MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of February 25, 2019. This discussion should be read in conjunction with the audited consolidated financial statements and accompanying notes of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the year ended December 31, 2018. The audited consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").

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

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

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

General Description of the Company

First National Financial Corporation is the parent company of First National Financial LP ("FNFLP"), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over $106 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.

2018 Results Summary

Management is pleased with the results of 2018. Despite new mortgage insurance rules announced in late 2016 and tighter underwriting rules on uninsured mortgages required under OSFI's revised B-20 guidelines introduced in 2018, which the Company has adopted, single family origination increased 10% year over year in 2018. Combined with commercial segment origination and steady renewals, First National increased its total origination by 11% in the year compared to 2017. Despite this growth, tighter mortgage spreads and a trend toward increased securitization reduced normalized earnings by 9%.

- MUA grew to $106.2 billion at December 31, 2018 from $101.6 billion at December 31, 2017, an increase of 5%; the growth from September 30, 2018, when MUA was $105.0 billion, was also 5% on an annualized basis;
- Total new single-family mortgage origination was $12.2 billion in 2018 compared to $11.1 billion in 2017, an increase of 10%. The Company attributes this to the relaunch of its alternative lending product, Excalibur, and strong growth in the Toronto and Montreal regions. The commercial segment had a strong year with origination up 8% as volumes increased to $6.2 billion in 2018 from $5.8 billion in 2017. The Company attributes this to the continued development of its expertise in real estate across the country which increases the value proposition of its financial products to borrowers and investors alike. Overall new origination increased by 9% in the year;
- The Company took advantage of opportunities in the year to renew $6.1 billion of single-family mortgages. In 2017, the Company renewed $5.2 billion of single-family mortgages. For the commercial segment, renewals increased to $1.3 billion from $1.1 billion;
- Revenue for 2018 increased by 10% to $1.2 million from $1.1 billion in 2017. The increase is related to the rising interest rate environment offset by lower revenue from gains on financial instruments. Because of higher interest rates, interest revenue on securitized mortgages increased by $131 million as the portfolio composition transitioned to mortgages with higher interest rate coupons. Higher interest rates also impacted mortgage investment income which was higher by $20 million. However because of changing interest rates and the adoption of hedge accounting in 2018, gains of financial instruments were lower by $53 million year over year. Without this component of revenue, revenue increased by 15%;
- Income before income taxes decreased from $285.4 million in 2017 to $227.4 million in 2018 because of changing capital markets conditions and the way new hedge accounting rules adopted in 2018 accounted for the related gains and losses on financial instruments. In aggregate, the impact from financial instruments decreased this measure by $53.1 million comparing 2017 to 2018;
- The Company's earnings before income taxes, depreciation and amortization and gains and losses on financial instruments ("Pre-FMV EBITDA") for the year decreased by 4%, from $234.3 million to $225.2 million in 2018. This measure was lower in 2018 largely due to tighter securitization margins and lower placement fee revenue both of which are the result of tightening mortgage spreads. Although the Company set a new record for overall origination, including renewal volume, in 2018, most of the additional origination was securitized. Securitization, while perhaps economically superior, delays the recognition of earnings when compared to a placement transaction; and
- Net income was $166.4 million (2.73 per common share) in 2018, compared to $209.7 million (3.42 per common share) in 2017. This was the Company's 30th consecutive year of profitable operations.

Selected Quarterly Information

Quarterly Results of First National Financial Corporation

($000s, except per share amounts)

	Revenue	Net Income for the period	Pre-FMV EBITDA for the period (1)	Net Income per Common Share	Total Assets
2018					
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
First Quarter	$232,238	$36,127	$53,084	$0.58	$29,901,289

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

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

Generally, in the years after the credit crisis in 2008, the Company grew its origination volumes which provided larger servicing and securitization portfolios. To the extent the Company employed securitization strategies, net interest margins were locked in for five and ten year terms. These margins were wide in 2008 as financial institutions maintained mortgage rates despite a significant drop in the cost of funds. Since 2008, such margins have steadily declined with competitive pressures and new securitizations are at much tighter spreads. For the Company this has meant that as high spread securitization transactions have matured and been replaced with new securitizations, profitability has decreased. This trend is evident in the Pre-FMV EBITDA figures above. In the third quarter 2017, Pre-FMV EBITDA was lower than expected as placement fees were negatively affected by a rising interest rate environment. The Company earned $14.4 million as a gain on holding short bonds in the second quarter 2017. Consistent with the Company's reporting practice, this amount was deducted from earnings to determine Pre-FMV EBITDA. However this gain reduced the value of the hedged mortgages and when these were placed in the third quarter 2017, earnings were negatively affected. Using normalized earnings, third quarter 2018 earnings were 5% lower compared to those in the third quarter of 2017. The decrease was due to tighter mortgage spreads and more securitization which delays the earning's process in comparison to placement fees which are earned in the same period as origination. Fourth quarter 2018 earnings were lower by 9% for the same reasons.

Outstanding Securities of the Corporation

At December 31, 2018 and February 25, 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, 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 Balance Sheet Highlights 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 December 31, 2018, MUA totalled $106.2 billion, up from $101.6 billion at December 31, 2017, an increase of 5%. The growth of MUA in the fourth quarter of 2018 on an annualized increase is also 5%.

Growth in Origination of Mortgages

Direct origination by the Company

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. Increased origination satisfies demand from its institutional customers and produces volume for the Company's own securitization programs. In 2018, the Company's single-family origination grew at a steady rate. Whether it is the effect of OSFI guideline B-20 or gaining market share in the mortgage broker channel, the Company experienced higher origination in eastern Canada while its Calgary and Vancouver offices suffered from regional real estate related issues: Toronto (+19%), Vancouver (-3%), Calgary (-11%) and Montreal (+28%). In aggregate, the Company's single-family origination increased in 2018 by 10%. The commercial segment demonstrated steady growth as volume increased 8% over 2017. Together, overall new origination for 2018 increased 9% year over year.

Third Party Mortgage Underwriting and Fulfillment Processing Services

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

Relaunch of Excalibur Mortgage Products

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

Raising Capital for Operations

Bank Credit Facility

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

Preferred Share Issuance

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

Employing Securitization Transactions to Minimize Funding Costs

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

The Company has 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%

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels; however, in 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. This trend continued into 2016, as optimism about the economy was mixed such that spreads remained at levels in excess of 1.8% until the third quarter when increased competition made for tighter spreads. With the recent strength in the economy and tougher mortgage rules, competition further increased and spreads have tightened significantly. While funding spreads have also improved, generally the advantage of securitization compared to placement with investors is not as pronounced as it was in the previous 10-year period. In 2018, the Company originated and renewed for securitization purposes approximately $9.0 billion of single-family mortgages and $1.1 billion of multi-unit residential mortgages. In 2018, the Company securitized through NHA-MBS approximately $8.2 billion of single-family mortgages and $0.7 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 2018, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), also took advantage of funding provided by the CMB, issuing three NHA MBS pools totaling $85 million and securitizing those pools in two 5-year CMB transactions.

Adoption of New IFRS Accounting Standards

IFRS 9 – Financial Instruments

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

Classifications and Measurement

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

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

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

Impairment

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

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

Hedge Accounting

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

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

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

IFRS 15 – Revenue from Contracts with Customers

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

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

Key Performance Indicators

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

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

- Dividend payout ratio.

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

	Quarter ended		Year ended	
	December 31, 2018	**December 31, 2017**	**December 31, 2018**	**December 31, 2017**
For the Period		($ 000's)		
Revenue	312,039	270,015	1,181,510	1,078,768
Income before income taxes	44,050	63,158	227,417	285,402
Pre-FMV EBITDA (1)	55,780	61,093	225,186	234,278
At Period end				
Total assets	36,038,527	32,776,278	36,038,527	32,776,278
Mortgages under administration	106,151,363	101,589,153	106,151,363	101,589,153

Note:

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

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

Determination of Common Share Dividend Payout Ratio

	Quarter ended		Year ended	
	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
For the Period		($000s)		
Net income attributable to common shareholders	31,465	44,972	163,499	205,331
Total dividends paid or declared on common shares	88,202	102,694	171,407	184,400
Dividends paid or declared on common shares, excluding special dividend	28,235	27,735	111,440	109,441
Total common share dividend payout ratio	280%	228%	105%	90%
Regular common share dividend payout ratio (1)	90%	62%	68%	53%
After-tax Pre-FMV dividend payout ratio (2)	72%	65%	70%	67%

Note:

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

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

For the year ended December 31, 2018, the common share payout ratio was 105% compared to 90% in 2017. However, in November of both 2018 and 2017, the Company declared a special dividend which represented the distribution of excess retained earnings generated over the course of several prior years. Including such dividends distorts the payout ratios. If the special dividends are excluded from the calculation, the payout ratios would have been 68% in 2018 and 53% in 2017. In both 2018 and 2017, the Company recorded gains on account of the changes in fair value of financial instruments. The gains are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact is largely to be reflected in narrower spreads in the future from the mortgages pledged for securitization. Accordingly, management does not consider this revenue to be available for dividend payment. If the gains on financial instruments in the two years are excluded, the dividend payout ratio for 2018 would have been 70% compared to 67% in 2017.

The Company also paid $2.9 million of dividends on its preferred shares in 2018 compared to $2.7 million in 2017.

Revenues and Funding Sources

Mortgage Origination

The Company derives a significant amount of its revenue from mortgage origination activities. Most mortgages originated are funded either by placement with institutional investors or through securitization conduits, in each case with retained servicing. Depending upon market conditions, either an institutional placement or a securitization conduit may be the most cost-effective means for the Company to fund individual mortgages. In general, originations are allocated from one funding source to another depending on market conditions and strategic considerations related to maintaining diversified funding sources. The Company retains servicing rights on virtually all of the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2018, new origination volume increased from $16.9 billion to $18.5 billion, or about 9%, compared to 2017.

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 $25.9 billion of new originations and renewals in 2018, $10.1 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 $25.9 billion of new originations and renewals in 2018, $14.9 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

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

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

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

Results of Operations

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

	Quarter ended		Year ended	
	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
	($ millions)			
Mortgage Originations by Segment				
New single-family residential	2,760	2,787	12,231	11,133
New multi-unit and commercial	1,848	1,645	6,237	5,770
Sub-total	4,608	4,432	18,468	16,903
Single-family residential renewals	1,322	1,124	6,083	5,219
Multi-unit and commercial renewals	592	257	1,338	1,127
Total origination and renewals	6,522	5,813	25,889	23,249
Mortgage Originations by Funding Source				
Institutional investors – new residential	2,446	1,254	6,495	6,240
Institutional investors – renew residential	628	564	2,490	2,688
Institutional investors – multi/commercial	1,873	1,271	5,957	5,342
NHA-MBS/ CMB/ABCP securitization	1,359	2,449	10,109	8,199
Internal Company resources/CMBS	216	275	838	780
Total	6,522	5,813	25,889	23,249
Mortgages under Administration				
Single-family residential	79,166	77,423	79,166	77,423
Multi-unit residential and commercial	26,985	24,166	26,985	24,166
Total	106,151	101,589	106,151	101,589

Total new mortgage origination volumes increased in 2018 compared to 2017 by 9%. Single-family volumes increased by 10% and commercial segment volumes increased by 8% year over year. The increase in the single-family segment is due to growth in eastern Canada which offset lower volumes experienced by the Company's Calgary and Vancouver offices, which together had volumes 6% lower than in 2017. When combined with renewals, total production increased from $23.2 billion in 2017 to $25.9 billion in 2018, or by 11%. The Company believes higher new single-family origination is partially the result of the relaunch of its Excalibur program which has added origination volume where there was none in 2017. Overall volumes were also affected favourably by a 28% increase in the Quebec market. In 2017 there was significant mortgage rate pressure in this region from local competitors. In 2018 this subsided so as to make the Company's products more competitive. The Company's expertise in mortgage underwriting drove commercial segment origination (including renewals) higher by 10% in 2018. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of $10.1 billion in 2018. Although the Company used such securitization funding to a greater degree in 2018 compared to 2017, the Company continued to grow origination for its arms-length investors so as to support its long-term strategy of maintaining diverse funding sources.

Net Interest - Securitized Mortgages

Comparing the year ended December 31, 2018 to the year ended December 30, 2017, "net interest – securitized mortgages" decreased by 2% to $144.1 million from $146.8 million. The decrease was due to a tighter weighted-average spread on the portfolio, offset by a larger portfolio of securitized mortgages year over year. The portfolio of securitized mortgages increased by 11% from $27.6 billion at December 31, 2017 to $30.6 billion by the end of December 2018. The increase in the securitized portfolio was offset by tighter securitization spreads as mortgage spreads to risk-free Government of Canada have decreased by about 0.50% since 2015. The impact of accounting for financial instruments has also affected this revenue. The consequence of large gains on financial instruments recognized in 2017 and 2016, 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 by $11.3 million year over year.

Placement Fees

Placement fee revenue decreased by 2% to $141.9 million from $144.6 million in 2018. The decrease would be larger if the 2017 revenue was normalized for the impact of changing interest rates which arguably understated placement fee revenue that year. As described in the 2017 MD&A, the Company recorded about $14.4 million of gains on financial instruments in the second quarter of 2017 which detracted from placement fee revenue in the third quarter of 2017 (when the related mortgages were placed). If the amount is added back to 2017 revenues, placement fees were lower by 12% compared to 2018. This decrease resulted from a change in product mix with the re-introduction of the Excalibur program. Because the Excalibur mortgages are shorter term (typically 1 year), the fee for placement is lower on a per unit basis. With the Company's success at originating this product, average placement fees were adversely affected. The broker fees associated with Excalibur mortgages are also smaller such that despite the lower revenue, the origination is favorable to net income. First National was also successful in increasing single-family renewals by about 17% year over year; however, the Company elected to securitize a larger portion of these in 2018 compared to 2017 such that lower placement fees were earned on these mortgages. The decline was also the result of tightening mortgage spreads which reduced the per unit placement fee with a portion of the Company's institutional investors. These placements were transacted based on capital market conditions which were less favorable in 2018 compared to 2017. Commercial placement fees increase 3% year over year in line with higher volume.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue increased 17% to $11.7 million from $10.0 million. The gains related to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Although, volumes for these transactions increased by 33% from 2017, spreads on these transactions tightened such that the Company realized lower per unit gains..

Mortgage Servicing Income

Mortgage servicing income increased 4% to $146.2 million from $140.8 million. This increase was largely due to the third-party underwriting business which experienced an increase in the volume of mortgages processed, and the benefits associated with higher MUA.

Mortgage Investment Income

Mortgage investment income increased 23% to $84.3 million from $68.3 million. The increase was due primarily to an increase in market interest rates providing more investment income. The Company recorded mark-to-market losses of $4.0 million (2017 – credit losses of $4.0 million) regarding four non-performing properties in the commercial bridge portfolio in 2018. These were recorded as losses on financial instruments in 2018. In addition, the interest rates associated with the Company's mortgages warehoused prior to securitization were higher this year such that more interest income was earned during the warehousing period.

Realized and Unrealized Gains (Losses) on Financial Instruments

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

	Quarter ended		Year ended	
Summary of realized and unrealized gains (losses) on financial instruments	**December 31, 2018**	**December 31, 2017**	**December 31, 2018**	**December 31, 2017**
		($000s)		
Gains on short bonds used for the economic hedging program	(14,285)	1,383	5,822	35,467
Losses on mortgages held at fair value	(1,000)	(7,171)	(4,000)	(25,311)
Gains (losses) on interest rate swaps	3,569	9,276	1,340	47,133
Other losses	—	137	—	(1,030)
Net gains on financial instruments	(11,716)	3,625	3,162	56,259

In 2017, economic data turned positive and interest rates jumped higher with the expectations of a Bank of Canada increase in overnight rates. This meant that 5-year bond prices decreased so that generally the Company recorded large gains on its hedging program. This trend continued through the first three quarters of 2018 and bond yields increased steadily. However in November 2018, economic sentiment changed and bond yields decreased abruptly and returned to the same levels recorded at the beginning of the year. The impact of the movement in 2018 had a lower impact to the Company's gains and losses on financial instruments due to the adoption of hedge accounting such that a portion of both gains and losses recorded during the year were removed from the Company's statement of income.

In 2018, the Company recorded gains on these instruments of $5.8 million (2017 – $35.5 million). On its commercial segment hedges, the value of the Company's hedges increased by $3.2 million; however because of the designation of a hedge relationship, the amount was recorded in Other Comprehensive Income. This amount will be amortized into the Company's regular income over the terms of the related securitization and placement transactions. Because of the nature of the timing of such gains and losses within the year, $7.5 million of gains were amortized into the Company's income. For the residential segment, the Company has designated hedge relationships to protect the fair value of funded mortgages prior to securitization or placement. The $5.8 million gain above reflects the increase in value of short bonds used to hedge the Company's commitments for which the Company does not attempt to document a hedge relationship. The change in value related to funded mortgages that were hedged effectively in the year was deferred on the Company's balance sheet.

Brokerage Fees Expense

Brokerage fees expense decreased 9% to $75.4 million from $83.3 million. This decrease is explained by lower origination volumes of prime single-family mortgages for institutional investors and lower per unit broker fees in the residential segment. Despite the increase in overall single-family origination of 10%, origination for institutional investors increased by just 6%. This increase was largely the result of the relaunch of the Excalibur program. These mortgages are generally for 1 year terms and accordingly have a significantly lower broker fee per unit cost than a typical prime mortgage origination. Accordingly comparable broker costs where lower year over year based on origination volumes. For prime mortgage origination, per unit broker fees were also lower than in 2017. Generally in 2017, broker compensation for insured mortgages was abnormally high as the market competed for such mortgages after new insurance rules, announced in 2016, reduced the amount of insured mortgages available in the market. In 2018 fees returned to "normal" levels such that 2018 per-unit broker fees were generally 5% lower than in 2017. Portfolio insurance costs are also included in this expense line and were also lower than in 2017 as the Company was able to use previously purchased insurance policies to cover a portion of 2018's insurance requirements.

Salaries and Benefits Expense

Salaries and benefits expense increased by 2% to $99.7 million from $97.8 million. Salaries were higher by 2% and overall headcount increased by 5% (936 employees as at December 31, 2017 and 987 at December 31, 2018). Although overall headcount rose, much of the increase occurred in the fourth quarter and expenses for salaries grew by standard cost of living increases. These increases were offset by $1.4 million of lower compensation earned by commercial sales staff as spreads were tighter in the year. 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 51% to $69.9 million from $46.4 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% beginning in the third quarter of 2017. The Company also held higher balances of mortgages accumulated for securitization and mortgage and loan investments in 2018, which required greater use of the Company's credit facilities.

Other Operating Expenses

Other operating expenses increased by 17% to $63.0 million from $53.9 million. Other operating expenses increased by $6.9 million related to higher hedge expenses which increased in step with higher bond yields and a larger hedge book. Because of more mortgages originated for securitization, the Company carried notional hedges of approximately $2.0 billion during 2018. In addition, the rising interest rate environment which was prevalent during most of the year, created a steeper yield curve which made it more expensive to carry the short bonds the Company employs to mitigate interest rate risk associated with the Company's commitment and funded warehouse pipeline. The remaining increase in other operating expenses of $2.2 million reflects costs to support a growing business including information technology and the relaunch of the Excalibur program.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes decreased by 20% to $227.4 million from $285.4 million. This decrease was affected by changing capital markets. In 2018, the Company recorded $7.2 million of gains on financial instruments (excluding $4.0 million of losses related to mortgage and loan investments). In 2017, the Company recorded $56.3 million of gains on financial instruments. The change in these values accounted for a $49.1 million decrease in comparative income before income taxes. Pre-FMV EBITDA, which eliminates the impact of gains and losses on financial instruments, decreased by 4% to $225.2 million from $234.3 million. This decrease was partially the result of fair value accounting on placement fee revenues in the third quarter of 2017. As described in the 2017 MD&A, the Company recorded about $14.4 million of gains on financial instruments in the second quarter of 2017 which detracted from placement fee revenue in the third quarter of 2017 when the related mortgages were placed. If the amount is added back to 2017 Pre-FMV EBITDA, the decrease between 2018 and 2017 was 9%. The decrease in this normalized earning measure is the result of tighter securitization spreads. As described previously in this MD&A, the spread between the interest rates on prime mortgages and the cost of 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 placement fees as well as there was less spread to share with some of the Company's institutional investors who securitize the mortgages that they purchase from First National. Lower net income from securitization and placement of prime mortgages was offset partially by increased earnings from mortgage servicing and the Excalibur program which was relaunched in early 2018. Although origination increased by approximately 10% from 2017, most of the additional volume was securitized by the Company. By securitizing mortgages instead of placing them with institutional investors, the Company delays the earning's process: placement fee revenues are reduced and the costs of hedging and interest during the warehousing period are increased.

Provision for Income Taxes

The provision for taxes decreased by 20% to $61.0 million from $75.8 million. The provision decreased proportionately with net income before income taxes. The overall effective tax rate was marginally higher in 2018 as a provincial tax rate increased by 1% at the start of 2018.

Other Comprehensive Income

Beginning January 1, 2018, the Company adopted IFRS 9. As a part of this transition the Company began accounting for some of its interest rate risk mitigation strategies as hedges for reporting purposes. For the commercial segment, the Company hedges the interest rate risk associated with insured multi-residential mortgages. This hedging begins on commitment and ends when the Company either securitizes the mortgages (primarily through CMB funding) or places the mortgage with an institutional investor. As the Company determined that these hedges were effective, the Company recorded $3.2 million of net gains on such hedges in 2018 that would have been recorded in gains on financial instruments under the previous IFRS standard. The amount consisted of $19.7 million of gains and $16.5 million of losses.

Because the losses pertained primarily to the fourth quarter of 2018 when bond prices rose significantly, the related mortgages have not yet been securitized or placed. Accordingly the losses were largely unamortized while the gains have been amortized. The net amortization of the values in OCI totaled $7.5 million for 2018 and has been reflected in the Company's Net Income. The remaining OCI amount represents losses of $4.3 million which will be amortized 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	**December 31, 2018**	**December 31, 2017**	**December 31, 2018**	**December 31, 2017**
Originations and renewals	18,314,129	16,352,753	7,574,443	6,897,582
Percentage change	*12%*		*10%*	
Revenue	913,301	827,160	268,209	251,608
Percentage change	*10%*		*7%*	
Income before income taxes	164,897	215,370	62,517	70,032
Percentage change	*(23%)*		*(11%)*	
As at	**December 31, 2018**	**December 31, 2017**	**December 31, 2018**	**December 31, 2017**
Identifiable assets	27,717,831	25,653,160	8,289,520	7,093,342
Mortgages under administration	79,165,363	77,422,655	26,985,711	24,166,498

Residential Segment

Overall residential origination including renewals increased by 12% between the 2018 and 2017 while residential revenues increased by 10%. Revenues in both quarters were affected by gains of fair value associated with rising interest rates. If revenues are normalized for these gains, revenue increased by 14%. Revenue growth exceeded the growth in origination as the Company's revenue from securitized mortgages in this segment increased by 21% 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 $184.4 million in 2017 to $157.7 million in 2018 or by 14%. This was the result of tighter securitization margins and the Company's decision to securitize a larger portion of its residential origination in the year. The costs of underwriting, hedging and warehousing these mortgages are significant and there is only a marginal contribution to earnings on new transactions in the year of securitization. Identifiable assets increased from December 31, 2017, as the Company increased its investment in mortgages pledged under securitization by about $2.1 billion.

Commercial Segment

2018 commercial revenues increased by about 7% compared to 2017. Without the impact of gains and losses on account of fair value, revenue increased by 11% year over year. This was in line with the increased origination and higher interest revenue on securitized mortgages of 16% year over year as the average mortgage rate in the securitized portfolio increased with the higher interest rate environment. Income before income taxes was also affected by fair value considerations. By excluding fair value gains and losses, this measure would have increased by 6% year over year as the large increases in origination evidenced in 2018 and 2017 created higher net securitization and servicing income, which more than offset lower placement fees. Identifiable assets increased from those at December 31, 2017, as the

Company increased its investment mortgages pledged for securitization by $0.9 billion and mortgages accumulated for securitization by $0.3 billion. The reduction of $0.2 billion of its investment in mortgage investments was offset by an increase in hedging assets.

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 December 31, 2018, the Company entered into repurchase transactions with financial institutions to borrow $1.3 billion related to $1.3 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At December 31, 2018, outstanding bank indebtedness was $918.3 million (December 31, 2017 - $643.8 million). Together with the unsecured notes of $175 million (December 31, 2017 – $175 million), this "combined debt" was used to fund $902.0 million (December 31, 2017 - $556.1 million) of mortgages accumulated for sale or securitization. At December 31, 2018, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $41.6 million (December 31, 2017 – $41.3 million) and (2) mortgage and loan investments of $188.7 million (December 31, 2017 - $379.7 million). The difference between "combined debt" and the mortgages accumulated for sale or securitization funded by it, which the Company considers a proxy for "true leverage", has decreased between December 31, 2017 and December 31, 2018, and now stands at $191.1 million (December 31, 2017 – $262.4 million). This represents a debt-to-equity ratio of approximately 0.36:1. This ratio decreased from 0.48:1 at December 31, 2017. In general, in 2018, the Company used the cash from repayment of $191 million of mortgage and loan investments to (1) invest in $79 million of broker fees related to securitized mortgages and, (2) to pay the special dividend of $60 million in December 2018. 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 December 31, 2018, the investment in cash collateral was $75.9 million (December 31, 2017 - $66.4 million).

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

Financial Instruments and Risk Management

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 December 31, 2018, the Company had about $1.3 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund, and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages to be sold to the Company's other securitization vehicles. As at December 31, 2018, the Company had entered into $0.5 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 December 31, 2018, the aggregate notional value of these swaps, maturing between June 2021 and September 2026, was $37.4 million. During 2018, the value of these swaps increased by $1.3 million.

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

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of June 2011 and continuing through the current period, it was priced at a discount to BAs. At the same time, the Company has leveraged on changing credit spreads. The success of this approach has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages. As at December 31, 2018, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost $2.2 billion of mortgages that 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 year ended December 31, 2018, the Company purchased new computer equipment and software. In the long term, the Company expects capital expenditures on fixed assets will be approximately $5.0 million annually.

Summary of Contractual Obligations

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

		Payments Due by Period			
	Total	0-1 Years	1-3 Years	4-5 Years	After 5 Years
			($000s)		
Lease Obligations	36,089	7,467	22,240	6,382	—

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 December 31, 2018 continue to be consistent with those used for the year ended December 31, 2017 and the quarters ended September 30, June 30 and 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.

Future Accounting Changes

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

IFRS 16 – Leases

In January 2016, the IASB issued IFRS 16 – Leases, replacing IAS 17 – Leases. IFRS 16 requires lessees to recognize assets and liabilities for most leases instead of previous categories of finance leases, which are reported on the balance sheet, or operating leases, which are disclosed only in the notes to the financial statements, under IAS 17. IFRS 16 also set out enhanced guidance for the recognition, measurement, presentation and disclosure of the leasing activities. IFRS 16 is effective for annual periods beginning on or after January 1, 2019.

The Company's major leases are office space leases for its Toronto head office and four regional offices. The Company's various office equipment leases are insignificant for application of the new standard. Based on the preliminary assessment, the Company will record approximately $30 million as right-of-use asset as well as lease liability on its consolidated statements of financial position as of January 1, 2019.

Disclosure Controls and Internal Controls over Financial Reporting

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

As of December 31, 2018, management evaluated, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, management concluded that the Company's disclosure controls and procedures, as defined by National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings, were effective as of December 31, 2018.

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with reporting standards; however, because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements on a timely basis.

Management evaluated, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's internal control over financial reporting based on the criteria set forth in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and, based on that evaluation, concluded that the Company's internal control over financial reporting was effective as of December 31, 2018 and that no material weaknesses have been identified in the Company's internal control over financial reporting as of December 31, 2018. No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Risks and Uncertainties Affecting the Business

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

Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as ''may'', ''will'', ''should'', ''expect'', ''plan'', ''anticipate'', ''believe'', ''intend'', ''estimate'', ''predict'', ''potential'', ''continue'' or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management's future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the ''Risk and Uncertainties Affecting the Business'' section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the ''Risk and Uncertainties Affecting the Business'' section, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management's expectations as of February 25, 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

Management is pleased with the results of 2018. Despite the addition of a new debt service qualifying test to B-20 underwriting guidelines in January 2018, the Company's new single-family origination increased by 10%. New commercial mortgage origination increased by 8%. Including renewals, total origination was up 11% for the year ended December 31, 2018. While earnings, adjusted for fair value considerations related to hedging activities, were lower by 9%, a large part of this was the outcome of shifting mortgages to securitization programs from placement transactions. By securitizing mortgages instead of placing them directly with institutional investors, the Company delays the earning's process: current period placement fee revenues are reduced and the costs associated with securitization are increased. In addition, the Company recognized significant gains related to hedging activities in 2017. The narrower margin on the related securitization is recognized over the remaining term of the mortgages and was partially reflected in 2018 earnings

Going into 2019, the Company is cautiously optimistic. Economic concerns arose in November 2018 and continued through to year end. Equity markets sold off and credit spreads widened. While perhaps too early to determine if these events are a harbinger for a recession, in the short term the consequences may be lessened at First National. Because the Company uses government sponsored funding programs such as NHA MBS and CMB, it expects these sources of funding to remain liquid and to outperform other debt instruments during a spread widening cycle. In addition, while the yields on underlying government bond benchmarks have fallen, mortgage lenders have been disciplined in the face of an uncertain economy and mortgage coupons have not fallen to the same extent. The consequence is a wider spread between the interest rates on prime mortgages and the costs of CMHC sponsored funding sources, despite increased credit spreads. Generally if persistent, these circumstances will provide the Company with greater securitization margins in 2019. It is unclear, however, how long this environment will last and whether competitive pressures will reduce these margins back to the levels experienced in 2018. 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 $30 billion portfolio of mortgages pledged under securitization and $73 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.