
| **Total liabilities and equity** | **38,314,904** | 37,685,593 |

*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, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| | $ | $ | $ | $ |
| **Revenue** | | | | |
| Interest revenue – securitized mortgages | **202,366** | 221,103 | **626,773** | 654,722 |
| Interest expense – securitized mortgages | **(167,473)** | (185,250) | **(535,543)** | (553,220) |
| Net interest – securitized mortgages *[note 3]* | **34,893** | 35,853 | **91,230** | 101,502 |
| Placement fees | **98,424** | 69,755 | **233,341** | 157,450 |
| Gains on deferred placement fees *[note 4]* | **12,882** | 3,602 | **23,585** | 8,843 |
| Mortgage investment income | **15,532** | 22,497 | **53,366** | 64,489 |
| Mortgage servicing income | **46,033** | 43,914 | **123,541** | 114,011 |
| Realized and unrealized gains (losses) on financial instruments *[note 12]* | **(1,477)** | 1,962 | **(67,615)** | (15,130) |
| | **206,287** | 177,583 | **457,448** | 431,165 |
| **Expenses** | | | | |
| Brokerage fees | **46,826** | 33,605 | **102,929** | 75,244 |
| Salaries and benefits | **36,500** | 29,042 | **102,330** | 85,942 |
| Interest | **10,594** | 20,845 | **42,965** | 57,854 |
| Other operating | **13,600** | 11,313 | **44,768** | 37,005 |
| | **107,520** | 94,805 | **292,992** | 256,045 |
| **Income before income taxes** | **98,767** | 82,778 | **164,456** | 175,120 |
| Income tax expense | **26,250** | 22,200 | **43,350** | 46,900 |
| **Net income for the period** | **72,517** | 60,578 | **121,106** | 128,220 |
| **Earnings per share** | | | | |
| Basic *[note 11]* | **1.20** | 1.00 | **1.98** | 2.10 |

*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, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| | $ | $ | $ | $ |
| **Net income for the period** | **72,517** | 60,578 | **121,106** | 128,220 |
| **Other comprehensive income (loss) items** | | | | |
| **items that may be subsequently reclassified to income** | | | | |
| Net losses from change in fair value of cash flow hedges | **(916)** | (14,260) | **(74,112)** | (39,780) |
| Reclassification of net losses to income | **8,112** | 14,666 | **31,773** | 26,551 |
| | **7,196** | 406 | **(42,339)** | (13,229) |
| Income tax recovery (expense) | **(1,900)** | (100) | **11,200** | 3,500 |
| Total other comprehensive income (loss) | **5,296** | 306 | **(31,139)** | (9,729) |
| **Total comprehensive income for the period** | **77,813** | 60,884 | **89,967** | 118,491 |

**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 loss | Total equity |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| Balance as at January 1, 2020 | **122,671** | **97,394** | **345,029** | **(3,434)** | **561,660** |
| Net income | **—** | **—** | **121,106** | **—** | **121,106** |
| Other comprehensive loss | **—** | **—** | **—** | **(31,139)** | **(31,139)** |
| Dividends paid or declared | **—** | **—** | **(89,890)** | **—** | **(89,890)** |
| **Balance as at September 30, 2020** | **122,671** | **97,394** | **376,245** | **(34,573)** | **561,737** |

| | Common shares | Preferred shares | Retained earnings | Accumulated other comprehensive loss | Total equity |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| Balance as at January 1, 2019 | 122,671 | 97,394 | 315,294 | (3,116) | 532,243 |
| Net income | — | — | 128,220 | — | 128,220 |
| Other comprehensive loss | — | — | — | (9,729) | (9,729) |
| Dividends paid or declared | — | — | (87,747) | — | (87,747) |
| **Balance as at September 30, 2019** | 122,671 | 97,394 | 355,767 | (12,845) | 562,987 |

**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, 2020** | September 30, 2019 | **September 30, 2020** | September 30, 2019 |
| | **$** | $ | **$** | $ |
| **Operating activities** | | | | |
| Net income for the period | **72,517** | 60,578 | **121,106** | 128,220 |
| Add (deduct) items | | | | |
| Decrease (increase) in deferred income taxes | **4,900** | 4,100 | **(5,000)** | 1,600 |
| Non-cash portion of gains on deferred placement fees | **(12,616)** | (3,469) | **(22,938)** | (8,564) |
| Decrease (increase) in restricted cash | **112,315** | 32,149 | **83,297** | (131,393) |
| Net investment in mortgages pledged under securitization | **(84,645)** | (281,936) | **(1,717,718)** | (984,548) |
| Net increase (decrease) in debt related to securitized mortgages | **(43,875)** | 221,574 | **1,528,978** | 1,075,752 |
| Securities purchased under resale agreements, net | **1,180,519** | (137,414) | **1,339,880** | (252,453) |
| Securities sold short, net | **(1,135,046)** | 168,707 | **(1,436,734)** | 254,898 |
| Amortization of deferred placement fees receivable | **2,621** | 2,573 | **7,832** | 7,864 |
| Amortization of property, plant and equipment | **2,528** | 1,855 | **7,583** | 5,565 |
| Unrealized losses (gains) on financial instruments | **(32,333)** | (29,683) | **61,369** | (15,735) |
| | **66,885** | 39,034 | **(32,345)** | 81,206 |
| Net change in non-cash working capital balances related to operations | **(479,164)** | 238,512 | **(407,612)** | 215,155 |
| **Cash provided by (used in) operating activities** | **(412,279)** | 277,546 | **(439,957)** | 296,361 |
| **Investing activities** | | | | |
| Additions to property, plant and equipment | **(56)** | (754) | **(387)** | (5,900) |
| Investment (repayment) of cash held as collateral for securitization | **17,861** | (5,012) | **(10,576)** | (1,436) |
| Investment in mortgage and loan investments | **(222,802)** | (162,222) | **(498,849)** | (822,483) |
| Repayment of mortgage and loan investments | **202,303** | 289,175 | **652,093** | 827,865 |
| **Cash provided by (used in) investing activities** | **(2,694)** | 121,187 | **142,281** | (1,954) |
| **Financing activities** | | | | |
| Dividends paid | **(29,995)** | (29,247) | **(89,989)** | (87,733) |
| Obligations related to securities and mortgages sold under repurchase agreements | **486,442** | (420,671) | **345,342** | (327,840) |
| Repayment of senior unsecured notes | **—** | — | **(175,000)** | — |
| **Cash provided by (used in) financing activities** | **456,447** | (449,918) | **80,353** | (415,573) |
| **Net decrease (increase) in bank indebtedness, during the period** | **41,474** | (51,185) | **(217,323)** | (121,166) |
| Bank indebtedness, beginning of period | **(1,056,555)** | (988,328) | **(797,758)** | (918,347) |
| **Bank indebtedness, end of period** | **(1,015,081)** | (1,039,513) | **(1,015,081)** | (1,039,513) |
| **Supplemental cash flow information** | | | | |
| Interest received | **241,445** | 264,343 | **751,617** | 777,049 |
| Interest paid | **170,717** | 196,392 | **562,118** | 582,083 |
| Income taxes paid | **32,325** | 14,028 | **51,009** | 38,114 |

# Notes to interim condensed consolidated financial statements

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

September 30, 2020

## 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 residential [single family and multi unit] and commercial mortgages. With over $117 billion in mortgages under administration as at September 30, 2020, FNFLP is 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. 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, 2019.

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 27, 2020.

### Estimates and Use of Judgement

Management has exercised judgement in the process of applying the Company's accounting policies. Some of the Company's accounting policies require subjective, complex judgements and estimates relating to matters that are inherently uncertain. The preparation of these interim condensed consolidated financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the consolidated balance sheet dates and the reported amounts of revenue and expenses during the reporting periods.

The global pandemic related to an outbreak of COVID-19 has cast additional uncertainty on the assumptions used by management in making its judgements and estimates. Governments and central banks have reacted with significant monetary and fiscal interventions designed to stabilize economic conditions. The duration and impact of the COVID-19 outbreak is unknown at this time, as is the efficacy of the government and central bank interventions. It is not possible to reliably estimate the length and severity of these developments and the impact on the financial results and condition of the Corporation and its operating subsidiaries in future periods. Given that the full extent of the impact that COVID-19, including government and/or regulatory responses to the outbreak, will have on the Canadian economy and the Company's business is highly uncertain and difficult to predict at this time, there is a higher level of uncertainty with respect to management's judgements and estimates related to the fair value of mortgage and loan investments and the amount of expected credit losses for uninsured residential mortgages.

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

### 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, 2020, the cash held as collateral for securitization was $94,163 [December 31, 2019 – $83,587].

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

| | **September 30, 2020** | | **December 31, 2019** | |
|---|---|---|---|---|
| | **Carrying amount of securitized mortgages** | **Carrying amount of associated liabilities** | **Carrying amount of securitized mortgages** | **Carrying amount of associated liabilities** |
| | $ | $ | $ | $ |
| Securitized mortgages | **33,472,841** | **(33,810,578)** | 31,776,442 | (32,303,342) |
| Capitalized amounts related to hedge accounting | **132,367** | **(115,660)** | 43,280 | (43,418) |
| Capitalized origination costs | **180,177** | **—** | 175,702 | — |
| Debt discounts | — | **79,224** | — | 100,967 |
| | **33,785,385** | **(33,847,014)** | 31,995,424 | (32,245,793) |
| **Add** | | | | |
| Principal portion of payments held in restricted cash | **544,687** | **—** | 623,253 | — |
| | **34,330,072** | **(33,847,014)** | 32,618,677 | (32,245,793) |

# Notes to interim condensed consolidated financial statements

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

September 30, 2020

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 are as follows:

| | **2020**<br>$ | **2019**<br>$ |
|---|---|---|
| **Opening balance, June 30** | **181,716** | 170,082 |
| Add: new origination costs capitalized in the period | **20,340** | 22,824 |
| Less: amortization in the period | **(21,879)** | (20,604) |
| **Ending balance, September 30** | **180,177** | 172,302 |

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

| | **September 30, 2020**<br>$ | **December 31, 2019**<br>$ |
|---|---|---|
| **Arrears days** | | |
| 31 to 60 | **2,693** | 3,098 |
| 61 to 90 | **1,110** | 416 |
| Greater than 90 | **6,494** | 4,464 |
| | **10,297** | 7,978 |

All the mortgages listed above are insured, except for ten mortgages which are uninsured and have a principal balance of $2,678 as at September 30, 2020 [December 31, 2019 – five mortgages, $874]. The Company's exposure to credit loss is limited to uninsured mortgages with principal balances totaling $2,318,216 [December 31, 2019 – $1,975,154], before consideration of the value of underlying collateral. The majority of such mortgages are conventional prime single-family mortgages, with an 80% or less loan to value ratio at origination and verified borrower income. The Company has provided an allowance of $2,543 as of September 30, 2020 [December 31, 2019 – $214].

In order to assist its borrowers during the COVID-19 pandemic, in the first quarter of 2020, the Company started providing up to three months of payment deferrals to all single-family mortgagors applying for payment relief because of temporary hardship resulting from the pandemic. In the second and third quarters, the Company granted extensions to the original three months period to certain borrowers based on additional due diligence. The payment deferral program ended September 30, 2020. Interest continues to accrue on these mortgages and the interest otherwise collectible is capitalized to the mortgage's principal. As the deferral is provided temporarily in keeping with a larger industry wide relief program, the Company does not consider these mortgages to be in arrears for ECL disclosure purposes. As of September 30, 2020, the Company had permitted $61,476 of payment deferrals related to mortgages pledged under securitization. A small portion of this amount has amortized down during the quarter as the affected mortgages have matured, refinanced or resumed regular payments such that the deferred payment balance are being repaid over the amortization of the mortgage. As at October 26, 2020, the Company had permitted $61,057 of payment deferrals related to mortgages pledged under securitization.

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

## 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.

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 but is expected to be minimal.

During the three months ended September 30, 2020, $1,071,623 [2019 – $731,476] of mortgages were placed with institutional investors which created gains on deferred placement fees of $12,882 [2019 – $3,602]. Cash receipts on deferred placement fees receivable for the three months ended September 30, 2020 were $3,169 [2019 – $3,966].

## 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, 2020** | **December 31, 2019** |
|---|---|---|
| | $ | $ |
| Mortgages accumulated for securitization | **2,221,761** | 1,884,571 |
| Mortgages accumulated for sale | **104,032** | 34,010 |
| | **2,325,793** | 1,918,581 |

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

The Company's exposure to credit loss is limited to $463,960 [December 31, 2019 – $587,465] of principal balances of uninsured mortgages within mortgages accumulated for sale or securitization, before consideration of the value of underlying collateral. As at September 30, 2020, none of these mortgages is in arrears past 31 days. These are primarily 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.

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 unrealized losses on account of fair value of $600 [2019 – $1,000] for the quarter ended September 30, 2020.

The portfolio contains $7,528 [December 31, 2019 – $18,209] of insured mortgages and $205,642 [December 31, 2019 – $352,205] of uninsured mortgage and loan investments as at September 30, 2020. Of the uninsured mortgages, approximately $35,080 [December 31, 2019 – $35,014] have principal balance in arrears past 31 days. Three of these mortgages are non-performing and the Company has stopped interest on accrual. These mortgages had a total original principal balance of $38,421 and are recorded at fair value of $8,729 as at September 30, 2020 [December 31, 2019 – three mortgages, original principal balance of $38,825, and fair value of $13,133].

## 7. Other assets

The components of other assets are as follows as at September 30:

| | 2020<br>$ | 2019<br>$ |
|---|---|---|
| Property, plant and equipment, net | **6,480** | 11,029 |
| Right-of-use assets | **4,616** | 7,263 |
| Goodwill | **29,776** | 29,776 |
| | **40,872** | 48,068 |

The right-of-use assets pertain to five premises leases for the Company's office space across the country. The leases have terms of two to five years remaining. The related lease liability of $4,815 [December 31, 2019 – $7,466] is grouped with accounts payable and accrued liabilities on the interim condensed consolidated statements of financial position.

The recoverable amount of the company's goodwill is calculated by reference to the Company's market capitalization, mortgages under administration, origination volume, and profitability. These factors indicate that the Corporation's recoverable amount exceeds the carrying value of its net assets and accordingly, goodwill is not impaired.

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

### 8. Mortgages under administration

As at September 30, 2020, the Company managed mortgages under administration of $117,116,971 [December 31, 2019 – $111,378,891], 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, 2020, the Company administered 345,136 mortgages [December 31, 2019 – 310,415] for 104 institutional investors [December 31, 2019 – 108] with an average remaining term to maturity of 41 months [December 31, 2019 – 40 months].

Mortgages under administration are serviced as follows:

| | **September 30, 2020** | **December 31, 2019** |
|---|---|---|
| | $ | $ |
| Institutional investors | **79,378,482** | 76,040,779 |
| Mortgages accumulated for sale or securitization and mortgage and loan investments | **2,564,918** | 2,306,608 |
| Mortgages pledged under securitization | **33,472,841** | 31,776,442 |
| CMBS conduits | **1,700,730** | 1,255,062 |
| | **117,116,971** | 111,378,891 |

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.

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, 2020 was $702,566 [December 31, 2019 – $690,394].

### 9. Bank indebtedness

Bank indebtedness includes a revolving credit facility of $1,250,000 [December 31, 2019 – $1,250,000] maturing in March 2024. At September 30, 2020, $1,015,081 [December 31, 2019 – $797,758] 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.

# Notes to interim condensed consolidated financial statements

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

September 30, 2020

## 10. Debt related to securitized mortgages

Debt related to securitized mortgages represents the funding for mortgages pledged under the NHA-MBS, CMB and ABCP programs. As at September 30, 2020, debt related to securitized mortgages was $33,847,014 [December 31, 2019 – $32,245,793], net of unamortized discount of $79,224 [December 31, 2019 – $100,967]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

Debt related to securitized 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.

## 11. 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, 2019 and September 30, 2020 | **59,967,429** | **122,671** | **4,000,000** | **97,394** |

### [c] Earnings per share

| | Three months ended | | Nine months ended | |
|---|---|---|---|---|
| | **September 30, 2020** | **September 30, 2019** | **September 30, 2020** | **September 30, 2019** |
| | $ | $ | $ | $ |
| Net income attributable to shareholders | **72,517** | 60,578 | **121,106** | 128,220 |
| Less: dividends declared on preferred shares | **(666)** | (767) | **(2,188)** | (2,294) |
| Net earnings attributable to common shareholders | **71,851** | 59,811 | **118,918** | 125,926 |
| Number of common shares outstanding | **59,967,429** | 59,967,429 | **59,967,429** | 59,967,429 |
| Basic earnings per common share | **1.20** | 1.00 | **1.98** | 2.10 |

## 12. 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**

Mortgages and loan investments are measured at FVTPL. The fair value of these mortgages is based on non-observable inputs, and is measured at management's best estimated of the net realizable value.

**[b] Deferred placement fees receivable**

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

**[c] Securities owned and sold short**

The fair values of securities owned and sold short used by the Company to hedge its interest rate exposure are determined by quoted prices on a secondary market.

**[d] Servicing liability**

The fair value of the servicing liability is determined by internal valuation models using market data inputs, where possible. The fair value is determined by discounting the expected future cost related to the servicing 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.

**[e] Other financial assets and financial liabilities**

The fair value 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.

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

### [f] Fair value of financial instruments not carried at fair value

The fair value of these financial instruments are determined by discounting projected cash flows using market industry pricing practices, including the rate of unscheduled prepayment. 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. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3], and are calculated for disclosure purposes only.

**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 $33,785,385 [December 31, 2019 – $31,995,424] and a fair value of $35,841,947 [December 31, 2019 – $32,831,505], debt related to securitized mortgages, which has a carrying value of $33,847,014 [December 31, 2019 – $32,245,793] and a fair value of $34,570,481 [December 31, 2019 – $31,831,691], and senior unsecured notes, which have a carrying value of $199,204 [December 31, 2019 – $374,025] and a fair value of $204,120 [December 31, 2019 – $375,916]. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3].

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

| | September 30, 2020 | | | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| | $ | $ | $ | $ |
| **Financial assets** | | | | |
| Mortgages accumulated for sale | — | **104,032** | — | **104,032** |
| Mortgage and loan investments | — | — | **213,170** | **213,170** |
| Interest rate swaps | — | **26,034** | — | **26,034** |
| **Total financial assets** | — | **130,066** | **213,170** | **343,236** |
| **Financial liabilities** | | | | |
| Securities sold short | — | **1,072,487** | — | **1,072,487** |
| **Total financial liabilities** | — | **1,072,487** | — | **1,072,487** |

# Notes to interim condensed consolidated financial statements

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

September 30, 2020

| | December 31, 2019 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | $ | $ | $ | $ |
| **Financial assets** | | | | |
| Mortgages accumulated for sale | — | 34,010 | — | 34,010 |
| Mortgage and loan investments | — | — | 370,414 | 370,414 |
| Interest rate swaps | — | 29,970 | — | 29,970 |
| **Total financial assets** | — | 63,980 | 370,414 | 434,394 |
| **Financial liabilities** | | | | |
| Securities sold short | — | 2,397,325 | — | 2,397,325 |
| Interest rate swaps | — | 1,870 | — | 1,870 |
| **Total financial liabilities** | — | 2,399,195 | — | 2,399,195 |

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, 2020 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 $600 [2019 – $1,000]. 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.

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 losses of $35,026 [2019 – gains of $39,679] of the Company's financial assets and financial liabilities for the three months ended September 30, 2020 and 2019, all of which have been classified as FVTPL:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2020 | 2019 | 2020 | 2019 |
| | $ | $ | $ | $ |
| FVTPL mortgages | **(600)** | (1,000) | **(4,000)** | (3,600) |
| Securities sold short | **(1,127)** | 3,508 | **(75,803)** | (14,200) |
| Interest rate swaps | **250** | (546) | **12,188** | 2,670 |
| | **(1,477)** | 1,962 | **(67,615)** | (15,130) |

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

**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 nine months ended September 30, 2020 and 2019. 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 January 1, 2020** $ | **Investments** $ | **Unrealized losses recorded in income** $ | **Payment and amortization** $ | **Fair value as at September 30, 2020** $ |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Mortgage and loan investments | **370,414** | **144,360** | **(4,000)** | **(297,604)** | **213,170** |

| | **Fair value as at January 1, 2019** $ | **Investments** $ | **Unrealized losses recorded in income** $ | **Payment and amortization** $ | **Fair value as at September 30, 2019** $ |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Mortgage and loan investments | 188,666 | 270,503 | (3,600) | (275,885) | 179,684 |

## 13. Capital management

The Company's objective is to maintain a 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 common share capital and retained earnings. FNFLP 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, 2020, the ratio was 2.02:1 [December 31, 2019 – 1.91:1]. The Company was in compliance with the bank covenant throughout the period.

# Notes to interim condensed consolidated financial statements

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

September 30, 2020

## 14. 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, 2020** | | | **Nine months ended September 30, 2020** | | |
|---|---|---|---|---|---|---|
| | **Residential** | **Commercial** | **Total** | **Residential** | **Commercial** | **Total** |
| | $ | $ | $ | $ | $ | $ |
| **Revenue** | | | | | | |
| Interest revenue – securitized mortgages | **140,089** | **62,277** | **202,366** | **444,410** | **182,363** | **626,773** |
| Interest expense – securitized mortgages | **(116,588)** | **(50,885)** | **(167,473)** | **(385,862)** | **(149,681)** | **(535,543)** |
| Net interest – securitized mortgages | **23,501** | **11,392** | **34,893** | **58,548** | **32,682** | **91,230** |
| Placement and servicing | **108,045** | **49,294** | **157,339** | **273,795** | **106,672** | **380,467** |
| Mortgage investment income | **11,246** | **4,286** | **15,532** | **35,590** | **17,776** | **53,366** |
| Realized and unrealized losses on financial instruments | **(877)** | **(600)** | **(1,477)** | **(63,615)** | **(4,000)** | **(67,615)** |
| | **141,915** | **64,372** | **206,287** | **304,318** | **153,130** | **457,448** |
| **Expenses** | | | | | | |
| Amortization | **2,289** | **239** | **2,528** | **6,865** | **718** | **7,583** |
| Interest | **8,938** | **1,656** | **10,594** | **32,448** | **10,517** | **42,965** |
| Other operating | **76,731** | **17,667** | **94,398** | **192,679** | **49,765** | **242,444** |
| | **87,958** | **19,562** | **107,520** | **231,992** | **61,000** | **292,992** |
| **Income before income taxes** | **53,957** | **44,810** | **98,767** | **72,326** | **92,130** | **164,456** |
| Identifiable assets | **28,876,604** | **9,408,524** | **38,285,128** | **28,876,604** | **9,408,524** | **38,285,128** |
| Goodwill | | | **29,776** | | | **29,776** |
| **Total assets** | **28,876,604** | **9,408,524** | **38,314,904** | **28,876,604** | **9,408,524** | **38,314,904** |
| **Capital expenditures** | **39** | **17** | **56** | **271** | **116** | **387** |

# Notes to interim condensed consolidated financial statements

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

September 30, 2020

| | Three months ended September 30, 2019 | | | Nine months ended September 30, 2019 | | |
|---|---|---|---|---|---|---|
| | Residential | Commercial | Total | Residential | Commercial | Total |
| | $ | $ | $ | $ | $ | $ |
| **Revenue** | | | | | | |
| Interest revenue – securitized mortgages | 166,226 | 54,877 | 221,103 | 494,643 | 160,079 | 654,722 |
| Interest expense – securitized mortgages | (139,419) | (45,831) | (185,250) | (420,028) | (133,192) | (553,220) |
| Net interest – securitized mortgages | 26,807 | 9,046 | 35,853 | 74,615 | 26,887 | 101,502 |
| Placement and servicing | 95,248 | 22,023 | 117,271 | 222,676 | 57,628 | 280,304 |
| Mortgage investment income | 16,896 | 5,601 | 22,497 | 45,111 | 19,378 | 64,489 |
| Realized and unrealized gains (losses) on financial instruments | 2,962 | (1,000) | 1,962 | (11,506) | (3,624) | (15,130) |
| | 141,913 | 35,670 | 177,583 | 330,896 | 100,269 | 431,165 |
| **Expenses** | | | | | | |
| Amortization | 1,819 | 36 | 1,855 | 5,078 | 487 | 5,565 |
| Interest | 16,958 | 3,887 | 20,845 | 44,189 | 13,665 | 57,854 |
| Other operating | 60,216 | 11,889 | 72,105 | 156,751 | 35,875 | 192,626 |
| | 78,993 | 15,812 | 94,805 | 206,018 | 50,027 | 256,045 |
| **Income before income taxes** | 62,920 | 19,858 | 82,778 | 124,878 | 50,242 | 175,120 |
| Identifiable assets | 28,796,254 | 8,423,113 | 37,219,367 | 28,796,254 | 8,423,113 | 37,219,367 |
| Goodwill | — | — | 29,776 | — | — | 29,776 |
| **Total assets** | 28,796,254 | 8,423,113 | 37,249,143 | 28,796,254 | 8,423,113 | 37,249,143 |
| **Capital expenditures** | 526 | 228 | 754 | 4,130 | 1,770 | 5,900 |

## 15. Related party and other transactions

The Company has servicing contracts in connection with commercial mezzanine mortgages originated by the Company and 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 $7,175 of new mortgages for the related parties. The related parties also funded several progress draws totaling $3,583 on existing mortgages originated by the Company. All such mortgages, which are administered by the Company, have a balance of $153,742 as at September 30, 2020 [December 31, 2019 – $188,968]. As at September 30, 2020, 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, 2020 was $726 [2019 – $1,043], net of third-party investor reimbursement.

## 16. Comparative unaudited interim condensed consolidated financial statements

Certain comparative figures have been reclassified to conform to the current period's presentation.

# 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@firstnational.ca

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