

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 March 1, 2022. 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, 2021. 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 Income” and “After-tax Pre-FMV Dividend Payout Ratio”, should not be construed as alternatives to net income or loss or other comparable measures determined in accordance with IFRS as an indicator of performance or as a measure of liquidity and cash flow. These measures do not have standard meanings prescribed by IFRS and therefore may not be comparable to similar measures presented by other issuers.

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

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

General Description of the Company

First National Financial Corporation is the parent company of First National Financial LP (“FNFLP”), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With almost \$124 billion in mortgages under administration (“MUA”), First National is one of Canada’s largest non-bank originators and underwriters of mortgages and is among the top three in market share in the mortgage broker distribution channel.

2021 Results Summary

Management is pleased with First National’s performance in 2021. Supported by a robust housing market across Canada, the Company increased single-family origination 22% year over year. Commercial segment originations were up by 7% as conventional lending picked up to augment insured mortgage volumes. Total combined new origination was higher by 17% comparing both years. As a result, Mortgages Under Administration (MUA), the source of most of the Company’s earnings, increased to a record high. Profitability measures were solid despite a significant decline in mortgage spreads, particularly in the final six months of 2021. In the prior year, such spreads were abnormally wide due to pandemic related effects on interest rates and competition.

The following summarizes the performance of the Company's significant metrics:

- MUA grew to \$123.9 billion at December 31, 2021 from \$118.7 billion at December 31, 2020, an increase of 4%; the growth from September 30, 2021, when MUA was \$122.3 billion, was 5% on an annualized basis.
- Total new single-family mortgage origination was \$23.4 billion in 2021 compared to \$19.2 billion in 2020, an increase of 22%. The Company attributes this to a robust real estate market and a strong market share in the mortgage broker distribution channel which is the result of the Company's long-time broker relationships built on good service, competitive products and effective technology. Commercial segment origination of \$9.7 billion was 7% higher than the \$9.1 billion originated in 2020. Total new origination increased by 17% in 2021 compared to 2020.
- The Company took advantage of available opportunities in the year to renew over \$6.3 billion of single-family mortgages (\$6.7 billion a year ago). For the commercial segment, renewals were higher by 35% (\$2.7 billion compared to \$2.0 billion a year ago). The Company believes the lower single-family results are the result of some borrowers choosing to refinance to take advantage of low mortgage rates which reduces its opportunities.
- Revenue for 2021 increased by 1% to \$1.39 billion from \$1.38 billion in 2020. This change was the result of higher gains related to changes in fair market value of financial instruments. Largely because of the financial disruption experienced at the start of the pandemic, the Company incurred losses on holding financial instruments related to interest rate hedging of \$67 million. In 2021 there were gains of \$5.8 million. Lower revenue was also evident in placement transactions. This was the result of mortgage spread compression between 2021 and 2020. Commercial placement fees, in particular, were lower due to a change in funding mix. With a greater proportion of insured mortgages being allocated for securitization, the Company sacrificed placement fees in 2021 for future net securitization margin.
- Income before income taxes was \$263.8 million in compared to \$258.7 million in 2020. The increase reflected the result of changing capital market conditions in the comparative years. Excluding gains and losses related to financial instruments, the Company's earnings before income taxes and gains and losses on financial instruments ("Pre-FMV Income") ⁽¹⁾ for 2021 decreased by 20% to \$257.3 million from \$323.0 million in 2020. This change was largely the result of a return to pre-pandemic spread environment and shifts in the commercial segment's product mix and resulting funding strategy to allocate more origination volume to securitization as opposed to institutional placement. Generally, the increase in commercial origination volume was for uninsured products which is less profitable than insured origination. Together with increased borrower preference for shorter-term insured mortgages, per unit placement fee revenue for the commercial segment was lower than in 2020.

In the fourth quarter of 2021, the Company's Board of Directors announced a special common share dividend in the amount of \$1.25 per share, which was paid on December 15, 2021 to shareholders of record on November 30, 2021. This payment reflected the Board's determination that the Company generated excess capital in the past year and that the capital needed for near-term growth could be generated from current operations. As a result of an increase in the Company's monthly common share dividend in June 2021 – to an annualized rate of \$2.35 per share – and this special dividend, First National declared a record \$210.9 million in common share dividends in 2021.

(1) This non-IFRS measure adjusts income before income taxes by eliminating the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments. See Key Performance Indicators section in this MD&A.

Selected Quarterly Information

Quarterly Results of First National Financial Corporation

(\$000s, except per share amounts)

	Revenue	Net Income (loss) for the Period	Pre-FMV Income for the Period ⁽¹⁾	Net Income (loss) per Common Share	Total Assets
2021					
Fourth quarter	\$339,292	\$41,971	\$57,045	\$0.69	\$42,274,158
Third quarter	\$353,704	\$47,614	\$64,867	\$0.78	\$40,763,169
Second quarter	\$365,118	\$52,401	\$71,218	\$0.86	\$41,727,249
First quarter	\$336,492	\$52,575	\$64,146	\$0.87	\$40,586,601
2020					
Fourth quarter	\$387,303	\$69,123	\$94,937	\$1.13	\$39,488,527
Third quarter	\$373,760	\$72,517	\$99,644	\$1.20	\$38,314,904
Second quarter	\$344,581	\$50,844	\$75,506	\$0.84	\$39,040,298
First quarter	\$274,650	(\$2,255)	\$52,921	(\$0.05)	\$39,203,792

- (1) This non-IFRS measure adjusts income before income taxes by eliminating the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments. See Key Performance Indicators section in this MD&A and reconciliation below.

Reconciliation of Quarterly Determination of Pre-FMV Income

(\$000s, except per share amounts)

	Income (loss) before income tax for the Period	Add/ deduct Realized and unrealized losses (gains)	Deduct (losses), add gains related to mortgage and loan investments	Pre-FMV Income for the Period
2021				
Fourth quarter	\$57,111	\$71	(\$137)	\$57,045
Third quarter	\$65,134	\$383	(\$650)	\$64,867
Second quarter	\$70,101	\$1,217	(\$100)	\$71,218
First quarter	\$71,475	(\$7,486)	\$157	\$64,146
2020				
Fourth quarter	\$94,273	(\$260)	\$924	\$94,937
Third quarter	\$98,767	\$1,477	(\$600)	\$99,644
Second quarter	\$68,944	\$7,562	(\$1,000)	\$75,506
First quarter	(\$3,255)	\$58,576	(\$2,400)	\$52,921

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

In the past eight quarters, the Company experienced a relatively volatile economic environment. In 2019, the economic outlook was positive and there was a surplus of liquidity for investment in financial assets. This bred a competitive marketplace but one in which mortgage funding spreads were relatively steady and the Company earned consistent revenue and net income. 2020 began slowly and volumes were not particularly strong. COVID-19-related financial turmoil at the end of 2020's first quarter created large losses on financial instruments and the Company reported a small loss. In the final three quarters of 2020, the Company benefited from both its business model which does not rely on face-to-face interactions and abnormally wide mortgage spreads. The spreads were the result of the aftermath of the COVID-19-related financial crisis that began at the end of the 2020 first quarter. These spreads were the basis for growth in Pre-FMV Income in the last three quarters of 2020. To start 2021, net income remained steady as financial markets stabilized and the Company earned income from higher origination volumes and wider spreads locked in its securitization portfolio. Competition accelerated in mid 2021 on signs of an improving economy and a risk-on environment and, over the past six months, spreads returned to pre-pandemic levels. The ensuing spread tightening reduced profitability for the Company in the third and fourth quarter of 2021 compared to periods of exceptional profitability in 2020.

Outstanding Securities of the Corporation

At December 31, 2021, and March 1, 2022, the Corporation had 59,967,429 common shares; 2,984,835 Class A preference shares, Series 1; 1,015,165 Class A preference shares, Series 2; 200,000 November 2024 senior unsecured notes; and 200,000 November 2025 senior unsecured notes outstanding.

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

(\$000s, except per share amounts)

	2021	2020	2019
For the Year Ended December 31, Income Statement Highlights			
Revenue	1,394,606	1,380,294	1,326,523
Interest expense – securitized mortgages	(630,279)	(708,162)	(739,071)
Brokerage fees	(201,786)	(159,018)	(102,596)
Salaries, interest and other operating expenses	(298,720)	(254,385)	(243,143)
Add (deduct): realized and unrealized losses (gains) on financial instruments	(5,815)	67,355	9,655
Deduct: unrealized losses regarding mortgage investments	(730)	(3,076)	(4,300)
Pre-FMV Income ⁽¹⁾	257,276	323,008	247,068
Add (deduct): realized and unrealized gains (losses) on financial instruments excluding those on mortgage investments	6,545	(64,279)	(5,355)
Provision for income taxes	(69,260)	(68,500)	(64,500)
Net income	194,561	190,229	177,213
Common share dividends declared	210,885	148,419	144,421
Per Share Highlights			
Net income per common share	3.20	3.12	2.90
Dividends per common share	3.52	2.47	2.41
At Year End			
Balance Sheet Highlights			
Total assets	42,274,158	39,488,527	37,685,593
Total long-term financial liabilities	398,888	398,554	374,025

Notes:

- (1) Pre-FMV Income is not a recognized earnings measure under IFRS and does not have a standardized meaning prescribed by IFRS. Therefore, Pre-FMV Income may not be comparable to similar measures presented by other issuers. Investors are cautioned that Pre-FMV Income should not be construed as an alternative to net income or loss determined in accordance with IFRS as an indicator of the Company's performance or as an alternative to cash flows from operating, investing and financing activities as a measure of liquidity and cash flows. The figures for 2019 have been restated to conform to the 2021 and 2020 presentation.

Vision and Strategy

The Company provides mortgage financing solutions to the residential and commercial mortgage markets in Canada. By offering a full range of mortgage products, with a focus on customer service and superior technology, the Company believes that it is a leading non-bank mortgage lender. 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 business processes and service to mortgage brokers and borrowers; 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, create longer-term value from servicing rights, renewals and the growth of the customer base for marketing initiatives. As at December 31, 2021, MUA totalled \$123.9 billion, up from \$118.7 billion at December 31, 2020, an increase of 4%. The growth of MUA in the fourth quarter of 2021, was 5% on an annualized basis.

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 2021, the Company's single-family origination increased. The Company believes this is the result of its strong broker relationship and technology, which have both been significant benefits in the pandemic period. Generally, the Company's business practices do not rely on face-to-face interactions. Together with a lower interest rate environment, the Company's single-family origination grew by 22% in 2021 compared to 2020. The commercial segment had a strong year. Total commercial volumes increased by 7% to \$9.7 billion compared to \$9.1 billion in 2020. Together, overall new origination for 2021 increased 17% year over year.

Third-Party Mortgage Underwriting and Fulfilment Processing Services

In 2015, the Company launched its third-party underwriting and fulfilment processing services business with a large Canadian schedule I bank ("Bank"). This business is designed to adjudicate mortgages originated by the Bank through the single-family residential mortgage broker channel. First National employs a customized software solution based on its industry-leading MERLIN technology to accept mortgage applications from the Bank in the mortgage broker channel and underwrite these mortgages in accordance with the Bank's underwriting guidelines. The Bank funds all the mortgages underwritten under the agreement and retains full responsibility for mortgage servicing and the client relationship. Management considers the agreement a way to leverage the capabilities and strengths of First National in the mortgage broker channel and add some diversity to the Company's service offerings. In late 2019, the Company entered into a similar agreement with another Canadian bank.

Excalibur Mortgage Products

The Company originates alternative single-family (“Excalibur”) mortgage products. Alternative lending describes single-family residential mortgages that are originated using broader underwriting criteria than those applied in originating prime mortgages. These mortgages generally have higher interest rates than prime mortgages. First National’s relationships with mortgage brokers and its underwriting systems allow for cost effective origination of significant volumes. The product is originated primarily for placement with institutional investors, but beginning in April 2019, the Company finalized an agreement with a bank-sponsored securitization conduit to fund a portion of the Excalibur origination. In early 2020, an agreement was entered into with another bank-sponsored conduit to provide additional funding for this product. The Excalibur relaunch was rolled out gradually, beginning in Ontario. Currently the program originates the majority of its mortgages in Ontario with a small but growing amount in Western Canada.

Raising Capital for Operations

Bank Credit Facility

The Company has a \$1.5 billion revolving line of credit with a syndicate of banks. This facility enables the Company to fund the large amounts of mortgages accumulated for securitization. In second quarter of 2021, the Company extended the term of the facility by two years to March 2026 and increased the commitment amount by \$250 million. 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 senior unsecured notes, which are fully drawn during their term; (3) the five-year remaining term gives the Company a committed facility for the medium term; and (4) the cost of borrowing reflects the Company’s BBB issuer rating.

Note Issuance

In November 2020, the Company issued 200,000 2.961% Series 3 senior unsecured notes for a five-year term pursuant to a private placement under an offering memorandum. These notes add to the Company’s 2019 issuance of 200,000 3.582% Series 2 senior unsecured notes. The net proceeds of both offerings, after broker commissions, were invested in FNFLP. On settlement, the proceeds were used to pay down a portion of the indebtedness under the bank credit facility. The Company’s medium-term debt capital now stands at approximately \$400 million.

Preferred Share Issuance

Pursuant to the original prospectus, effective April 1, 2021, the Company reset the annual dividend rate on the outstanding Class A Series 1 preference shares to 2.895% for a five-year term to March 31, 2026. After the exercise of shareholder conversion rights in March 2021, there were 2,984,835 Class A Series 1 shares outstanding and 1,015,165 Class A Series 2 outstanding. The Series 2 shares 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 Directors approval, and are redeemable at the discretion of the Company such that after each five-year term ending on March 31, 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 (and vice versa), there is no provision of redemption rights to these shareholders. As such, the Company considers these shares to represent a permanent source of capital.

Employing Securitization Transactions to Minimize Funding Costs

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

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

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

Period	Average Five-Year Mortgage Spread for the Period
2006	1.12%
2007	1.50%
2008	2.68%
2009–2016	1.77%
2017–2018	1.36%
2019	1.42%
2020	1.76%
2021	1.17%

Generally, when this spread is wider, the Company can earn higher returns from its securitization activities, although funding spreads also affect profitability. Between 2009 and 2019, liquidity issues at financial institutions created by the 2008 financial crisis diminished and the competition for mortgages increased such that spreads tightened in the 10-year period as shown above, falling to a low of 1.10% in the third quarter of 2018. Toward the end of the first quarter of 2020, fears of a global pandemic related to COVID-19 led to a dramatic and sudden decrease in bond yields as central banks cut overnight rates significantly. Credit spreads widened and the capital markets ceased to function normally. In the second quarter of 2020, as financial systems began to normalize, mortgage coupons remained elevated as other credit spreads, including those on NHA-MBS, narrowed. The resulting spreads had positive impacts on 2020 results and increased the profitability inherent in the Company’s securitization portfolio. In 2021, spreads narrowed returning to 2018 levels at first and then closing to levels not seen since before the 2008 financial crisis. In 2021, the Company originated and renewed for securitization purposes approximately \$8.9 billion of single-family mortgages and \$4.0 billion of multi-unit residential mortgages.

The Company is subject to various regulations put in place by CMHC to control the amount of NHA-MBS that a single issuer can create. These rules include the amount of CMHC guarantees that is a requirement to issue a pool. Currently there is a tiered NHA-MBS guarantee fee pricing structure, such that any guarantees issued to one issuer over \$9.0 billion of issuance have a higher price. The tiered limit of \$9.0 billion remains unchanged for 2022.

Canada Mortgage Bonds Program

The CMB program is an initiative where Canada Housing Trust (“CHT”) issues securities to investors in the form of semi-annual interest-yielding five- and 10-year bonds. 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.

Key Performance Indicators

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

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

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

	Quarter ended		Year Ended	
	December 31, 2021	December 31, 2020	December 31, 2021	December 31, 2020
For the Period			(\$000s)	
Revenue	339,292	387,303	1,394,606	1,380,294
Income before income taxes	57,111	94,273	263,821	258,729
Pre-FMV Income ⁽¹⁾	57,045	94,937	257,276	323,008
At Period End				
Total assets	42,274,158	39,488,527	42,274,158	39,488,527
Mortgages under administration	123,907,627	118,723,990	123,907,627	118,723,990

Note:

- (1) This non-IFRS measure adjusts income before income taxes by eliminating the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments (except those on mortgage investments)

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

Determination of Common Share Dividend Payout Ratio

	Quarter Ended		Year Ended	
	December 31, 2021	December 31, 2020	December 31, 2021	December 31, 2020
For the Period			(\$000s)	
Net income attributable to common shareholders	41,287	68,465	191,866	187,383
Total dividends paid or declared on common shares	110,190	60,717	210,885	148,419
Dividends paid or declared on common shares, excluding special dividends	35,231	30,733	135,926	118,435
Total common share dividend payout ratio	267%	89%	110%	79%
Regular common share dividend payout ratio ⁽¹⁾	85%	45%	71%	63%
After-tax Pre-FMV dividend payout ratio ⁽²⁾	85%	45%	73%	50%

Note:

- (1) This ratio is calculated by excluding the payment of the special dividends declared at the end of the years presented.
- (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 income so as to eliminate the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments. The Company uses its aggregate effective tax rate to tax affect the impact of the valuation of financial instruments on this ratio.

For the year ended December 31, 2021, the common share payout ratio was 110% compared to 79% for the year ended December 31, 2020. However, in both 2021 and 2020, the Company declared a special dividend and recorded gains and losses on account of the changes in fair value of financial instruments. Gains and losses are recorded in the period in which the prices on Government of Canada bonds change; however, the offsetting economic impact is generally reflected in narrower or wider spreads in the future once the mortgages have been pledged for securitization. Accordingly, management does not consider such gains and losses to affect its dividend payment policy in the short term. If the special dividends and gains and losses on financial instruments in the two years are excluded from the above calculations, the dividend payout ratio for 2021 would have been 73% compared to 50% in 2020.

The Company also paid \$2.7 million of dividends on its preferred shares in 2021 (\$2.8 million in 2020).

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. In general, originations are allocated from one funding source to another depending on different criteria, including type of mortgage and securitization limits, with an overall consideration related to maintaining diversified funding sources. The Company retains servicing rights on virtually all the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2021, new origination volume increased to \$33.2 billion from \$28.3 billion, or about 17%, compared to 2020.

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 \$42.1 billion of new originations and renewals in 2021, \$12.9 billion was originated for its own securitization programs.

Placement Fees and Gain on Deferred Placement Fees

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as “placement fees”. The present value of additional amounts expected to be received over the remaining life of the mortgage sold (excluding normal market-based servicing fees) is recorded as a “deferred placement fee”. A deferred placement fee arises when mortgages with spreads in excess of a base spread are placed. Normally the Company would earn an upfront cash placement fee, but investors prefer paying the Company over time, as they earn net interest margin on such transactions. Upon the recognition of a deferred placement fee, the Company establishes a “deferred placement fee receivable” that is amortized as the fees are received by the Company. Of the Company’s \$42.1 billion of new originations and renewals in 2021, \$27.8 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

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

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

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

Results of Operations

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

	Quarter Ended		Year Ended	
	December 31, 2021	December 31, 2020	December 31, 2021	December 31, 2020
(\$ millions)				
Mortgage Originations by Segment				
New single-family residential	5,218	5,962	23,414	19,165
New multi-unit and commercial	3,045	2,723	9,747	9,112
Sub-total	8,263	8,685	33,161	28,277
Single-family residential renewals	1,491	1,648	6,306	6,668
Multi-unit and commercial renewals	902	558	2,658	1,962
Total origination and renewals	10,656	10,891	42,125	36,907
Mortgage Originations by Funding Source				
Institutional investors	6,863	8,011	27,813	25,019
NHA-MBS/CMB/ABCP securitization	3,475	2,547	12,923	11,036
Internal Company resources/CMBS	318	333	1,389	852
Total	10,656	10,891	42,125	36,907
Mortgages under Administration				
Single-family residential	84,896	83,601	84,896	83,601
Multi-unit residential and commercial	39,012	35,123	39,012	35,123
Total	123,908	118,724	123,908	118,724

Total new mortgage origination volumes increased in 2021 compared to 2020 by 17%. Single-family volumes increased by 22% and commercial segment volumes increased by 7% year over year. Management believes the growth in the single-family segment was due to several factors that include its strong broker and investor relationships, robust market conditions, and its MERLIN technology and operating systems, which support physical distancing and allowed the Company to continue to underwrite efficiently during the pandemic. Lower mortgage rates also encouraged home purchasing across the country. In the commercial segment, the Company's expertise in underwriting multi-unit mortgages is a fundamental competency. After a slow start to 2021, commercial origination volumes increased 7% in 2021 compared to 2020. When combined with renewals, total production for both business segments increased by 14% to \$42.1 billion in 2021 from \$36.9 billion in 2020. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy, with volume of \$12.9 billion in 2021.

Net Interest – Securitized Mortgages

Comparing the year ended December 31, 2021, to the year ended December 31, 2020, "net interest – securitized mortgages" increased by about 26% to \$163.2 million from \$129.4 million. The portfolio of mortgages pledged under securitization grew 4% from about \$34.1 billion at December 31, 2020 to \$35.4 billion at December 31, 2021. The growth in profitability was due to several factors: the reduction in the amount of indemnities payable to MBS bondholders, growth in the commercial portfolio which grew at rate of 24% in 2021, and the performance of the Excalibur securitization program. These growth factors were offset by the prime residential program which experienced higher than expected rates of prepayment. Higher prepayment activity appears to be a function of a pandemic-related drop in interest rates as borrowers took advantage of lower mortgage rates to refinance their mortgages. This roll off resulted in a premature loss of income-producing assets and, as these mortgages prepaid, the Company's exposure to the cost of indemnities payable to MBS debtholders increased. The indemnities are calculated

to make whole NHA-MBS debtholders and assume the prepayment principal is reinvested at risk free reinvestment rates. With the decrease in such interest rates in 2020, the cost of such indemnities increased significantly. While still relevant for the Company, indemnity costs slowed as interest rates stabilized. The Company has determined that indemnity costs in 2021 were lower by \$15.9 million compared to those in 2020. Accordingly, Net Interest – Securitized Mortgages was higher by that amount in 2021. The Company’s prime ABCP programs securitization margins were tighter in 2020 as the cost of funds reacted negatively to the financial turmoil produced by the pandemic such that profitability was decreased. In comparison, 2021 interest costs were stable and securitization margins increased comparatively.

Placement Fees

Placement fee revenue decreased by 9% to \$303.7 million from \$333.7 million in the comparative year. The decrease was the result of several factors. Despite a 11% increase in origination volumes sold to institutional investors, mortgage spreads returned to pre-pandemic levels. Accordingly, mortgages sold on a funded basis attracted a lower per unit placement fee. For the residential segment, average per unit fees were lower by about 13% year over year. For the commercial segment, mortgage spreads were also tighter than in 2020 and funding decisions had a significant impact on placement fees. Commercial placement fees were lower by \$40.1 million year over year on tighter spreads and a shift of funding strategy from placement to securitization for 10-year insured mortgage origination. In 2021, the Company benefited from CMHC programs that increased CMB access for issuers who lend on affordability-linked real estate. This program is limited to 10-year insured mortgages, such that the Company elected to securitize a larger percentage of its insured commercial mortgage origination and there was less insured product available to place with institutional investors the Company. By shifting these mortgages to its own securitization, the Company has foregone placement fees for future net securitization margin. While arguably economically superior, the value of this securitization is recognized in income over ten years as opposed to a placement where much of the value is recognized in the current period. In 2021, the Company securitized \$2.7 billion and placed about \$2.6 billion of its five- and ten-year insured origination. In 2020, the Company securitized \$1.3 billion and placed about \$4.6 billion of its five- and ten-year insured mortgage origination. The Company estimates that the economic value of the additional \$1.4 billion of mortgages securitized is approximately \$26 million. 2021 also featured a shift within insured origination from 10-year term product to 5-year term product. In 2021, with a changing interest rate market, underwriting rules made it more difficult for borrowers to qualify for ten-year terms such that 5-year term origination increased to the detriment of 10-year origination. Placement fees are directly linked to the term of mortgages, such that 5-year mortgages provide approximately 50% lower revenue on a per-unit basis. This shift was magnified by the Company’s securitization strategy. Lastly, in 2020, spreads were abnormally wide for about 9 months of the year after mortgage lenders reacted to the financial impact of the pandemic. As the Company placed these mortgages with institutional investors, it earned larger per-unit placement fees than typical. In 2021, spreads returned to pre-pandemic levels about mid year such that spreads were between 15 to 50% lower than just 12 months prior.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue decreased 50% to \$16.1 million from \$32.4 million. These gains related primarily to multi-unit residential mortgages originated and sold to institutional investors. Volumes for these transactions decreased by 30% from 2020 as the Company elected to securitize directly more of the mortgages that support this revenue. Spreads on these mortgages were also narrower in 2021 compared to 2020 as described in the Placement Fees section above.

Mortgage Servicing Income

Mortgage servicing income increased 21% to \$211.6 million from \$175.0 million. This increase was attributable to growing administration revenue on growing MUA and growth in the Company's third-party underwriting business unit. Much like the Company's experience in single-family origination, First National's third-party underwriting customers benefited from the Company's MERLIN technology. Management believes this technology and First National's business model have been advantageous during the pandemic and led to increased origination volumes.

Mortgage Investment Income

Mortgage investment income decreased 7% to \$63.9 million from \$69.0 million. The decrease was due primarily to the interest rate environment. Short-term rates fell significantly in March 2020 as the Bank of Canada cut its overnight rate by 1.5%. Accordingly, most of the decrease was related to the first quarter of each year such that 2021's revenue was lower than 2020 by about \$7 million. After the 2020 first quarter, the Company decreased its offered mortgage rates. The result was lower amounts of interest earned on mortgages while they are accumulated for securitization on the balance sheet.

Realized and Unrealized Gains (Losses) on Financial Instruments

This financial statement line item consists of three primary components: (1) gains and losses related to the Company's economic hedging of single-family commitments, (2) gains and losses related to holding a portfolio of mortgage and loan investments at fair value, and (3) gains and losses on interest rate swaps used to mitigate interest rate risk on its CMB activity. With the adoption of IFRS 9 in 2018, a significant portion of the Company's interest rate management program qualifies as "hedging" for accounting purposes. The Company has elected to document hedging relationships for virtually all of the multi-residential commitments and mortgages it originates for its own securitization programs. It has also done the same for funded single-family mortgages and the swaps used in its ABCP programs. This decision has reduced the volatility of gains and losses on financial instruments otherwise recorded in the Company's regular earnings, as gains and losses on hedged items are generally deferred and amortized into income over the term of the related mortgages. The Company has not documented a hedging relationship for its interest mitigation program for its single-family mortgage commitments. The Company believes, given the optional nature of these commitments, it is difficult to establish a valid hedging relationship. For financial reporting purposes, this means that there will still be gains and losses on financial instruments, but these should be limited to those on the bonds sold short used to mitigate such risk. The following table summarizes these gains and losses by category in the periods indicated:

Summary of Realized and Unrealized Gains (Losses) on Financial Instruments	Quarter Ended		Year Ended	
	December 31, 2021	December 31, 2020	December 31, 2021	December 31, 2020
			(\$000s)	
Gains (losses) on short bonds used for the economic hedging program	3,155	114	15,397	(75,689)
Gains (losses) on mortgages held at fair value	(137)	924	(730)	(3,076)
Gains (losses) on interest rate swaps	(3,089)	(778)	(8,852)	11,410
Net gains (losses) on financial instruments	<u>(71)</u>	<u>260</u>	<u>5,815</u>	<u>(67,355)</u>

In the first quarter of 2020, there were significant financial repercussions related to the pandemic. After the significant disruption in that quarter, bond yields continued to fall but at a slower pace. The impact on the Company's short-bond position used to mitigate interest rate risk on single-family commitments was \$75.7 million of losses in the full year 2020. In contrast, 2021 was a more stable period where bond yields remained relatively flat with a slow rise toward the end of the fourth quarter as economic predictions suggested an inflationary environment. For 2021, the Company recorded \$15.4 million of gains related to short bonds used to manage the interest rate risk of residential mortgage commitments.

Brokerage Fees Expense

Brokerage fees expense increased 27% to \$201.8 million from \$159.0 million. This increase reflected higher origination volumes of single-family mortgages for institutional investors, which increased by almost \$3.7 billion or 28% year over year. The growth was offset by lower commercial segment broker fees and moderated by more Excalibur broker fees which are lower due to the shorter terms of these mortgages. Unit broker fees for prime residential mortgages were about 1% higher in 2021 compared to 2020.

Salaries and Benefits Expense

Salaries and benefits expense increased 23% to \$177.0 million from \$143.5 million. Salaries were higher as overall headcount increased by 30% (1,579 employees at December 31, 2021 compared to 1,211 at December 31, 2020). Headcount growth is primarily in the residential underwriting departments. If the impact of commercial underwriting compensation is taken out of the figures above, salaries and benefits increased by 29% between 2020 and 2021. Management salaries were paid to the two senior executives (co-founders) who together control about 71% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO") in 2006.

Interest Expense

Interest expense decreased 8% to \$48.9 million from \$53.2 million. As discussed in the "Liquidity and Capital Resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the investor or funding with a securitization vehicle. The Company used senior unsecured notes together with a \$1.5 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense decreased from 2020 due to lower prevailing interest rates on the Company's debt, particularly when comparing the first quarter of 2021 to the pre-pandemic first quarter of 2020 when interest rates were higher.

Other Operating Expenses

Other operating expenses increased by 26% to \$72.8 million from \$57.6 million. The primary change in other operating expenses was a \$5.8 million increase in hedging costs associated with a larger notional hedging program to support the company's securitization programs and a steepening bond yield curve which makes hedging more expensive. Expenses for depreciation were also higher than in 2020 as the Company invested in equipment to support its growing workforce and work-from-home business continuity strategy. Discretionary costs, including promotion, travel and entertainment were lower as a result of government-mandated measures related to the pandemic.

Income before Income Taxes and Pre-FMV Income

Income before income taxes increased by 2% to \$263.8 million from \$258.7 million in 2020. This increase was largely the result of changing capital markets. The Company's results include gains or losses on account of financial instruments used to economically hedge residential mortgage commitments. As described previously in this MD&A, the Company's results include gains or losses on account of financial instruments used to economically hedge residential mortgage commitments. Because of the financial disruption related to the pandemic, large losses were recorded in 2020. All told, the Company recorded \$64.3 million of losses on financial instruments (excluding losses related to mortgage and loan investments). Comparatively, in 2021, the Company recorded \$6.5 million of gains on financial instruments (excluding the losses related to mortgage and loan investments). The change in these values, excluding the losses on mortgage investments, accounted for a \$70.8 million increase in comparative income before income taxes. Pre-FMV Income, which excludes these changes, decreased by 20% to \$257.3 from \$323.0 million. Early in 2020, bond yields dropped significantly and rapidly. This had a direct and immediate effect on the financial instruments the Company uses to hedge its residential mortgage commitments. However, as those mortgage commitments transformed into funded mortgages, the Company originated mortgages with comparatively high mortgage coupons. These mortgages together

with mortgages subsequently originated in the wider spread environment, produced larger placement fees as the Company placed these mortgages with investors. Management believes that the Company comparatively earned about \$30 million of additional revenue from such placements. The decrease in Pre-FMV income was also the result of the commercial segment. In 2021, earnings were affected by tighter mortgage spreads and a shift in funding sources. Because of favorable CMB treatment, the Company securitized about \$1.4 billion more of its 5- and 10-year insured commercial segment mortgage origination volume compared to 2020. Although perhaps economically superior, this election delays the recognition of earnings for the Company. As described previously, placement fees in the commercial segment were lower by approximately \$26.0 million from the shift to securitization. This decrease directly impacted earnings as the compensation to the Company's underwriters generally does not change when mortgages are securitized as opposed to placed. Higher headcount was another unfavorable factor on earnings. In order to support the record volumes of residential mortgage origination, historically high third-party underwriting volumes and demands on information technology, headcount increased by 30% comparing 2021 to 2020. Growth in the Company's securitization portfolio and higher origination in third-party underwriting had favourable impacts on Pre-FMV income in 2021.

Income Tax Expense

The provision for taxes increased by 1% to \$69.3 million from \$68.5 million. The provision increased proportionately with net income before income taxes.

Other Comprehensive Income

For the commercial segment, the Company hedges the interest rate risk associated with insured multi-residential mortgages. This hedging begins on commitment and ends when the Company either securitizes the mortgages or places the mortgage with an institutional investor. As the Company determined that these cash flow hedges were effective, the Company recorded \$31.2 million of pre-tax net gains on such hedges in OCI in 2021. These gains would have been recorded as gains on financial instruments under the previous IFRS standard. In the year, the Company amortized a portion of the gains and losses in accumulated OCI into regular earnings. In 2021, this amortization totalled \$3.7 million. The remaining OCI amount will be amortized into net income in future periods.

Operating Segment Review

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

Operating Business Segments				
For the Year Ended	Residential		Commercial	
	(\$000s except percent amounts)			
	December 31, 2021	December 31, 2020	December 31, 2021	December 31, 2020
Originations and renewals	29,719,176	25,833,197	12,404,946	11,075,085
<i>Percentage change</i>	<i>15%</i>		<i>12%</i>	
Revenue	1,030,550	975,979	364,056	404,315
<i>Percentage change</i>	<i>6%</i>		<i>(10%)</i>	
Income before income taxes	199,366	141,085	64,455	117,644
<i>Percentage change</i>	<i>41%</i>		<i>(45%)</i>	
As at	December 31, 2021	December 31, 2020	December 31, 2021	December 31, 2020
Identifiable assets	28,813,695	28,945,884	13,430,687	10,512,867
Mortgages under administration	84,895,778	83,600,868	39,011,848	35,123,122

Residential Segment

Overall residential origination volumes including renewals increased by 15% between 2021 and 2020 while residential revenues increased by 6%. Revenue was affected by the impact of financial instruments. Excluding the impact of these revenues, adjusted revenue decreased by 2%. Revenue was negatively affected in 2021 by tighter mortgage spreads and lower mortgage rates. Narrower spreads affected placement fees which were up 4% or \$10 million despite 15% growth in origination. The Company's portfolio of securitized mortgages decreased by \$0.8 billion from 2020 to 2021. This change represented new mortgages added in the year of almost \$9 billion offset by run-off and prepayment of almost \$10 billion. The effect was the replacement of older mortgages with higher coupons with new mortgages at lower coupons reflective of the current intertest rate environment. Accordingly, revenue in this area was lower by \$54 million. Lower interest rates also affected mortgage investment income and, partially, mortgage servicing revenue. Net income before tax was also affected by fair value-related revenues. Without the impact of these revenues, net income before tax decreased to \$192.8 million in 2021 from \$205.4 million in 2020, or by 6%. This is the outcome of the lower per-unit revenues on placement activity combined with higher headcount which has created comparatively higher operating expenses. Identifiable assets decreased from December 31, 2020, as the Company's residential portfolio of mortgages pledged under securitization decreased by about \$0.8 billion. Increases in mortgages accumulated for sale and related hedge assets offset most of this decrease.

Commercial Segment

2021 commercial revenues were lower compared to 2020 largely because of a shift in the product mix in mortgage origination and a tighter mortgage spread environment. Despite the growth in origination of 12%, all of this growth has been used in securitization which produces revenue over a longer period as opposed to placement transactions. The Company elected to securitize a larger percentage of its commercial mortgage origination, specifically 10-year term insured mortgages. This has shifted the most profitable product from one that earns the Company current period placement fees to one that creates future net securitization margin. Income before income taxes decreased by 45% year over year. The decrease is due to lower placement fee revenues as described and higher comparative compensation paid to the Company's inhouse underwriters. Despite mortgages being placed or securitized, these employees are paid on funding of the mortgage such that overall employee costs increased 12% in this department.

Identifiable assets increased from those at December 31, 2020 as the Company increased securitized mortgages by about \$2.1 billion, mortgages accumulated for securitization by \$0.2 billion, and hedging related assets by \$0.6 billion.

Liquidity and Capital Resources

The Company's fundamental liquidity strategy has been to invest in prime Canadian mortgages. Management's belief has always been that these mortgages are considered "AAA" by investors and should always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, and once again in the COVID-19 crisis, when capital markets were disrupted and the demand for high-quality assets increased. As the Company's results in those years demonstrated, First National was able to attract investors to purchase its mortgage origination at profitable margins. Originating prime mortgages also allows the Company to securitize in the capital markets; however, this activity requires significant cash resources to purchase and hold mortgages prior to arranging for term debt through the securitization markets. For this purpose, the Company uses the combination of unsecured notes and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) the origination costs associated with securitization, and (3) mortgage and loan investments. The Company has a credit facility with a syndicate of financial institutions for total credit of \$1.5 billion. This facility was extended in June 2021 for a five-year term maturing in March 2026. At December 31, 2021, the Company had entered into repurchase transactions with financial institutions to borrow \$1.8 billion related to \$1.8 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At December 31, 2021, outstanding bank indebtedness was \$965.4 million (December 31, 2020 - \$682.8 million). Together with the unsecured notes of \$399 million (December 31, 2020 - \$399 million), this "combined debt" was used to fund \$951.3 million (December 31, 2020 - \$805.7 million) of mortgages accumulated for sale or securitization. At December 31, 2021, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$64.4 million (December 31, 2020 - \$62.5 million) and (2) mortgage and loan investments of \$192.3 million (December 31, 2020 - \$213.3 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, increased between December 31, 2020, and December 31, 2021, and now stands at \$413.0 million (December 31, 2020 - \$275.8 million). This represents a debt-to-equity ratio of approximately 0.72:1. This ratio is higher than the ratio of 0.48:1 at December 31, 2020. In general, the increase was the result of investing \$157 million in investments in mortgages pledged for securitization, largely to support its Alt-A securitization program. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

Since being approved as an issuer of NHA-MBS, the Company has funded the difference between the mortgages it uses to create NHA-MBS and the debt obligations it assumes upon issuance. In recent years, this requirement has generally been limited to mortgages in arrears where First National does not receive payments from the borrower but is obliged to pay the interest and amortizing principal on the NHA-MBS debt. However, due to 2020 related national unemployment pursuant to the COVID-19 pandemic, this funding requirement increased as borrowers requested mortgage payment deferrals. In such situations, the Company determined to grant mortgage payment deferrals. Qualifying borrowers received three months of payment deferral. In cases of extended hardship, the Company provided a second three-month deferral after the initial deferral period ended. During this deferral period, a portion of such mortgages ceased to amortize and interest otherwise payable was capitalized to the principal of the mortgage. The three mortgage default insurers approved these steps, permitting the deferrals to occur without any impact on subsequent claims under the mortgage insurance policies. In turn, First National has been required to make "timely payments" on the NHA-MBS securities. This means that despite not receiving payments from borrowers on the mortgages that support the NHA-MBS, the Company has been required to pay the interest and amortizing principal on the debt. In effect, the Company de-leveraged its balance sheet by paying off the debt while the related mortgages did not as amortize as quickly. At December 31, 2021, the Company estimates that it had reduced its NHA MBS debt by approximately \$46 million (December 31, 2020 - \$64 million) because of the impact of deferred payments. This has been funded by the Company's available cash resources.

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 before long-term financing. 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.

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, 2021, the investment in cash collateral was \$105.1 million (December 31, 2020 – \$88.2 million).

The Company's Board of Directors has elected to pay dividends, when declared, on a monthly basis on the outstanding common shares and on a quarterly basis on the outstanding preference shares. For purposes of the enhanced dividend tax credit rules contained in the *Income Tax Act* (Canada) and any corresponding provincial and territorial tax legislation, all dividends (and deemed dividends) paid by the Company to Canadian residents on both common and preference shares after June 30, 2010, are designated as "eligible dividends". Unless stated otherwise, all dividends (and deemed dividends) paid by the Company hereafter are designated as "eligible dividends" for the purposes of such rules.

Financial Instruments and Risk Management

Commencing January 1, 2018, the Company has recorded mortgages accumulated for sale and mortgage and loan investments as financial assets measured at "fair value through profit or loss" such that changes in market value are recorded in the consolidated statement of income. The mortgages accumulated for sale are held for very short periods, and any change in value due to changing interest rates is the obligation of the ultimate institutional investor. Accordingly, the Company believes there will be little, if any, effect on its income related to the change in fair value of these mortgages. The majority of mortgages in mortgage and loan investments are uninsured commercial segment bridge loans. These are primarily floating rate loans that have mortgage terms of 18 months or less. As the mortgages do not conform to conventional mortgage lending, there are few active quoted markets available to determine the fair value of these assets. The Company estimates fair value based upon: benchmark interest rates, credit spreads for similar products, creditworthiness and status of the borrower, valuation of the underlying real property, payment history, and other conditions specific to the rationale for the loan. Any favourable or unfavourable amounts will be recorded in the statement of income each quarter.

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. Prior to 2018, the Company did not attempt to adopt hedge accounting; however, with the introduction of IFRS 9 on January 1, 2018, the Company began designating hedging relationships such that the results of any effective hedging will not affect the Company's statement of income. See previous discussion in this MD&A under "Realized and Unrealized Gains (Losses) on Financial Instruments". As at December 31, 2021, the Company had \$1.4 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, 2021, the Company had entered into \$1.1 billion of notional value forward bond sales for this segment. The Company is also a party to three 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, 2021, the aggregate notional value of these swaps, maturing between December 2023 and September 2026, was \$195 million. During 2021, the value of these swaps decreased by \$8.9 million.

As described above, the Company employs various strategies to reduce interest rate risk. In the normal course of business, the Company also takes on credit spread risk. This is the risk that the credit spread at which a mortgage is originated changes between the date of commitment of that mortgage and the ultimate date of placement or securitization. If credit spreads widen during this holding period, this is unfavourable for the Company. It means that the Company cannot fund the mortgages originated with a funding source as effectively as originally intended. Despite entering into effective interest rate hedges, the Company's exposure to credit spreads will remain. This risk is inherent in the Company's business model and the Company believes it cannot be economically hedged. As at December 31, 2021, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were approximately \$2.7 billion of mortgages that were susceptible to some degree of changing credit spreads.

Capital Expenditures

A significant portion of First National's business model is the origination and placement or securitization of financial assets. Generally, placement activities do not require any capital investment. Securitization transactions may require the investment of significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. The business requires capital expenditures on technology (both software and hardware), leasehold improvements, and office furniture. During the year ended December 31, 2021, the Company purchased new computer equipment and software and made leasehold improvements. In the long term, the Company expects capital expenditures on fixed assets will be approximately \$10 million annually. 2021 expenditures were much higher at \$32 million as the Toronto office moved to its new premises and invested in new leasehold improvements.

Summary of Contractual Obligations

The Company's long-term obligations include leases of premises with terms up to 15 years for its offices across Canada, and its obligations for the ongoing servicing of mortgages sold to securitization conduits and mortgages related to purchased servicing rights. The Company sells its mortgages to securitization conduits on a fully serviced basis and is responsible for the collection of the principal and interest payments on behalf of the conduits, including the management and collection of mortgages in arrears.

	<u>Total</u>	<u>0-1 Years</u>	<u>Payments Due by Period</u>		
			<u>1-3 Years</u> (S000s)	<u>4-5 Years</u>	<u>After 5 Years</u>
Lease Obligations	134,426	10,339	18,966	17,639	87,482

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, 2021. The policies that First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

The Company uses estimates in valuing its gain or loss on the sale of its mortgages placed with institutions earning a deferred placement fee. Under IFRS, valuing a gain on deferred placement fees requires the use of estimates to determine the fair value of the retained interest 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.

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 year ended December 31, 2021, are consistent with those used for the year ended December 31, 2020 and the quarters ended September 30, June 30 and March 31, 2021.

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. A portion of the bonds sold short are designated as an effective hedge, and accordingly, 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 has reduced the volatility in earnings as changes in the value on short bonds have been matched to the recognition of the change in value of the hedged 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 where it is difficult to find independent valuation comparatives. The Company uses information in its underwriting files, regional real estate information and other internal measures to determine the fair value of these assets.

As a mortgage lender, the Company invests in uninsured mortgages. When it funds these mortgages through securitization debt, it continues to be liable for any credit losses. The key inputs in the measurement of any expected credit loss ("ECL") include probability of default, loss given default and forecast of future economic conditions, which involves significant judgment. Upon application of IFRS 9 with respect to impairment, there has been no impact on the Company's earnings. Because of the high proportion of government-insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends, no significant amount of credit losses were recorded in 2021.

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, 2021, 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, 2021.

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, 2021, and that no material weaknesses have been identified in the Company's internal control over financial reporting as of December 31, 2021. No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2021, that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

ESG

The Company issued its initial Public Accountability Statement in the fall of 2021. This report explores First National's approach to sustainability and provides environmental, social and governance disclosure that has been reviewed and approved by our Board of Directors. It complements our Management Information Circular, Annual Information Form, Management Discussion and Analysis and Annual Report, all of which offer more information about the financial position, priorities, responsibilities and commitments of the consolidated operations of First National.

Risks and Uncertainties Affecting the Business

The business, financial condition and results of operations of the Company are subject to a number of risks and uncertainties and are affected by a number of factors outside the control of management of the Company. In addition to the risks addressed elsewhere in this discussion and the financial statements, these risks include: ability to sustain performance and growth, reliance on sources of funding, concentration of institutional investors including third-party servicing customers, reliance on independent mortgage brokers, changes in interest rates, repurchase obligations and breach of representations and warranties on mortgage sales, risk of servicer termination including the impact of trigger events on cash collateral and retained interests, reliance on multi-unit residential and commercial mortgages, general economic conditions, legislation and government regulation (including regulations imposed by the Department of Finance and CMHC and the policies set by and for mortgage default insurance companies), potential for losses on uninsured mortgages, competition, reliance on mortgage insurers, reliance on key personnel and the ability to attract and retain employees and executives, conduct and compensation of independent mortgage brokers, failure or unavailability of computer and data processing systems and software, insufficient insurance coverage, change in or loss of ratings, impact of natural disasters and other events, unfavourable litigation, and environmental liability. In addition, there are risks associated with the structure of the Company, including: those related to the dependence on FNFLP, leverage and restrictive covenants, dividends that are not guaranteed and could fluctuate with the Company's performance, restrictions on potential growth, the market price of the Company's shares, statutory remedies, control of the Company, and contractual restrictions. The Company is subject to Canadian federal and provincial income and commodity tax laws and pays such taxes as it determines are compliant with such legislation. Among the risks of all potential tax matters, there is a risk that tax legislation changes are detrimental to the Company or that Canadian tax authorities interpret tax legislation differently than the Company's filing positions. Risk and risk exposure are managed through a combination of insurance, a system of internal controls and sound operating practices. The Company's key business model is to originate primarily prime mortgages and find funding through various channels to earn ongoing servicing or spread income. For the single-family residential segment, the Company relies on independent mortgage brokers for origination and several large institutional investors for sources of funding. These relationships are critical to the Company's success. In October 2019, the sale transaction involving an institution for which the Company administers a large portfolio of third-party originated mortgages was completed. The new owners of the institution may decide not to renew the existing contract with First National or to exercise termination clauses within the agreement. In the event of non-renewal or termination, the Company's MUA will decrease. For a more complete discussion of the risks affecting the Company, reference should be made to the Company's Annual Information Form.

It became clear to the Company in mid-March 2020 that COVID-19 was highly contagious, and the Company executed its business continuity plan. In this case, the plan called for a "working from home" contingency. Within the first month, most of the Company's staff across the country transitioned to working from home. The Company is prepared for a hybrid return to office in 2022 subject to health guidelines but as of the date of this MD&A, the contingency plan remains in effect. The COVID-19 crisis has been the cause of unemployment across the country and widespread economic hardship. During the duration of this crisis, the probability of the risks listed above having a negative impact on the Company has increased. Related losses could be material.

Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as “may”, “will”, “should”, “expect”, “plan”, “anticipate”, “believe”, “intend”, “estimate”, “predict”, “potential”, “continue” or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management’s future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the “Risk and Uncertainties Affecting the Business” section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the “Risk and Uncertainties Affecting the Business” section, that 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 March 1, 2022, 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

2021 saw a return to a fully competitive marketplace and mortgage spreads tightened to pre-pandemic levels. In some periods, spreads tightened to levels not seen since before the 2008 financial crisis. The Company successfully grew MUA despite the competitive environment and built a larger portfolio of mortgages pledged under securitization. First National will benefit from this growth in the future: earning income from mortgage administration, net securitization margin and increased renewal opportunities. In the short term, the expectation for the start of 2022 is lower origination. There are indications of slowing origination as housing inventories fall and as mortgage rates rise driven by an expected change in the Bank of Canada's monetary policy in 2022. Generally, higher interest rates will decrease affordability and dampen activity. Management estimates that residential origination will be lower than the almost \$4.4 billion recorded in the comparative 2021 first quarter. Management recognizes that home purchasing in the past two years has been at levels that are likely unsustainable and that while drivers such as higher immigration are strong, a market slowdown seems inevitable. However, it is confident that First National will remain competitive and a leader in the marketplace. Management anticipates commercial origination will remain strong in 2022 based on the current pipeline.

During the pandemic, the value of First National's business model has been demonstrated. By designing systems that do not rely on face-to-face interactions, the Company's business practices have resonated with mortgage brokers and borrowers alike during this period. The economic effects of COVID-19 are expected to slowly diminish although the duration and impact of the pandemic is unknown at this time, as is the long-term efficacy of the government and central bank interventions. It is still not possible to reliably estimate the length and severity of these developments and the impact on the financial results and condition of the Company and its operating subsidiaries in future periods.

First National is well prepared to execute its business plan. In 2022, the Company expects to enjoy the value of its goodwill with broker partners earned over the last 30+ years and reinforced during the pandemic. The funding side shows strong demand for the Company's mortgages from institutional investors due to the substantial amount of liquidity in the financial system. Securitization markets are robust and provide consistent and reliable source of funding.

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 \$33 billion portfolio of mortgages pledged under securitization and \$88 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.

Effective January 12, 2022, subsequent to year end, the Company announced the appointments of Stephen Smith as Executive Chairman of the Board and Jason Ellis as President, Chief Executive Officer and Director. Mr. Smith co-founded First National in 1988 with Moray Tawse. Since taking First National public in 2006, Mr. Smith served as the Company's founding Chairman and Chief Executive Officer and now will continue to provide strategic guidance to the management team in the newly created role of Executive Chairman. Mr. Ellis joined First National in 2004 with responsibility for First National's treasury and capital markets activities, was appointed Chief Operating Officer in 2018 and added the title of President in 2019. Mr. Ellis will be responsible for day-to-day operations and the design and maintenance of strategy in the pursuit of business excellence. Although just recently appointed as CEO, Mr. Ellis has played increasingly important strategic roles within the business for over 15 years and is dedicated to leading the organization through the next stage of growth.