FIRST NATIONAL

FINANCIAL CORPORATION

# Report to Shareholders

# Period Ended March 31, 2019

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

**Fellow Shareholders:**

First National remained profitable in the first quarter (three months ended March 31, 2019) despite tighter mortgage spreads, a turbulent interest rate environment and a reduction in single-family originations.

As expected, residential mortgage market activity was naturally lower due to seasonality, and the year-over-year comparison was made worse by an artificially high level of mortgage closings in the same period last year when home purchases completed prior to the implementation of new B-20 Guidelines were funded. This is disappointing, but as we ended the quarter, the tempo of single-family residential originations increased and while we expect tight securitization margins to remain a factor this year, recent volumes done at more attractive spreads cause us to feel more positive.

The quarter's key financial metrics were as follows:

- Mortgages Under Administration increased 5% to $107.0 billion
- Revenue increased 12% to $286.3 million
- Net income was $23.5 million ($0.38 per share) compared to $35.9 million ($0.59 per common share) a year ago
- Common share dividends amounted to $28.5 million compared to $27.7 million in the first quarter of 2018, reflecting a dividend increase in December 2018 that brought the annualized rate to $1.90 per share

Looking at mortgage originations, single-family volumes in Eastern Canada were almost on par with last year, but this was due to the contribution made by our *Excalibur* program, which addresses the Ontario alternative mortgage market. Conversely, prime mortgage volumes in Western Canada dipped 35%. Despite these results, First National's single-family national market share held steady. In commercial, where First National is Canada's largest mortgage lender, total originations including renewals were 17% higher.

Looking ahead, the Company will continue to generate income and cash flow from its $31 billion portfolio of mortgages pledged under securitization and $74 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.

**Yours sincerely,**

Stephen Smith
Chairman and Chief Executive Officer

Moray Tawse
Executive Vice President

## MANAGEMENT'S DISCUSSION AND ANALYSIS

*The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of April 30, 2019. 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 March 31, 2019. The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").*

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

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

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

### General Description of the Company

First National Financial Corporation is the parent company of First National Financial LP ("FNFLP"), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over $107 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.

## First Quarter 2019 Results Summary

Management is somewhat disappointed with the results of the first quarter of 2019. Single family origination decreased 15% in the first quarter of 2019. Combined with commercial segment origination and steady renewals, total origination was lower by 5% in the quarter compared to 2018. With tighter mortgage spreads and a turbulent interest rate environment, Pre-FMV earnings decreased by 20%.

- MUA grew to $107.0 billion at March 31, 2019 from $102.2 billion at March 31, 2018, an increase of 5%; the growth from December 31, 2018, when MUA was $106.2 billion, was 3% on an annualized basis;
- Total new single-family mortgage origination was $1.8 billion in the first quarter of 2019 compared to $2.2 billion in the 2018 comparative quarter, a decrease of 15%. The Company attributes this to the effect of new B-20 guidelines. When these rule changes were announced but not yet implemented, it was apparent that mortgage borrowing activity increased as housing buyers accelerated their purchase decision in order to avoid the consequences of the new B-20 rules which became effective January 1, 2018. This phenomenon increased mortgage commitments in late 2017. These commitments resulted in higher mortgage closings in the first quarter of 2018. In the first quarter of 2019, not only was there no such acceleration, but the quarter bore the full impact of the B-20 guidelines which generally reduce housing affordability. Volume related to the Company's alternative lending product, Excalibur, offset the decrease in Ontario. The commercial segment had a steady start to the year with origination of $1.2 billion, the same as originated in the first quarter of 2018. Overall new origination decreased by 10% in the quarter compared to the first quarter of 2018;
- The Company took advantage of opportunities in the quarter to renew $0.9 billion of single-family mortgages. In 2018 first quarter, the Company renewed $1.0 billion of single-family mortgages. For the commercial segment, renewals increased to $386 million from $152 million;
- Revenue for first quarter of 2019 increased by 12% to $286.3 million from $256.7 million in the first quarter of 2018. The increase is related to the comparatively higher interest rate environment which began in mid-2017. Because of higher interest rates in recent years, mortgages added to the portfolio of securitized mortgages in those years have higher interest rates than the average rates of the mortgages maturing in the securitized portfolio. Interest revenue on securitized mortgages increased by $30.4 million between the quarters. However, because of changing interest rates, which fell rapidly during the first quarter of 2019, the Company incurred losses on financial instruments of $8.6 million compared to losses of $0.8 million in the first quarter of 2018;
- Income before income taxes decreased to $32.1 million in the first quarter of 2019 from $49.3 million in the first quarter 2018. A significant reason for the decrease was changing capital markets conditions. In aggregate, the impact from financial instruments decreased this measure by $7.8 million comparing the first quarter of 2019 to the 2018 quarter; and
- The Company's earnings before income taxes, depreciation and amortization and gains and losses on financial instruments ("Pre-FMV EBITDA") for the first quarter of 2019 decreased by 20% to $40.2 million from $50.4 million in the 2018 quarter. This measure was lower largely due to tighter securitization margins - the result of competitive forces in the marketplace – and the accounting convention used for economic hedges prior to 2018. Not only were mortgages securitized in 2017 and 2018 at tight spreads, but interest rates increased so that the Company recorded significant gains on financial instruments. Those gains were deducted to calculate Pre-FMV EBITDA in those years. However, the offset is more expensive securitization related debt. These factors combine to reduce net securitization interest by $7.3 million when comparing the two quarters. The results were exacerbated by lower single-family volumes and a flat yield curve which increased the costs of carrying mortgages accumulated for securitization on the balance sheet prior to securitization.

## Selected Quarterly Information

*Quarterly Results of First National Financial Corporation*

($000s, except per share amounts)

| | Revenue | Net Income for the period | Pre-FMV EBITDA for the period (1) | Net Income per Common Share | Total Assets |
|---|---|---|---|---|---|
| **2019** | | | | | |
| First Quarter | $286,311 | $23,478 | $40,225 | $0.38 | $36,193,793 |
| **2018** | | | | | |
| Fourth Quarter | $312,039 | $32,220 | $55,780 | $0.53 | $36,038,527 |
| Third Quarter | $321,835 | $51,958 | $62,989 | $0.85 | $35,597,827 |
| Second Quarter | $290,935 | $46,347 | $56,048 | $0.76 | $35,794,066 |
| First Quarter | $256,701 | $35,902 | $50,368 | $0.59 | $33,846,283 |
| **2017** | | | | | |
| Fourth Quarter | $270,015 | $45,948 | $61,093 | $0.75 | $32,776,278 |
| Third Quarter | $284,315 | $58,809 | $51,826 | $0.96 | $31,548,130 |
| Second Quarter | $292,200 | $68,768 | $68,275 | $1.13 | $30,832,883 |

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

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

Generally, in the years after the credit crisis in 2008, the Company grew its origination volumes which provided larger servicing and securitization portfolios. To the extent the Company employed securitization strategies, net interest margins were locked in for five- and ten-year terms. These margins were wide in 2008 as financial institutions maintained mortgage rates despite a significant drop in the cost of funds. Since 2008, such margins have steadily declined with competitive pressures and new securitizations are at much tighter spreads. For the Company this has meant that as high spread securitization transactions have matured and been replaced with new securitizations, profitability has decreased. This trend is evident in the Pre-FMV EBITDA figures above. In the third quarter 2017, Pre-FMV EBITDA was lower than expected as placement fees were negatively affected by a rising interest rate environment. The Company earned $14.4 million as a gain on holding short bonds in the second quarter 2017. Consistent with the Company's reporting practice, this amount was deducted from earnings to determine Pre-FMV EBITDA. However, this gain reduced the value of the hedged mortgages and when these were placed in the third quarter 2017, earnings were negatively affected. In the first quarter of 2019, Pre-FMV EBITDA was lower than the first quarter of 2018 due primarily to securitization spreads which have tightened significantly over the past several years.

## Outstanding Securities of the Corporation

At March 31, 2019 and April 30, 2019, the Corporation had 59,967,429 common shares; 2,887,147 Class A preference shares, Series 1; 1,112,853 Class A preference shares, Series 2; and 175,000 April 2020 senior unsecured notes outstanding.

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

($000s, except per share amounts)

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| **For the Year ended December 31,**<br>Income Statement Highlights | | | |
| Revenue | 1,181,510 | 1,078,768 | 1,049,818 |
| Interest expense – securitized mortgages | (646,069) | (511,939) | (495,681) |
| Brokerage fees | (75,354) | (83,260) | (103,719) |
| Salaries, interest and other operating expenses | (227,739) | (193,032) | (169,129) |
| Deduct: realized and unrealized gains on financial instruments | (3,162) | (56,259) | (27,750) |
| Deduct: unrealized losses regarding mortgage investments | (4,000) | — | — |
| Pre-FMV EBITDA(1) | 225,186 | 234,278 | 253,539 |
| Amortization of intangible and capital assets | (4,931) | (5,135) | (7,160) |
| Add: realized and unrealized gains on financial instruments excluding those on mortgage investments | 7,162 | 56,259 | 27,750 |
| Provision for income taxes | (60,990) | (75,750) | (72,300) |
| Net income | 166,427 | 209,652 | 201,829 |
| Common share dividends declared | 171,407 | 184,400 | 98,946 |
| Per Share Highlights | | | |
| Net income per common share | 2.73 | 3.42 | 3.28 |
| Dividends per common share | 2.86 | 3.08 | 1.65 |
| **At Year End**<br>Balance Sheet Highlights<br>Total assets | 36,038,527 | 32,776,278 | 30,394,465 |
| Total long-term financial liabilities | 174,829 | 174,693 | 174,556 |

Notes:

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

## Vision and Strategy

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

## Key Performance Drivers

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

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

## Growth in Portfolio of Mortgages under Administration

Management considers the growth in MUA to be a key element of the Company's performance. The portfolio grows in two ways: through mortgages originated by the Company and through third-party mortgage servicing contracts. Mortgage originations not only drive revenues from placement and interest from securitized mortgages, but perhaps more importantly, longer-term value from servicing rights, renewals and the growth of the customer base for marketing initiatives. As at March 31, 2019, MUA totalled $107.0 billion, up from $102.2 billion at March 31, 2018, an increase of 5%. The growth of MUA in the first quarter of 2019 on an annualized basis was 3%.

## Growth in Origination of Mortgages

### *Direct origination by the Company*

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. Increased origination satisfies demand from its institutional customers and produces volume for the Company's own securitization programs. In the first quarter of 2019, the Company's single-family origination declined across the country. The Company believes this is the result of OSFI guideline B-20 which bolstered first quarter 2018 volumes but hindered those in 2019. The impact had different results across the regions: Toronto (-1%), Vancouver (-35%), Calgary (-36%) and Montreal (-5%). In aggregate, the Company's single-family origination decreased in the first quarter of 2019 by 15%. The commercial segment remained solid with volume consistent with that recorded in the 2018 first quarter. Together, overall new origination for the first quarter of 2019 decreased 10% year over year.

### *Third Party Mortgage Underwriting and Fulfillment Processing Services*

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

### *Relaunch of Excalibur Mortgage Products*

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

## 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. The facility bears interest at floating rates and matures in March 2023. The Company has elected to undertake this debt for a number of reasons: (1) the facility provides the amount of debt required to fund mortgages originated for securitization purposes; (2) the debt is revolving and can be used and repaid as the Company requires, providing more flexibility than the senior unsecured notes, which are fully drawn during their term; (3) the five-year remaining term gives the Company a committed facility for the medium term; and (4) the cost of borrowing reflects the Company's BBB issuer rating.

### *Preferred Share Issuance*

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

## Employing Securitization Transactions to Minimize Funding Costs

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

The Company has 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 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 - 2013 | 1.79% |
| 2014 | 1.57% |
| 2015 | 1.87% |
| 2016 | 1.76% |
| 2017 | 1.36% |
| 2018 | 1.36% |
| 2019 first quarter | 1.67% |

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels; however, in 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. This trend continued into 2016, as optimism about the economy was mixed such that spreads remained at levels in excess of 1.8%. In 2017 and 2018, economic information was favorable and competition was strong such that spreads were the tightest seen in the past decade. With renewed worries about global economics, interest rates on government debt decreased suddenly in the first quarter of 2019. Mortgage rates stayed relatively higher as lenders delayed reducing profit margins in an unsettled economy. While this wider spread period may not last for long, the value of securitization is currently more pronounced that it has been in the past two years. In the first quarter of 2019, the Company originated and renewed for securitization purposes approximately $1.4 billion of single-family mortgages and $0.3 billion of multi-unit residential mortgages. In the first quarter of 2019, the Company securitized through NHA-MBS approximately $1.8 billion of single-family mortgages and $0.2 billion of multi-unit residential mortgages.

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

*Canada Mortgage Bonds Program*

The CMB program is an initiative sponsored by CMHC whereby the CHT issues securities to investors in the form of semi-annual interest-yielding five- and 10-year bonds. Pursuant to the Company's approval as a seller into the CMB, the Company is able to make direct sales into the program. The ability to sell into the CMB has given the Company access to lower costs of funds on both single-family and multi-family mortgage securitizations. Because of the effectiveness of the CMB, many institutions have indicated their desire to participate. As a result, CHT has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is subject to these limitations. Beginning in July 2016, CHT effectively increased the price of the timely payment guarantees which CMB participants are required to purchase with the issuance of each CMB transaction. Although nominally CMB fees decreased, these rules require guarantee fees to be levied on the creation of NHA MBS pools being sold to the CMB. Prior to this rule change, the NHA MBS pools to be sold into the CMB were exempt from such fees. In aggregate, guarantee fees increased between 25% and 50% for CMB participants. This increase translates to approximately five basis points of cost over the term of the securitization. Since 2016, CMHC has also modified the tiered NHA MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees from $7.5 billion to $9.0 billion. The tiered limit of $9.0 billion remains unchanged for 2019. In the first quarter of 2019, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), also took advantage of funding provided by the CMB, issuing five NHA MBS pools totalling $43 million and securitizing those pools in the CMB program.

## Key Performance Indicators

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

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

- Dividend payout ratio.

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

| | **Quarter ended** | |
|---|---|---|
| | **March 31, 2019** | **March 31, 2018** |
| **For the Period** | **($ 000's)** | |
| Revenue | 286,311 | 256,701 |
| Income before income taxes | 32,078 | 49,272 |
| Pre-FMV EBITDA (1) | 40,225 | 50,368 |
| **At Period end** | | |
| Total assets | 36,193,793 | 33,846,283 |
| Mortgages under administration | 107,034,925 | 102,172,763 |

Note:

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

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

### *Determination of Common Share Dividend Payout Ratio*

| | Quarter ended | |
|---|---|---|
| | **March 31, 2019** | **March 31, 2018** |
| **For the Period** | **($000s)** | |
| Net income attributable to common shareholders | 22,715 | 35,197 |
| Total dividends paid or declared on common shares | 28,484 | 27,735 |
| Total common share dividend payout ratio | 125% | 79% |
| After-tax Pre-FMV dividend payout ratio (2) | 102% | 79% |

Note:

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

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

For the quarter ended March 31, 2019, the common share payout ratio was 125% compared to 79% in the 2018 first quarter. In both 2019 and 2018 quarters, the Company recorded losses on account of the changes in fair value of financial instruments. The losses are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact is largely to be reflected in wider spreads in the future from the mortgages pledged for securitization. Accordingly, management considers this a timing issue related to income recognition. If the losses on financial instruments in the two periods are excluded, the dividend payout ratio for 2019 would have been 102% compared to 79% in 2018.

The Company also paid $0.8 million of dividends on its preferred shares in the first quarter of 2019 compared to $0.7 million in 2018 first 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 of the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the quarter ended March 31, 2019, new origination volume decreased from $3.4 billion to $3.0 billion, or about 10%, compared to 2018.

### *Securitization*

The Company securitizes a portion of its origination through various vehicles, including NHA-MBS, CMB and Asset-backed Commercial Paper (“ABCP”). Although legally these transactions represent sales of mortgages, for accounting purposes they do not meet the requirements for sale recognition and instead are accounted for as secured financings. These mortgages remain as mortgage assets of the Company for the full term and are funded with securitization-related debt. Of the Company’s $4.3 billion of new originations and renewals in the first quarter of 2019, $1.7 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 $4.3 billion of new originations and renewals in the first quarter of 2019, $2.4 billion was placed with institutional investors.

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

### *Mortgage Servicing and Administration*

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

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

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

## Results of Operations

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

| | Quarter ended March 31, 2019 | March 31, 2018 |
|---|---|---|
| | ($ millions) | |
| **Mortgage Originations by Segment** | | |
| New single-family residential | 1,835 | 2,170 |
| New multi-unit and commercial | 1,202 | 1,201 |
| Sub-total | 3,037 | 3,371 |
| Single-family residential renewals | 916 | 1,023 |
| Multi-unit and commercial renewals | 386 | 152 |
| Total origination and renewals | 4,339 | 4,546 |
| **Mortgage Originations by Funding Source** | | |
| Institutional investors – new residential | 1,010 | 726 |
| Institutional investors – renew residential | 322 | 361 |
| Institutional investors – multi/commercial | 1,124 | 920 |
| NHA-MBS/ CMB/ABCP securitization | 1,659 | 2,337 |
| Internal Company resources/CMBS | 224 | 202 |
| Total | 4,339 | 4,546 |
| **Mortgages under Administration** | | |
| Single-family residential | 79,193 | 77,519 |
| Multi-unit residential and commercial | 27,842 | 24,654 |
| Total | 107,035 | 102,173 |

Total new mortgage origination volumes decreased in the first quarter of 2019 compared to 2018 by 10%. Single-family volumes decreased by 15% and commercial segment volumes were flat year over year. Management believes the decrease in the single-family segment is due to changes in the regulatory environment. In the first quarter of 2018, new B-20 guidelines became effective. These guidelines included new qualifying stress tests which reduced the buying power of mortgage borrowers. The consequence of the announced regulation meant some borrowers accelerated their buying decisions and entered into mortgage commitments at the end of 2017. A portion of these commitments pertained to home purchases funding in the first quarter of 2018 such that volume in that quarter was higher than a typical first quarter. In 2018 and 2019 there have been few, if any, new regulatory announcements which would have accelerated purchasing into the first quarter. Without any such incentive combined with the impact of the B-20 regulation, the overall mortgage market slowed significantly to start 2019. The Company believes that the decline in single-family origination is industry wide and the Company has maintained its market share. While eastern Canada volumes were down 1% from 2018, the Company's western Canada offices experienced a dip in volumes of 35% compared to first quarter 2018. When combined with renewals, total production decreased from $4.5 billion in 2018 to $4.3 billion in 2018, or by 5%. The Company believes part of the strength in eastern Canada for new single-family origination is partially the result of the relaunch of its Excalibur program which has added origination volume where there was none to start 2018. The Company's expertise in mortgage underwriting drove commercial segment origination (including renewals) higher by 17% to begin 2019. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of $1.7 billion in the first quarter of 2019.

### *Net Interest - Securitized Mortgages*

Comparing the quarter ended March 31, 2019 to the quarter ended March 31, 2018, "net interest – securitized mortgages" decreased by 19% to $31.0 million from $38.3 million. The decrease was due to the impact of accounting for financial instruments and tighter weighted-average mortgage spreads on the portfolio. Prior to adopting hedge accounting in 2018, the Company recorded gains and losses on financial instruments in its current earnings and earned tighter or wider securitization spreads in future periods. In both 2017 and 2016 the Company recorded very large gains as interest rates began to climb. The offset to these gains is generally more expensive debt raised on the securitized mortgages. As the securitization transactions related to these debts performs, a lower net securitization margin is recorded. The Company estimates that the impact of this accounting treatment has decreased net interest – securitized mortgages in the first quarter of 2019 by about $4.0 million year over year. Second, as described earlier in this MD&A, 2018 represented the tightest period for mortgage spreads since 2006. Although spreads widened in the first quarter of 2019, for the most part, mortgages originated in that period will not be securitized until after quarter end. In particular spreads on floating rate securitizations were abnormally tight as 30-day CDOR rates, which form the base rate for the Company's securitization interest expense, peaked on January 1, 2019. The Company's interest revenue on floating rate mortgages is based on First National's Prime lending rate which has not changed since late October 2018. Accordingly, the spread between these two indexes was about 0.20% narrower to start the year than it has been in the past decade. While the spread returned to normal levels by March 1, 2019, this had a negative impact on first quarter 2019 securitization net interest margin.

### *Placement Fees*

Placement fee revenue increased by 38% to $27.3 million from $19.7 million in 2018. The increase was the result of a changing funding mix between the quarters. Despite lower origination, the Company placed about $1.0 billion of single-family volume with institutional investors compared to $0.7 billion in the 2018 quarter. The increase of 39% was at the expense of securitization volume but drove the increase in placement fees. This increase was also an outcome of the re-introduction of the Excalibur program. With the Company's success at originating this product, placement fees were positively affected. In the 2018 first quarter, there was no Excalibur-related revenue. Although single-family renewals were lower by about 10% year over year, revenues were slightly higher in 2019. Commercial segment revenues were ahead of 2018 by 17% due to increased volumes, particularly those on renewed mortgages.

### *Gains on Deferred Placement Fees*

Gains on deferred placement fees revenue decreased 31% to $2.4 million from $3.5 million. The gains related to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Volumes for these transactions decreased by 38% from 2018 and spreads on these transactions where similar year over year such that the Company realized consistent per unit gains.

### *Mortgage Servicing Income*

Mortgage servicing income increased 1% to $31.1 million from $30.9 million. This increase was largely due to the benefits associated with higher MUA.

### *Mortgage Investment Income*

Mortgage investment income increased 7% to $20.2 million from $18.9 million. The increase was due primarily to mortgages accumulated for securitization held in the period. While the value of mortgages held was relatively consistent between the quarters, interest rates on the mortgages were significantly higher in the 2019 quarter. This is the result of the rising interest rate environment that existed for most of 2018. The Company's 5-year mortgage fixed interest rates increased by about 0.75% during the year. The Company earns these higher rates during the warehouse period prior to securitization. This increase was offset by investment income on mortgage and loan investments which were lower by $114 million comparing the portfolio at March 31, 2019 with that as March 31, 2018.

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

This financial statement line item typically consists of three components: (1) gains and losses related to the Company's economic hedging activities of single-family commitments, (2) gains and losses related to holding a portfolio of mortgage and loan investments at fair value, and (3) gains and losses on interest rate swaps used to mitigate interest rate risk associated with its CMB activity. With the adoption of IFRS 9 in 2018, a significant portion of the Company's interest rate management program qualifies as hedging for accounting purposes. The Company has elected to document hedging relationships for virtually all of the multi-residential commitments and mortgages it originates for its own securitization programs. It has also done the same for the funded single-family mortgages and the swaps used in its ABCP programs. This decision has reduced the volatility of gains and losses on financial instruments otherwise recorded in the Company's regular earnings as gains and losses on hedged items are generally deferred and amortized into income over the term of the related mortgages. The Company has not documented a hedging relationship for its interest mitigation program used to economically hedge commitments on single-family mortgages. The Company believes given the optional nature of these commitments it is difficult to establish a valid hedging relationship. For financial reporting purposes, this means that there will still be gains and losses on financial instruments, but these should be limited to those on the short bonds 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 | |
|---|---|---|
| **Summary of realized and unrealized gains (losses) on financial instruments** | **March 31, 2019** | **March 31, 2018** |
| | **($000s)** | |
| Gains (losses) on short bonds used for the economic hedging program | (11,282) | 776 |
| Losses on mortgages held at fair value | (1,400) | (1,000) |
| Gains (losses) on interest rate swaps | 4,091 | (567) |
| Net losses on financial instruments | (8,591) | (791) |

In 2018, economic data was generally positive and interest rates began the year climbing slowly higher. However, in the fourth quarter some poor economic data moved rates lower. Together with the adoption of hedge accounting by the Company in 2018, which effectively defers the impact of changes in interest rates on earnings, losses on financial instruments were just $0.8 million in the first quarter of 2018. To start 2019, mounting economic concerns had a significant impact on bond yields sending bond prices rapidly higher within the quarter. While the Company experienced losses of $37.9 million on its total short bond book, about $26.6 million of this pertained to mortgages which the Company was able to apply hedge accounting. This left losses on account of financial instruments of $8.6 million. These losses largely reflect the decrease in the value of short bonds used to mitigate interest rate risk related to the Company's single-family mortgage commitments which the Company does not attempt to document a hedge relationship.

### *Brokerage Fees Expense*

Brokerage fees expense increased 45% to $12.3 million from $8.5 million. This increase is explained by higher origination volumes of prime single-family mortgages for institutional investors with increased by 39% year over year. Broker fees on a per unit basis were slightly lower in the first quarter of 2019 compared to 2018; however, the 2018 quarter was the beneficiary of an adjustment for loyalty program costs. Reserves were set aside in 2017 to address additional costs anticipated for broker origination. In the first quarter of 2018 the portion of these costs which were not needed were credited to reduce broker fee expense. Portfolio insurance costs were also higher than in 2018 as the Company purchased new insurance policies to insure conventional mortgages originated for securitization.

### *Salaries and Benefits Expense*

Salaries and benefits expense increased by 14% to $27.3 million from $23.9 million. Salaries were higher as overall headcount increased by 6% (937 employees as at March 31, 2018 and 990 at March 31, 2019). The increase was also the result of $2.0 million of higher compensation earned by commercial sales staff pursuant to increased origination over the past 2 quarters. Management salaries were paid to the two senior executives (Co-founders) who together control about 74% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO") in 2006.

### *Interest Expense*

Interest expense increased 28% to $18.2 million from $14.2 million. As discussed in the "Liquidity and Capital Resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the investor or funding with a securitization vehicle. The Company used the senior unsecured notes together with a $1.25 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense increased from the prior year due to higher short-term interest rates pursuant to Bank of Canada announcements that increased short-term borrowing rates by 0.75% from January 1, 2018 to the current quarter - an increase of 23%. The Company also carried higher amounts of mortgages accumulated for securitization in the first quarter of 2019 compared to 2019 which increased the related interest costs.

### *Other Operating Expenses*

Other operating expenses decreased by 14% to $13.5 million from $15.7 million. The primary change in other operating expenses was lower hedge expenses which were $1.6 million lower in the 2019 quarter. The expense decreased as bond yields moved downward in the quarter. With 30-day interest rates remaining relatively static, it became cheaper to borrow the short bonds which the Company uses to hedge interest rate exposure. A smaller hedge book because of lower amounts of mortgages originated for securitization also had an impact on this expense. The remaining decrease in other operating expenses of $0.6 million reflects lower overhead cost savings across the organization.

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

Income before income taxes decreased by 35% to $32.1 million from $49.3 million. This decrease was affected by changing capital markets. In the first quarter of 2019, the Company recorded $8.6 million of losses on financial instruments (including $1.4 million of losses related to mortgage and loan investments). In the 2018 comparative quarter, the Company recorded $0.8 million of losses on financial instruments (including $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 $7.4 million decrease in comparative income before income taxes. Pre-FMV EBITDA, which eliminates the impact of such gains and losses on financial instruments, decreased by 20% to $40.2 million from $50.4 million. As described previously in this MD&A, the spread between the interest rates on prime mortgages and the cost of securitization debt used to fund these assets, has become significantly narrower in the last two years. This was particularly true for the third and fourth quarters of 2018 when Canadian banks maintained their offered mortgage rates despite a rising interest rate environment. Tight mortgage spreads not only affected the Company's net margin from securitized mortgages but increased the costs of accumulating mortgages for securitization. Despite lower mortgage rates in revenue, the Company's cost of short-term borrowing has not fallen in step. Another significant drag on earnings is the accounting for very large gains on fair value recorded in 2016 and 2017 as interest rates began to climb. The offset to these gains is generally more expensive debt raised on the securitized mortgages. The impact is fair value gains in the period when interest rate change followed by 5 and 10 year reduced net securitization margin. The Company estimates that the impact of this accounting treatment has decreased net interest – securitized mortgages in the first quarter of 2019 by about $4.0 million year over year. Lower net income from securitization was offset partially by increased earnings from mortgage servicing and the Excalibur program which was relaunched in mid-2018.

### *Provision for Income Taxes*

The provision for taxes decreased by 36% to $8.6 million from $13.4 million. The provision decreased proportionately with net income before income taxes. The overall effective tax rate was consistent between the two quarters.

### *Other Comprehensive Income*

Beginning January 1, 2018, the Company adopted IFRS 9. As a part of this transition the Company began accounting for some of its interest rate risk mitigation strategies as hedges for reporting purposes. For the commercial segment, the Company hedges the interest rate risk associated with insured multi-residential mortgages. This hedging begins on commitment and ends when the Company either securitizes the mortgages (primarily through CMB funding) or places the mortgage with an institutional investor. As the Company determined that these hedges were effective, the Company recorded $19.7 million of net losses on such hedges in the first quarter of 2019 that would have been recorded as losses on financial instruments under the previous IFRS standard. In the quarter, the Company amortized these losses and a portion of opening accumulated OCI into regular earnings. In total, $5.8 million was taken out of OCI and reflected in the Company's Net Income. The remaining OCI amount represents losses of $18.4 million which 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 quarter ended** | **March 31, 2019** | **March 31, 2018** | **March 31, 2019** | **March 31, 2018** |
| Originations and renewals | 2,751,016 | 3,193,067 | 1,588,347 | 1,352,831 |
| *Percentage change* | *(14%)* | | *17%* | |
| Revenue | 216,093 | 193,046 | 70,218 | 63,655 |
| *Percentage change* | *12%* | | *10%* | |
| Income before income taxes | 20,211 | 35,554 | 11,867 | 13,718 |
| *Percentage change* | *(43%)* | | *(13%)* | |
| **As at** | **March 31, 2019** | **December 31, 2018** | **March 31, 2019** | **December 31, 2018** |
| Identifiable assets | 27,956,784 | 27,717,831 | 8,207,233 | 8,289,520 |
| Mortgages under administration | 79,192,490 | 79,165,363 | 27,842,435 | 26,985,711 |

## Residential Segment

Overall residential origination including renewals decreased by 14% between the 2019 and 2018 first quarters while residential revenues increased by 12%. Revenues in both quarters were affected by losses of fair value associated with rising interest rates. If revenues are normalized for these losses, revenue would have increased by 16%. Revenue growth exceeded the growth in origination as the Company's revenue from securitized mortgages in this segment increased by 16% as mortgage interest rates increased in the market. Net income before tax was also affected by fair value related amounts. Without the impact of these revenues, net income before tax decreased from $35.3 million in 2018 to $27.4 million in 2019 or by 23%. This was the result of tighter securitization margins which are the product of a competitive mortgage market and the accounting convention prior to 2018 which produced the realization of large gains on financial instruments at the expense of future lower securitization margins. Identifiable assets increased from December 31, 2018, as the Company increased its investment in mortgages pledged under securitization by about $150 million and mortgages accumulated for securitization by about $200 million. Hedging related assets were lower by about $100 million.

## Commercial Segment

First quarter 2019 commercial revenues increased by about 17% compared to 2018. This was in line with the higher interest revenue on securitized mortgages of 18% year over year as the average mortgage rate in the securitized portfolio increased with the higher interest rate environment. Income before income taxes was not affected by fair value considerations. This measure decreased by 13% year over year as lower net securitization income and an additional decrease in the fair value of mortgage and loan investments reduced profitability. Identifiable assets decreased from those at December 31, 2018, as the increase in the Company's investment in mortgages pledged for securitization of $240 million and mortgage and loan investments of $80 million was offset by a decrease in mortgages accumulated for securitization of $390 million.

## Liquidity and Capital Resources

The Company's fundamental liquidity strategy has been to invest in prime Canadian mortgages. Management's belief has always been that these mortgages are considered "AAA" by investors and should always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, when capital markets faltered and only the highest-quality assets were bid. As the Company's results in those years demonstrated, First National had little trouble finding investors to purchase its mortgage origination at profitable margins. Originating prime mortgages also allows the Company to securitize in the capital markets; however, this activity requires significant cash resources to purchase and hold mortgages prior to arranging for term debt through the securitization markets. For this purpose, the Company uses the combination of the $175 million unsecured notes and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) the origination costs associated with securitization, and (3) mortgage and loan investments. The Company has a credit facility with a syndicate of ten financial institutions for a total credit of $1.25 billion. This facility was extended in May 2018 for a five-year term maturing in March 2023. At March 31, 2019, the Company entered into repurchase transactions with financial institutions to borrow $1.1 billion related to $1.1 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At March 31, 2019, outstanding bank indebtedness was $1,012.1 million (December 31, 2018 - $918.3 million). Together with the unsecured notes of $175 million (December 31, 2018 – $175 million), this "combined debt" was used to fund $904.5 million (December 31, 2018 - $902.0 million) of mortgages accumulated for sale or securitization. At March 31, 2019, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $41.2 million (December 31, 2018 – $41.6 million) and (2) mortgage and loan investments of $277.9 million (December 31, 2018 - $188.7 million). The difference between "combined debt" and the mortgages accumulated for sale or securitization funded by it, which the Company considers a proxy for "true leverage", has decreased between December 31, 2018 and March 31, 2019, and now stands at $282.5 million (December 31, 2018 – $191.1 million). This represents a debt-to-equity ratio of approximately 0.55:1. This ratio increased from 0.36:1 at December 31, 2018. In general, in the first quarter of 2019, the increase is due to the Company investing in net new mortgages of $89.2 million within mortgage and loan investments. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

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

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

The Company has used ABCP as an efficient source of funding primarily for short-term insured mortgages. In the May 2013 federal budget, the government announced it was going to take steps to limit the securitization of government insured mortgages to CMHC-sponsored programs. As ABCP is not sponsored by CMHC, such a limitation would impact the Company. Almost two years after the announcement, legislation was passed and detailed transition information was published. With the change in the federal government, the legislation was reconfirmed in February 2016 with some delayed application dates. Generally, the regulations make mortgage default insurance invalid for any single-family mortgages with maturity dates beyond December 31, 2021 in a non-CMHC sponsored securitization vehicle. Accordingly, existing single-family mortgages in ABCP conduits can be funded by ABCP until their maturity, not to exceed 5 years and new insured single-family mortgages can be sold in as long as the maturity date of the mortgage is prior to January 1, 2022. As this date approaches, the Company must find other funding sources for the insured mortgages it has historically funded with ABCP. The Company is considering various alternatives including whole loan sales and selling short-term NHA-MBS pools to ABCP conduits. The Company may also adjust its renewal offering to provide incentives to borrowers to select five-year terms as opposed to shorter terms. These alternatives may not be as economical to the Company as ABCP. A portion of the Company's capital has been employed to support its ABCP and NHA-MBS programs, primarily to provide credit enhancements as required by rating agencies. The most significant portion of cash collateral is the investment made on behalf of the Company's ABCP programs. As at March 31, 2019, the investment in cash collateral was $69.3 million (December 31, 2018 - $75.9 million).

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

## Financial Instruments and Risk Management

Commencing January 1, 2018, the Company has recorded mortgages accumulated for sale and mortgage and loan investments, as financial assets measured at "fair value through profit or loss" such that changes in market value are recorded in the consolidated statement of income. The mortgages accumulated for sale are held for very short periods and any change in value due to changing interest rates is the obligation of the ultimate institutional investor. Accordingly, the Company believes there will be little, if any, effect on its income related to the change in fair value of these mortgages. The majority of mortgages in mortgage and loan investments are uninsured commercial segment bridge loans. These are primarily floating rate loans that have mortgages terms of eighteen months or less. As the mortgages do not conform to conventional mortgage lending, there are few active quoted markets available to determine the fair value of these assets. The Company estimates fair value based upon: benchmark interest rates, credit spreads for similar products, creditworthiness and status of the borrower, valuation of the underlying real property, payment history, and other conditions specific to the rationale for the loan. Any favourable or unfavourable amounts will be recorded in the statement of income each quarter.

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. Prior to 2018, the Company did not attempt to adopt hedge accounting; however, with the introduction of IFRS 9 on January 1, 2018, the Company began designating hedging relationships such that the results of any effective hedging will not affect the Company's statement of income. See previous discussion in this MD&A under "Realized and Unrealized Gains (Losses) on Financial Instruments". As at March 31, 2019, the Company had about $1.1 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund, and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages to be sold to the Company's other securitization vehicles. As at March 31, 2019, the Company had entered into $0.6 billion of notional value forward bond sales for this segment.

The Company is party to four interest rate swaps that economically hedge the interest rate exposure related to certain CMB transactions in which the Company has replacement obligations. As at March 31, 2019, the aggregate notional value of these swaps, maturing between June 2021 and September 2026, was $39.7 million. During the first quarter of 2019, the value of these swaps increased by $4.1 million.

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

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of June 2011 and continuing through the current period, it was priced at a discount to BAs. At the same time, the Company has leveraged on changing credit spreads. The success of this approach has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages. As at March 31, 2019, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were over $2.0 billion of mortgages that are susceptible to some degree of changing credit spreads.

## Capital Expenditures

A significant portion of First National's business model consists of the origination and placement or securitization of financial assets. Generally, placement activities do not require much capital investment as the Company acts primarily in the capacity of a broker. On the other hand, the undertaking of securitization transactions may require significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. For fixed assets, the business requires capital expenditures on technology (both software and hardware), leasehold improvements, and office furniture. During the quarter ended March 31, 2019, the Company purchased new computer equipment and software. 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 six offices across Canada, and its obligations for the ongoing servicing of mortgages sold to securitization conduits and mortgages related to purchased servicing rights. The Company sells its mortgages to securitization conduits on a fully-serviced basis and is responsible for the collection of the principal and interest payments on behalf of the conduits, including the management and collection of mortgages in arrears.

## Critical Accounting Policies and Estimates

The Company prepares its financial statements in accordance with IFRS, which requires management to make estimates, judgments and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and other assumptions that it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. The significant accounting policies of First National are described in Note 2 to the Company's annual consolidated financial statements as at December 31, 2018. The policies which First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

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

On a quarterly basis, the Company reviews the estimates used to ensure their appropriateness and monitors the performance statistics of the relevant mortgage portfolios to adjust and improve these estimates. The estimates used reflect the expected performance of the mortgage portfolio over the lives of the mortgages. The method of determining the assumptions underlying the estimates used for the quarter ended March 31, 2019 continue to be consistent with those used for the year ended December 31, 2018 and the quarter ended March 31, 2018.

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

## Disclosure Controls and Internal Controls over Financial Reporting

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

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 March 31, 2019 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

## Risks and Uncertainties Affecting the Business

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

## Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as ''may'', ''will'', ''should'', ''expect'', ''plan'', ''anticipate'', ''believe'', ''intend'', ''estimate'', ''predict'', ''potential'', ''continue'' or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management's future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the ''Risk and Uncertainties Affecting the Business'' section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the ''Risk and Uncertainties Affecting the Business'' section, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management's expectations as of April 30, 2019, 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 seasonally slow first quarter was comparatively weaker than the comparative quarter in 2018 which featured accelerated volume associated with the transition to new B-20 guidelines within the single-family market. A rapid downward movement in interest rates also had an impact on financial results. Moving into the second quarter, management feels more positive. Single-family mortgage commitments in March 2019 were ahead of 2018 levels by about 10%, mortgages with wider spreads, which were originated during the first quarter, will be securitized in the second quarter and Prime-BA spreads, which effect returns on floating rate mortgage securitizations, returned to normal levels. Activity in the commercial segment also appears strong and interest rates have stabilized. Despite these favorable indications, the Company will continue to be faced with tight securitization margins and the effect of pre 2018 fair value accounting conventions on its income for most of 2019.

The Company is confident that its strong relationships with mortgage brokers and diverse funding sources will continue to set First National apart from its competition. The Company will continue to generate income and cash flow from its $31 billion portfolio of mortgages pledged under securitization and $74 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]

First quarter 2019

**First National Financial Corporation**

# Interim condensed consolidated statements of financial position

[Unaudited – in thousands of Canadian dollars]

As at

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | $ | $ |
| **Assets** | | |
| Restricted cash *[note 3]* | **571,403** | 577,096 |
| Cash held as collateral for securitization *[note 3]* | **69,289** | 75,913 |
| Accounts receivable and sundry | **148,787** | 150,668 |
| Mortgages accumulated for sale or securitization *[note 5]* | **2,032,992** | 2,204,886 |
| Mortgages pledged under securitization *[note 3]* | **30,958,285** | 30,567,036 |
| Deferred placement fees receivable *[note 4]* | **41,224** | 41,584 |
| Mortgage and loan investments *[note 6]* | **277,884** | 188,666 |
| Income taxes recoverable | **2,813** | 3,982 |
| Securities purchased under resale agreements | **2,039,007** | 2,188,149 |
| Other assets *[note 7]* | **52,109** | 39,147 |
| **Total assets** | **36,193,793** | 36,037,127 |
| **Liabilities and equity** | | |
| **Liabilities** | | |
| Bank indebtedness *[note 9]* | **1,012,135** | 918,347 |
| Obligations related to securities and mortgages sold under repurchase agreements | **1,097,367** | 1,262,395 |
| Accounts payable and accrued liabilities *[note 7]* | **170,698** | 124,451 |
| Debt related to securitized and participation mortgages *[note 10]* | **31,116,585** | 30,762,651 |
| Securities sold short | **2,032,745** | 2,183,411 |
| Senior unsecured notes | **174,864** | 174,829 |
| Deferred tax liabilities | **73,300** | 78,800 |
| **Total liabilities** | **35,677,694** | 35,504,884 |
| **Equity attributable to shareholders** | | |
| Common shares *[note 11]* | **122,671** | 122,671 |
| Preferred shares *[note 11]* | **97,394** | 97,394 |
| Retained earnings | **309,525** | 315,294 |
| Accumulated other comprehensive income | **(13,491)** | (3,116) |
| **Total equity** | **516,099** | 532,243 |
| **Total liabilities and equity** | **36,193,793** | 36,037,127 |

*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 | |
|---|---|---|
| | **March 31, 2019** | **March 31, 2018** |
| | $ | $ |
| **Revenue** | | |
| Interest revenue – securitized mortgages | **213,946** | 183,470 |
| Interest expense – securitized mortgages | **(182,934)** | (145,136) |
| Net interest – securitized mortgages *[note 3]* | **31,012** | 38,334 |
| | | |
| Placement fees | **27,254** | 19,749 |
| Gains on deferred placement fees *[note 4]* | **2,379** | 3,468 |
| Mortgage investment income | **20,212** | 19,940 |
| Mortgage servicing income | **31,111** | 30,865 |
| Realized and unrealized losses on financial instruments | **(8,591)** | (791) |
| | **103,377** | 111,565 |
| **Expenses** | | |
| Brokerage fees | **12,340** | 8,476 |
| Salaries and benefits | **27,256** | 23,877 |
| Interest | **18,225** | 14,194 |
| Other operating | **13,478** | 15,746 |
| | **71,299** | 62,293 |
| **Income before income taxes** | **32,078** | 49,272 |
| Income tax expense | **8,600** | 13,370 |
| **Net income for the period** | **23,478** | 35,902 |
| **Earnings per share** | | |
| Basic *[note 11]* | **0.38** | 0.59 |

*See accompanying notes*

**First National Financial Corporation**

# Interim condensed consolidated statements of comprehensive income

[Unaudited – in thousands of Canadian dollars]

| | Three months ended | |
|---|---|---|
| | **March 31, 2019** | **March 31, 2018** |
| | $ | $ |
| **Net income for the period** | **23,478** | 35,902 |
| **Other comprehensive income items that may be subsequently reclassified to income** | | |
| Net gains from change in fair value of cash flow hedges | **(19,967)** | 5,209 |
| Reclassification of net losses (gains) to income | **5,792** | (2,468) |
| | **(14,175)** | 2,741 |
| Income tax recovery (expense) | **3,800** | (730) |
| Total other comprehensive income | **(10,375)** | 2,011 |
| **Total comprehensive income for the period** | **13,103** | 37,913 |

**First National Financial Corporation**

# Interim condensed consolidated statements of changes in equity

[Unaudited – in thousands of Canadian dollars]

| | Common shares<br>$ | Preferred shares<br>$ | Retained earnings<br>$ | Accumulated other comprehensive income<br>$ | Total equity<br>$ |
|---|---|---|---|---|---|
| Balance as at January 1, 2019 | **122,671** | **97,394** | **315,294** | **(3,116)** | **532,243** |
| Net income | **—** | **—** | **23,478** | **—** | **23,478** |
| Total other comprehensive income, net of tax | **—** | **—** | **—** | **(10,375)** | **(10,375)** |
| Dividends paid or declared | **—** | **—** | **(29,247)** | **—** | **(29,247)** |
| **Balance as at March 31, 2019** | **122,671** | **97,394** | **309,525** | **(13,491)** | **516,099** |

| | Common shares<br>$ | Preferred shares<br>$ | Retained earnings<br>$ | Accumulated other comprehensive income<br>$ | Total equity<br>$ |
|---|---|---|---|---|---|
| Balance as at January 1, 2018 | 122,671 | 97,394 | 323,202 | — | 543,267 |
| Net income | — | — | 35,902 | — | 35,902 |
| Total other comprehensive income, net of tax | — | — | — | 2,011 | 2,011 |
| Dividends paid or declared | — | — | (28,440) | — | (28,440) |
| **Balance as at March 31, 2018** | 122,671 | 97,394 | 330,664 | 2,011 | 552,740 |

**First National Financial Corporation**

# Interim condensed consolidated statements of cash flows

[Unaudited – in thousands of Canadian dollars]

| | Three months ended | |
|---|---|---|
| | **March 31, 2019** | **March 31, 2018** |
| | $ | $ |
| **Operating activities** | | |
| Net income for the period | **23,478** | 35,902 |
| Add (deduct) items | | |
| Deferred income taxes | **(1,700)** | 770 |
| Non-cash portion of gains on deferred placement fees | **(2,278)** | (3,337) |
| Decrease in restricted cash | **5,693** | 10,898 |
| Net investment in mortgages pledged under securitization | **(363,541)** | (801,720) |
| Net increase in debt related to securitized mortgages | **353,934** | 766,559 |
| Securities purchased under resale agreements, net | **149,142** | (286,126) |
| Securities sold short, net | **(184,243)** | 312,435 |
| Amortization of deferred placement fees receivable | **2,638** | 2,677 |
| Amortization of property, plant and equipment | **1,855** | 1,305 |
| Unrealized gains on financial instruments | **16,711** | (12,666) |
| | **1,689** | 26,697 |
| Net change in non-cash working capital balances related to operations | **186,741** | 22,422 |
| **Cash provided by operating activities** | **188,430** | 49,119 |
| **Investing activities** | | |
| Additions to property, plant and equipment | **(3,957)** | (831) |
| Repayment (investment) of cash held as collateral for securitization | **6,624** | (3,805) |
| Investment in mortgage and loan investments | **(140,439)** | (138,219) |
| Repayment of mortgage and loan investments | **49,821** | 124,438 |
| **Cash used in investing activities** | **(87,951)** | (18,417) |
| **Financing activities** | | |
| Dividends paid | **(29,239)** | (28,436) |
| Obligations related to securities and mortgages sold under repurchase agreements | **(165,028)** | (158,586) |
| Decrease in debt related to participation mortgages | **—** | (9) |
| **Cash used in financing activities** | **(194,267)** | (187,031) |
| **Net increase in bank indebtedness during the period** | **(93,788)** | (156,329) |
| Bank indebtedness, beginning of period | **(918,347)** | (643,828) |
| **Bank indebtedness, end of period** | **(1,012,135)** | (800,157) |
| **Supplemental cash flow information** | | |
| Interest received | **252,870** | 218,259 |
| Interest paid | **189,882** | 147,056 |
| Income taxes paid | **9,130** | 23,520 |

# Notes to interim condensed consolidated financial statements

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

March 31, 2019

## 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 $107 billion in mortgages under administration as at March 31, 2019, 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. Except as indicated below, the interim condensed consolidated financial statements have been prepared using the same accounting policies used in the preparation of the audited annual consolidated financial statements for the year ended December 31, 2018.

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 April 30, 2019.

### Changes in accounting policies

IFRS 16 – *Leases*

On January 1, 2019, the Company adopted *IFRS 16 – Leases* [IFRS 16]. The Company has elected to apply IFRS 16 on a modified retrospective approach, with no restatement of comparative period results.

The Company has applied the cost method to measure the right-of-use asset. The right-of-use asset is subsequently amortized using the straight-line method. If any impairment is identified, the unamortized balance related to the impaired asset is charged fully to income. The lease liability is calculated using the present value of future lease payment, discounted at the Company’s incremental borrowing rate. The lease liability is subsequently measured at amortized cost.

The Company’s major leases are for premises at its Toronto head office and four regional offices. The Company has elected not to recognize right-of-use assets and a lease liability for its various office equipment leases which are insignificant for application of the new standard. As a result of adopting the new standard, the Company recorded a right-of-use asset of $10,859 and a lease liability of $10,859 on January 1, 2019.

[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 March 31, 2019, the cash held as collateral for securitization was $69,289 [December 31, 2018 – $75,913].

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

| | **March 31, 2019** | | **December 31, 2018** | |
|---|---|---|---|---|
| | **Carrying amount of securitized mortgages** | **Carrying amount of associated liabilities** | **Carrying amount of securitized mortgages** | **Carrying amount of associated liabilities** |
| | $ | $ | $ | $ |
| Securitized mortgages | **30,739,160** | **31,225,929** | 30,385,005 | 30,876,519 |
| Capitalized hedge losses | **51,673** | **—** | 12,578 | |
| Capitalized origination costs | **167,452** | **—** | 169,453 | — |
| Debt discounts | — | **(109,344)** | — | (113,868) |
| | **30,958,285** | **31,116,585** | 30,567,036 | 30,762,651 |
| **Add** | | | | |
| Principal portion of payments held in restricted cash | **516,328** | **—** | 521,690 | — |
| | **31,474,613** | **31,116,585** | 31,088,726 | 30,762,651 |

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

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 March 31 are as follows:

| | 2019<br>$ | 2018<br>$ |
|---|---|---|
| **Opening balance, January 1** | **169,453** | 141,121 |
| Add: new origination costs capitalized in the period | **16,447** | 23,002 |
| Less: amortization in the period | **(18,448)** | (16,893) |
| **Ending balance, March 31** | **167,452** | 147,230 |

The following table summarizes the mortgages pledged under securitization that are 31 days or more past due as at March 31:

| | March 31, 2019<br>$ | December 31, 2018<br>$ |
|---|---|---|
| **Arrears days** | | |
| 31 to 60 | **45,601** | 48,902 |
| 61 to 90 | **7,597** | 4,814 |
| Greater than 90 | **18,078** | 16,380 |
| | **71,276** | 70,096 |

All the mortgages listed above are insured, except for four mortgages which are uninsured and have a principal balance of $1,018 as at March 31, 2019 [December 31, 2018 – $605]. The Company's exposure to credit loss is limited to uninsured mortgages with principal balances totaling $1,278,317 [December 31, 2018 – $1,251,236], before consideration of the value of underlying collateral.  Virtually all such mortgages are conventional prime single-family mortgages, with an 80% or less loan to value ratio at origination, and verified borrower income. Accordingly, the expected credit loss related to these mortgages is insignificant, and the Company has not provided any allowance for expected credit loss for the quarter ended March 31, 2019.

# Notes to interim condensed consolidated financial statements

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

March 31, 2019

## 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 March 31, 2019, $444,733 [2018 – $720,744] of mortgages were placed with institutional investors which created gains on deferred placement fees of $2,379 [2018 – $3,468]. Cash receipts on deferred placement fees receivable for the three months ended March 31, 2019 were $3,086 [2018 – $3,172].

## 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:

| | **March 31, 2019** | **December 31, 2018** |
|---|---|---|
| | $ | $ |
| Mortgages accumulated for securitization | **2,000,749** | 2,170,416 |
| Mortgages accumulated for sale | **32,243** | 34,470 |
| | **2,032,992** | 2,204,886 |

The Company's exposure to credit loss is limited to $418,036 [December 31, 2018 – $321,341] of principal balances of uninsured mortgages within mortgages accumulated for sale or securitization, before consideration of the value of underlying collateral. These are conventional prime single-family mortgages similar to the mortgages described in note 3. Accordingly the expected credit loss related to these mortgages is insignificant.

# Notes to interim condensed consolidated financial statements

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

March 31, 2019

## 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 $1,400 [2018 - $1,000] for the quarter ended March 31, 2019.

The portfolio contains $16,112 [December 31, 2018 – $13,133] of insured mortgages and $284,882 [December 31, 2018 – $175,533] of uninsured mortgage and loan investments as at March 31, 2019. Of the uninsured mortgages, approximately $35,722 [December 31, 2018 – $39,941] have principal balance in arrears. Three of these mortgages are non-performing and the Company has stopped accrual of interest. These mortgages had a total original principal balance of $39,175 and are recorded at fair value of $20,012 as at March 31, 2019 [December 31, 2018 – three mortgages, original principal balance of $44,001, and fair value of $25,262].

## 7. Other assets

The components of other assets are as follows as at March 31:

| | **2019**<br>**$** | **2018**<br>**$** |
|---|---|---|
| Property, plant and equipment, net | **12,373** | 9,371 |
| Right-of-use assets | **9,960** | — |
| Goodwill | **29,776** | 29,776 |
| | **52,109** | 39,147 |

The right-of-use assets pertain to building leases for the Company's office space in five locations. The leases have terms of three to five years.

The related lease liability is grouped with accounts payable and accrued liabilities on the interim condensed consolidated statements of financial position, and has a balance of $10,011 as at March 31, 2019.

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 March 31, 2019, the Company managed mortgages under administration of $107,034,925 [December 31, 2018 – $106,151,363], 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 March 31, 2019, the Company administered 306,730 mortgages [December 31, 2018 – 306,221] for 108 institutional investors [December 31, 2018 – 111] with an average remaining term to maturity of 39 months [December 31, 2018 – 40 months].

Mortgages under administration are serviced as follows:

| | March 31, 2019<br>$ | December 31, 2018<br>$ |
|---|---|---|
| Institutional investors | **60,042,737** | 59,768,374 |
| Mortgages accumulated for sale or securitization and mortgage and loan investments | **2,334,168** | 2,387,285 |
| Deferred placement investors | **12,512,002** | 12,441,436 |
| Mortgages pledged under securitization | **30,739,160** | 30,385,005 |
| CMBS conduits | **1,406,857** | 1,169,263 |
| | **107,034,925** | 106,151,363 |

The Company's exposure to credit loss is limited to mortgage and loan investments as described in note 6, securitized mortgages as described in note 3 and uninsured mortgages held in mortgages accumulated for securitization as described in note 5. As at March 31, 2019, the Company has included in accounts receivable and sundry $84 [December 31, 2018 – $86] of uninsured non-performing mortgages.

The Company maintains trust accounts on behalf of the investors it represents. The Company also holds municipal tax funds in escrow for mortgagors. Since the Company does not hold a beneficial interest in these funds, they are not presented on the interim condensed consolidated statements of financial position. The aggregate of these accounts as at March 31, 2019 was $544,580 [December 31, 2018 – $630,166].

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

## 9. Bank indebtedness

Bank indebtedness includes a revolving credit facility of $1,250,000 [December 31, 2018 – $1,250,000] maturing in March 2023. At March 31, 2019 $1,012,135 [December 31, 2018 – $918,347] 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.

## 10. Debt related to securitized and participation mortgages

Debt related to securitized mortgages represents the funding for mortgages pledged under the NHA-MBS, CMB and ABCP programs. As at March 31, 2019, debt related to securitized mortgages was $31,116,585 [December 31, 2018 – $30,762,651], net of unamortized discounts of $109,344 [December 31, 2018 – $113,868]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

## 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, March 31, 2019 and December 31, 2018 | **59,967,429** | **122,671** | **4,000,000** | **97,394** |

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

**[c] Earnings per share**

| | Three months ended | |
|---|---|---|
| | **March 31, 2019** | **March 31, 2018** |
| | $ | $ |
| Net income and comprehensive income | **23,478** | 35,902 |
| Less: dividends declared on preferred shares | **(763)** | (705) |
| Net earnings attributable to common shareholders | **22,715** | 35,197 |
| Number of common shares outstanding | **59,967,429** | 59,967,429 |
| **Basic earnings per common share** | **0.38** | 0.59 |

## 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] Mortgages 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.

**[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 $30,958,285 [December 31, 2018 – $30,567,036] and a fair value of $31,837,163 [December 31, 2018 – $31,071,851], debt related to securitized and participation mortgages, which has a carrying value of $31,116,585 [December 31, 2018 – $30,762,651] and a fair value of $31,265,263 [December 31, 2018 – $30,574,471], and senior unsecured notes, which have a carrying value of $174,864 [December 31, 2018 – $174,829] and a fair value of $176,876 [December 31, 2018 – $175,856]. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3].

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

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

| | March 31, 2019 | | | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| | $ | $ | $ | $ |
| **Financial assets** | | | | |
| Mortgages accumulated for sale | **—** | **32,243** | **—** | **32,243** |
| Mortgage and loan investments | **—** | **—** | **277,884** | **277,884** |
| Interest rate swaps | **—** | **46,507** | **—** | **46,507** |
| **Total financial assets** | **—** | **78,750** | **277,884** | **356,634** |
| **Financial liabilities** | | | | |
| Securities sold short | **—** | **2,032,745** | **—** | **2,032,745** |
| Interest rate swaps | **—** | **693** | **—** | **693** |
| **Total financial liabilities** | **—** | **2,033,438** | **—** | **2,033,438** |

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| | $ | $ | $ | $ |
| **Financial assets** | | | | |
| Mortgages accumulated for sale | — | 34,470 | — | 34,470 |
| Mortgage and loan investments | — | — | 188,666 | 188,666 |
| Interest rate swaps | — | 51,410 | — | 51,410 |
| **Total financial assets** | — | 85,880 | 188,666 | 274,546 |
| **Financial liabilities** | | | | |
| Securities sold short | — | 2,183,411 | — | 2,183,411 |
| Interest rate swaps | — | 4,784 | — | 4,784 |
| **Total financial liabilities** | — | 2,188,195 | — | 2,188,195 |

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 March 31, 2019 that was estimated using a valuation technique based on assumptions that are not fully supported by observable market prices or rates was a loss of $1,400 [2018 – $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.

# Notes to interim condensed consolidated financial statements

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

March 31, 2019

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 $18,514 [2018 – gain of $16,616] of the Company's financial assets and financial liabilities for the three months ended March 31, 2019 and 2018, all of which have been classified as FVTPL:

| | **Three months ended March 31** | |
|---|---|---|
| | **2019** | **2018** |
| | $ | $ |
| FVTPL mortgages | **(1,400)** | (1,000) |
| Securities sold short | **(11,282)** | 776 |
| Interest rate swaps | **4,091** | (567) |
| | **(8,591)** | (791) |

**Movement in Level 3 financial instruments measured at fair value**

The following tables show the movement in Level 3 financial instruments in the fair value hierarchy for the three months ended March 31, 2019 and 2018. 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, 2019** | **Investments** | **Unrealized losses recorded in income** | **Payment and amortization** | **Fair value as at March 31, 2019** |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| **Financial assets** | | | | | |
| Mortgage and loan investments | **188,666** | **125,033** | **(1,400)** | **(34,415)** | **277,884** |

| | **Fair value as at January 1, 2018** | **Investments** | **Unrealized losses recorded in income** | **Payment and amortization** | **Fair value as at March 31, 2018** |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| **Financial assets** | | | | | |
| Mortgage and loan investments | 379,713 | 106,855 | (1,000) | (93,074) | 392,494 |
| | 379,713 | 106,855 | (1,000) | (93,074) | 392,494 |

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

### 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 March 31, 2019, the ratio was 2.12:1 [December 31, 2018 – 1.90:1]. The Company was in compliance with the bank covenant throughout the period.

### 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 March 31, 2019 | | |
|---|---|---|---|
| | **Residential** | **Commercial** | **Total** |
| | $ | $ | $ |
| **Revenue** | | | |
| Interest revenue – securitized mortgages | **163,536** | **50,410** | **213,946** |
| Interest expense – securitized mortgages | **(140,631)** | **(42,303)** | **(182,934)** |
| Net interest – securitized mortgages | **22,905** | **8,107** | **31,012** |
| Placement and servicing | **45,485** | **15,259** | **60,744** |
| Mortgage investment income | **14,420** | **5,972** | **20,212** |
| Realized and unrealized losses on financial instruments | **(7,168)** | **(1,423)** | **(8,591)** |
| | **75,462** | **27,915** | **103,377** |
| **Expenses** | | | |
| Amortization | **1,615** | **240** | **1,855** |
| Interest | **13,365** | **4,860** | **18,225** |
| Other operating costs | **40,271** | **10,948** | **51,219** |
| | **55,251** | **16,048** | **71,299** |
| **Income before income taxes** | **20,211** | **11,867** | **32,078** |
| Identifiable assets | **27,956,784** | **8,207,233** | **36,164,017** |
| Goodwill | — | **—** | **29,776** |
| **Total assets** | **27,956,784** | **8,207,233** | **36,193,793** |
| **Capital expenditures** | **2,770** | **1,187** | **3,957** |

# Notes to interim condensed consolidated financial statements

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

March 31, 2019

| | Three months ended March 31, 2018 | | |
|---|---|---|---|
| | Residential | Commercial | Total |
| | $ | $ | $ |
| **Revenue** | | | |
| Interest revenue – securitized mortgages | 140,774 | 42,696 | 183,470 |
| Interest expense – securitized mortgages | (109,716) | (35,420) | (145,136) |
| Net interest – securitized mortgages | 31,058 | 7,276 | 38,334 |
| | | | |
| Placement and servicing | 39,837 | 14,245 | 54,082 |
| Mortgage investment income | 12,213 | 7,727 | 19,940 |
| Realized and unrealized gains (losses) on financial instruments | 222 | (1,013) | (791) |
| | 83,330 | 28,235 | 111,565 |
| | | | |
| **Expenses** | | | |
| Amortization | 1,101 | 204 | 1,305 |
| Interest | 9,806 | 4,388 | 14,194 |
| Other operating costs | 36,869 | 9,925 | 46,794 |
| | 47,776 | 14,517 | 62,293 |
| **Income before income taxes** | 35,554 | 13,718 | 49,272 |
| | | | |
| Identifiable assets | 26,875,015 | 6,941,492 | 33,816,507 |
| Goodwill | — | — | 29,776 |
| **Total assets** | 26,875,015 | 6,941,492 | 33,846,283 |
| | | | |
| **Capital expenditures** | 582 | 249 | 831 |

## 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 $5,542 of new mortgages for the related parties. The related parties also funded several progress draws totaling $1,091 on existing mortgages originated by the Company. All such mortgages, which are administered by the Company, have a balance of $120,563 as at March 31, 2019 [December 31, 2018 – $121,556]. As at March 31, 2019, 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 March 31, 2019 was $362 [2018 – nil], net of third-party investor reimbursement. The insurance company had also engaged the Company to service a portfolio of mortgages at market servicing rates. The portfolio had a balance of $1,625 as at December 31, 2018, but was fully paid down during the quarter ended March 31, 2019.

## 16. Comparative unaudited interim condensed consolidated financial statements

The Company has reclassified two items on the comparative interim condensed consolidated statement of cash flows. Both securities purchased under resale agreements and securities sold short were reclassified from financing activities to operating activities. Together these items support the Company's hedging programs for interest rate risk on mortgages prior to securitization, and accordingly, represent an operating activity.

# 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