FIRST NATIONAL

FINANCIAL CORPORATION

Report to Shareholders

Period Ended September 30, 2021

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FINANCIAL CORPORATION

Fellow Shareholders:

First National's third quarter 2021 origination performance was in line with, and in some cases, ahead of our expectations. Mortgages under administration, the source of most of our earnings, increased 4% year over year to a record $122.3 billion on 10% growth in new originations and the renewal of $2.3 billion of mortgages.

Profitability measures were solid but came in below last year when high levels of home purchases and abnormally wide mortgage spreads created an ideal environment for earnings. Spreads are now as narrow as they were before the 2008 financial crisis. Even so, quarterly net income was $47.6 million ($0.78 per common share). Our common share dividend payout ratio was 75%, reflecting the dividend increase in June 2021 that brought the annualized payout to $2.35 per share.

On a year-to-date basis, strong growth in both revenue and earnings allowed First National to generate capital beyond what it needs. To remain capital efficient for our shareholders, our Board authorized the payment of a special dividend of $1.25 per share on December 15, 2021 to shareholders of record November 30, 2021. This is the 5th special dividend declared in the past five years. Coupled with the recent increase in the regular monthly dividend, First National has further entrenched its standing as a high-yielding, dividend-paying company.

Looking Forward

We are optimistic about the remainder of 2021 and into 2022. To preface the outlook found in the MD&A, our expectation for the fourth quarter of 2021 is lower year over year new mortgage origination due to slowing markets set against the 2020 fourth quarter which was exceptional. We estimate that residential origination may be as much as 25% lower than the almost $6 billion recorded in the comparative 2020 quarter but still some 20% above the fourth quarter of 2019 before the pandemic led to unusual market activity. We also anticipate commercial origination to remain strong in the fourth quarter.

Underpinning this outlook is our confidence in First National's relationships with mortgage brokers, strong institutional investor demand for the Company's mortgages and robust securitization markets that continue to provide consistent and reliable funding. The Company will also continue to generate income and cash flow from its $33 billion portfolio of mortgages pledged under securitization and $87 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.

Yours sincerely,

Stephen Smith
Chairman and Chief Executive Officer

Moray Tawse
Executive Vice President

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of October 26, 2021. This discussion should be read in conjunction with the unaudited condensed consolidated financial statements and accompanying notes of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the three months (the "period") ended September 30, 2021. The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").

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

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

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

General Description of the Company

First National Financial Corporation is the parent company of First National Financial LP ("FNFLP"), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over $122 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.

Third Quarter 2021 Results Summary

Management is pleased with First National's performance during the third quarter of 2021. Supported by a robust housing market across Canada, the Company increased single-family origination 4% year over year. Commercial segment originations were up by 33% as conventional lending picked up to augment insured mortgage volumes. Total combined new origination was higher by 10% comparing the third quarters of 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, while solid, were below 2020's results when financial pressures from the pandemic caused an abnormal widening in mortgage spreads.

- MUA grew to $122.3 billion at September 30, 2021 from $117.1 billion at September 30, 2020, an increase of 4%; the growth from June 30, 2021, when MUA was $121.5 billion, was 3% on an annualized basis.
- Total new single-family mortgage origination was $6.1 billion in the third quarter of 2021 compared to $5.9 billion in the 2020 comparative quarter, an increase of 4%. 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 and effective technology. Commercial segment origination of $2.3 billion was 33% higher than the $1.7 billion originated in the third quarter of 2020. Total new origination increased by 10% in the third quarter of 2021 compared to the third quarter of 2020.
- The Company took advantage of opportunities in the quarter to renew over $1.7 billion of single-family mortgages ($1.9 billion a year ago). For the commercial segment, renewals were higher by 49% ($604 million compared to $406 million 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 the third quarter of 2021 decreased by 5% to $353.7 million from $373.8 million in the third quarter of 2020. This change was the result of lower revenues on placement transactions, largely the result of mortgage spread compression between the 2021 quarter and the comparative quarter. Revenue was also affected by a change in product mix in the commercial segment. With a greater proportion of uninsured mortgage origination and a move to shorter-term mortgages by borrowers, this segments per unit placement fee revenues are lower than in the third quarter of 2020.
- Income before income taxes was $65.1 million in the 2021 third quarter compared to $98.8 million in the 2020 third quarter. The decrease reflected changing capital market conditions. 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") for the third quarter of 2021 decreased by 35% to $64.9 million from $99.6 million in 2020. This change was largely the result of a return to pre-pandemic spread environment and the shift in the commercial segments product mix including a shift of funding strategy to allocate more origination volume to securitization as opposed to institutional placement. Generally, the increase in commercial origination volume was in uninsured business 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 the 2020 quarter.

The Company's Board of Directors announced a special common share dividend in the amount of $1.25 per share, payable on December 15, 2021 to shareholders of record on November 30, 2021. This payment reflects the Board's determination that the Company has generated excess capital in the past year and that the capital needed for near-term growth can be generated from current operations.

Selected Quarterly Information

Quarterly Results of First National Financial Corporation

($000s, except per share amounts)

	Revenue	Net Income (loss) for the Period	Pre-FMV Income for the Period [(1)]	Net Income (loss) per Common Share	Total Assets
2021					
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
2019					
Fourth quarter	$342,138	$48,993	$60,418	$0.80	$37,685,593

(1) This non-IFRS measure adjusts income before income taxes by eliminating the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments. The figures presented for 2019 have been restated to conform to 2020's presentation.

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

In the past eight quarters, the Company has experienced a relatively volatile economic environment. In 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 has remained steady as financial markets have been stable 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 have returned to pre-pandemic levels. The ensuing spread tightening reduced profitability for the Company in the third quarter.

Outstanding Securities of the Corporation

At September 30, 2021, and October 26, 2021, 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)

	2020	2019	2018
For the Year Ended December 31, Income Statement Highlights			
Revenue	1,380,294	1,326,523	1,181,510
Interest expense – securitized mortgages	(708,162)	(739,071)	(646,069)
Brokerage fees	(159,018)	(102,596)	(75,354)
Salaries, interest and other operating expenses	(254,385)	(243,143)	(232,670)
Add (deduct): realized and unrealized losses (gains) on financial instruments	67,355	9,655	(3,162)
Deduct: unrealized losses regarding mortgage investments	(3,076)	(4,300)	(4,000)
Pre-FMV Income[1]	323,008	247,068	220,255
Add (deduct): realized and unrealized gains (losses) on financial instruments excluding those on mortgage investments	(64,279)	(5,355)	7,162
Provision for income taxes	(68,500)	(64,500)	(60,990)
Net income	190,229	177,213	166,427
Common share dividends declared	148,419	144,421	171,407
Per Share Highlights			
Net income per common share	3.12	2.90	2.73
Dividends per common share	2.47	2.41	2.86
At Year End Balance Sheet Highlights Total assets	39,488,527	37,685,593	36,037,127
Total long-term financial liabilities	398,554	374,025	174,829

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 and 2018 have been restated to conform to 2020's presentation.

Vision and Strategy

The Company provides mortgage financing solutions to the residential and commercial mortgage markets in Canada. By offering a full range of mortgage products, with a focus on customer service and superior technology, the Company believes that it is 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 service to mortgage brokers and borrowers, lower costs and rationalize business processes; and maintaining a conservative risk profile. An important element of the Company's strategy is its direct relationship with the mortgage borrower. The Company is considered by most of its borrowers as the mortgage lender. This is a critical distinction. It allows the Company to communicate with each borrower directly throughout the term of the related mortgage. Through this relationship, the Company can negotiate new transactions and pursue marketing initiatives. Management believes this strategy will provide long-term profitability and sustainable brand recognition for the Company.

Key Performance Drivers

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

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

Growth in Portfolio of Mortgages under Administration

Management considers the growth in MUA to be a key element of the Company's performance. The portfolio grows in two ways: through mortgages originated by the Company and through third-party mortgage servicing contracts. Mortgage originations not only drive revenues from placement and interest from securitized mortgages, but perhaps more importantly, longer-term value from servicing rights, renewals and the growth of the customer base for marketing initiatives. As at September 30, 2021, MUA totalled $122.3 billion, up from $117.1 billion at September 30, 2020, an increase of 4%. The growth of MUA in the third quarter of 2021 from June 30, 2021, was also 3% 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 the third quarter of 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. The rate of growth has slowed as results are now being compared to the second half of 2020 which featured exceptional volumes. 2020 volumes were a function of the Company's business practices which do not rely on face-to-face interactions and a lower interest rate environment. In aggregate, the Company's single-family origination grew by 4% in the third quarter of 2021 compared to the same period in 2020. The commercial segment had a solid quarter. Total commercial volumes increased by 33% to $2.3 billion compared to $1.7 billion in the 2020 third quarter. Together, overall new origination for the third quarter of 2021 increased 10% 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"). The business is designed to adjudicate mortgages originated by the Bank through the single-family residential mortgage broker channel. First National employs a customized software solution based on its industry-leading MERLIN technology to accept mortgage applications from the Bank in the mortgage broker channel and underwrite these mortgages in accordance with the Bank's underwriting guidelines. The Bank funds all the mortgages underwritten under the agreement and retains full responsibility for mortgage servicing and the client relationship. Management considers the agreement a way to leverage the capabilities and strengths of First National in the mortgage broker channel and add some diversity to the Company's service offerings. In late 2019, the Company entered into a similar agreement with another Canadian bank.

Excalibur Mortgage Products

The Company originates alternative single-family ("Excalibur") mortgage products. Alternative lending describes single-family residential mortgages that are originated using broader underwriting criteria than those applied in originating prime mortgages. 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 from Western Canada.

Raising Capital for Operations

Bank Credit Facility

The Company has a revolving line of credit with a syndicate of banks of $1.5 billion. 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 first quarter	1.45%
2021 second quarter	1.26%
2021 third quarter	1.15%

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 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 stopped functioning 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 have increased the profitability inherent in the Company's securitization portfolio. In 2021, spreads have narrowed first returning to 2018 levels and now to levels not seen sign before the 2008 financial crisis. In the third quarter of 2021, the Company originated and renewed for securitization purposes approximately $1.8 billion of single-family mortgages and $0.8 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 2021.

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 will be 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		Nine months Ended	
	September 30, 2021	September 30, 2020	September 30, 2021	September 30, 2020
For the Period		($000s)		
Revenue	353,704	373,760	1,055,313	992,991
Income before income taxes	65,134	98,767	206,710	164,456
Pre-FMV Income [(1)]	64,867	99,644	200,231	228,071
At Period End				
Total assets	40,763,169	38,314,904	40,763,169	38,314,904
Mortgages under administration	122,311,392	117,116,971	122,311,392	117,116,971

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		Nine months Ended	
	September 30, 2021	September 30, 2020	September 30, 2021	September 30, 2020
For the Period		($000s)		
Net income attributable to common shareholders	46,935	71,851	150,579	118,918
Total dividends paid or declared on common shares	35,231	29,234	100,695	87,702
Total common share dividend payout ratio	75%	41%	67%	74%
After-tax Pre-FMV dividend payout ratio [1]	75%	40%	69%	53%

Note:

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

For the quarter ended September 30, 2021, the common share payout ratio was 75%. For the quarter ended September 30, 2020, the common share payout ratio was 41%. Gains and losses are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact is generally reflected in narrower or wider spreads in the future once the mortgages have been pledged for securitization. Accordingly, management does not consider such gains and losses to affect its dividend payment policy. If the gains and losses on financial instruments in the two quarters are excluded from the above calculations, the dividend payout ratio for the third quarter of 2021 would have been 75% compared to 40% in the third quarter of 2020.

The Company also paid $0.7 million of dividends on its preferred shares in the third quarters of 2021 and 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 quarter ended September 30, 2021, new origination volume increased to $8.4 billion from $7.6 billion, or about 10%, compared to the 2020 quarter.

Securitization

The Company securitizes a portion of its origination through various vehicles, including NHA-MBS, CMB and asset-backed commercial paper ("ABCP"). Although legally these transactions represent sales of mortgages, for accounting purposes they do not meet the requirements for sale recognition and instead are accounted for as secured financings. These mortgages remain as mortgage assets of the Company for the full term and are funded with securitization-related debt. Of the Company's $10.7 billion of new originations and renewals in the third quarter of 2021, $2.6 billion was originated for its own securitization programs.

Placement Fees and Gain on Deferred Placement Fees

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as "placement fees". The present value of additional amounts expected to be received over the remaining life of the mortgage sold (excluding normal market-based servicing fees) is recorded as a "deferred placement fee". A deferred placement fee arises when mortgages with spreads in excess of a base spread are placed. Normally the Company would earn an upfront cash placement fee, but investors prefer paying the Company over time, as they earn net interest margin on such transactions. Upon the recognition of a deferred placement fee, the Company establishes a "deferred placement fee receivable" that is amortized as the fees are received by the Company. Of the Company's $10.7 billion of new originations and renewals in the third quarter of 2021, $7.7 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

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

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

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

Results of Operations

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

	Quarter Ended		Nine months Ended	
	September 30, 2021	September 30, 2020	September 30, 2021	September 30, 2020
	($ millions)			
Mortgage Originations by Segment				
New single-family residential	6,137	5,925	18,196	13,203
New multi-unit and commercial	2,264	1,697	6,702	6,389
Sub-total	8,401	7,622	24,898	19,592
Single-family residential renewals	1,731	1,948	4,815	5,020
Multi-unit and commercial renewals	604	406	1,756	1,404
Total origination and renewals	10,736	9,976	31,469	26,016
Mortgage Originations by Funding Source				
Institutional investors	7,749	6,929	20,950	17,008
NHA-MBS/CMB/ABCP securitization	2,643	2,832	9,448	8,489
Internal Company resources/CMBS	344	215	1,071	519
Total	10,736	9,976	31,469	26,016
Mortgages under Administration				
Single-family residential	84,664	83,028	84,664	83,028
Multi-unit residential and commercial	37,647	34,089	37,647	34,089
Total	122,311	117,117	122,311	117,117

Total new mortgage origination volumes increased in the third quarter of 2021 compared to 2020 by 10%. Single-family volumes increased by 4% and commercial segment volumes increased by 33% year over year. Management believes the growth in the single-family segment was due to several factors including 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 have also encouraged home purchasing across the country. In the commercial segment, the Company's expertise in underwriting multi-unit mortgages is its fundamental competency. After a slow start to 2021, commercial origination volumes increased 33% in the third quarter of 2021 over the same period in 2020. When combined with renewals, total production for both business segments increased by 8% to $10.7 billion in the 2021 third quarter from $10.0 billion in the third quarter of 2020. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy, with volume of $2.6 billion in the 2021 third quarter.

Net Interest – Securitized Mortgages

Comparing the quarter ended September 30, 2021, to the quarter ended September 30, 2020, "net interest – securitized mortgages" increased by about 15% to $40.1 million from $34.9 million. The portfolio of mortgages pledged under securitization grew 4% from about $33.4 billion at June 30, 2020 to $34.6 billion at June 30, 2021. The growth in profitability reflects growth in the securitized portfolio. This revenue was also favorably affected by the addition of wider-spread prime mortgages securitized in the past 12 months and an increase in the Excalibur program which has had lower credit loss ratios than originally expected. Pandemic-related issues also affected this growth. A significant impact of the pandemic was increased prepayment as single-family borrowers refinanced to take advantage of lower mortgage rates. Not only does the Company prematurely lose these income-producing assets, but as these mortgages prepaid, the Company's exposure related 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, the cost of such indemnities increased significantly. While still relevant for the Company, these costs have slowed as interest rates have stabilized. The Company calculates that because of the decrease in indemnity costs in the third quarter of 2021 compared to those in 2020, Net Interest – Securitized Mortgage is higher by $4.0 million comparing 2021 and 2020 third quarters.

Placement Fees

Placement fee revenue decreased by 14% to $85.0 million from $98.4 million in the comparative quarter. The decrease was the net result of several factors. Despite a 12% 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 7% year over year. For the commercial segment, the impact was even more pronounced. Generally, placement fees in this segment were lower by $18.5 million year over year for three reasons: a shift in product type originated for investors from insured to uninsured; a shift within insured origination from 10-year term product to 5-year term product; and tighter mortgage spreads. The Company elected to securitize a larger percentage of its insured commercial mortgage origination, so there was less insured product to place with institutional investors. While this shortfall in volume was offset by the origination and placement of uninsured mortgage product, per unit fees are generally lower on uninsured mortgage origination. In 2020, borrowers elected to take advantage of historically low mortgage rates and chose to take on more 10-year term mortgages. In 2021, with changing markets and borrower sentiment, the product mix moved so as to increase origination of 5-year term mortgages at the expense of 10-year term mortgages. 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. The Company has benefited in 2021 from CMHC programs that increase CMB access for issuers who lend on affordability-linked real estate. This program is limited to 10-year insured mortgages, such that the Company has moved the most profitable commercial origination away from placement transactions. 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. Lastly, in the third quarter of 2020, spreads were abnormally wide as mortgage lenders reacted to the pandemic. As the Company placed these mortgages with institutional investors, it earned larger per-unit placement fees than typical. In the third quarter of 2021, spreads returned to pre-pandemic levels such that spreads were between 15 to 50% lower than just 12 months prior. Excalibur origination has increased significantly but with short terms (1 to 3 years), placement fees per-unit earned were lower.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue decreased 73% to $3.5 million from $12.9 million. These gains related primarily to multi-unit residential mortgages originated and sold to institutional investors. Volumes for these transactions decreased by 42% from the 2020 quarter as the Company had the ability to securitize more of this origination directly. Spreads on these mortgages were narrower in the 2021 quarter compared to 2020's quarter as described in the Placement Fees section above.

Mortgage Servicing Income

Mortgage servicing income increased 12% to $51.4 million from $46.0 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 have 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 increased 5% to $16.2 million from $15.5 million. The increase was due primarily to the interest rate environment. After short-term rates fell significantly in March 2020 as the Bank of Canada cut its overnight rate by 1.5%, rates have grown modestly. As underlying bond rates have risen, the Company has increased its offered mortgage rates. The result has been higher amounts of interest earned while mortgages 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**		**Nine months Ended**	
	September 30, 2021	**September 30, 2020**	**September 30, 2021**	**September 30, 2020**
		($000s)		
Gains (losses) on short bonds used for the economic hedging program	653	(1,127)	12,242	(75,803)
Gains (losses) on mortgages held at fair value	(650)	(600)	(593)	(4,000)
Gains (losses) on interest rate swaps	(386)	250	(5,763)	12,188
Net gains (losses) on financial instruments	(383)	(1,477)	5,886	(67,615)

In the second quarter of 2020, financial repercussions related to the pandemic subsided. After the significant disruption in the first quarter of 2020, 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 $1.1 million of losses in the third quarter of 2020. The third quarter of 2021 was also a stable period where bond yields remained relatively flat (until the final two weeks of the quarter) as differing forecasts about the impact and timing of the post-pandemic recovery and inflation affected the momentum seen at the start of 2021. For the 2021 third quarter, the Company recorded $0.7 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 17% to $54.9 million from $46.8 million. This increase reflected higher origination volumes of single-family mortgages for institutional investors, which increased by $0.8 billion or 21% year over year. Commercial segment fees and portfolio insurance expenses were lower than in 2020 and moderated the effect of the growth in single family volumes. Unit broker fees were generally steady between the third quarters of 2021 and 2020.

Salaries and Benefits Expense

Salaries and benefits expense increased 22% to $44.7 million from $36.5 million. Salaries were higher as overall headcount increased by 35% (1,131 employees as at September 30, 2020, and 1,532 at September 30, 2021). The 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 33% between the third quarter of 2020 and the third quarter of 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 increased 18% to $12.5 million from $10.6 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 increased from the comparative quarter due to increased use of lending facilities to fund mortgages accumulated for securitization.

Other Operating Expenses

Other operating expenses increased by 37% to $18.7 million from $13.6 million. The primary change in other operating expenses was a $3.7 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. Mortgage servicing to support the high levels of MUA and securitization also increased by about $1.0 million. Discretionary costs, including promotion, travel and entertainment, continue to low as a result of government mandated health measures related to the pandemic.

Income before Income Taxes and Pre-FMV Income

Income before income taxes decreased by 34% to $65.1 million from $98.8 million in the third quarter of 2020. This increase was partially 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. In both quarters, these were relatively insignificant. Accordingly, Pre-FMV Income is similar to pre tax income, decreasing by 35% to $64.9 million from $99.6 million. The decrease in these

performance measures is largely the result of a tighter mortgage spread environment and the shifting nature of origination volumes, particularly in the commercial segment to securitization from placement which delays the recognition of earnings for the Company. As described in Placement Fees and Gains on Deferred Placement Fees previously, revenue lines in the commercial segment were lower by almost $28.0 million comparing the third quarters of each year. This decrease directly impacted earnings as the compensation to the Company's underwriters generally does not change significantly despite lower revenues. Together with higher headcount needed to support the record volumes of residential mortgage origination, third party underwriting and information technology, earnings are lower by about $34 million when comparing the third quarter 2021 to the 2020 quarter. Growth in the Company's securitization portfolio and higher origination in third-party underwriting had favourable impacts on Pre-FMV income in the 2021 quarter.

Income Tax Expense

The provision for taxes decreased by 33% to $17.5 million from $26.3 million. The provision decreased 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 $6.8 million of pre-tax net gains on such hedges in OCI in the third quarter of 2021. These gains would have been recorded as gains on financial instruments under the previous IFRS standard. In the quarter, the Company amortized a portion of the gains and losses in accumulated OCI into regular earnings. In the third quarter 2021, this amortization totalled $0.8 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			
	Residential		**Commercial**	
	($000s except percent amounts)			
For the Quarter Ended	**September 30, 2021**	**September 30, 2020**	**September 30, 2021**	**September 30, 2020**
Originations and renewals	7,867,877	7,873,360	2,867,402	2,103,442
Percentage change	*0%*		*36%*	
Revenue	263,104	258,503	90,600	115,257
Percentage change	*2%*		*(21%)*	
Income (loss) before income taxes	49,893	53,957	15,241	44,810
Percentage change	*(8%)*		*(66%)*	
As at	**September 30, 2021**	**December 31, 2020**	**September 30, 2021**	**December 31, 2020**
Identifiable assets	28,848,811	28,945,884	11,884,582	10,512,867
Mortgages under administration	84,663,645	83,600,868	37,647,747	35,123,122

Residential Segment

Overall residential origination volumes including renewals were essentially the same between the third quarters of 2021 and 2020 while residential revenues increased by 2%. Revenue in the 2021 quarter was favourably affected by an increase of origination for institutional investors which creates current period revenue. This origination volume increased 10% over the comparative quarter. Lower per unit placement fees were earned as mortgage spreads tightened, reducing the growth in revenues. Net income before tax was affected by the higher origination as broker fees increased in tandem with origination for institutional investors. However per unit costs stayed constant for these fees such that net income before tax decreased by 8%. Identifiable assets decreased from December 31, 2020, as the Company's portfolio of mortgages pledged under securitization decreased by about $0.2 billion.

Commercial Segment

2021 third quarter commercial revenues were lower compared to the 2020 quarter largely because of a shift in the product mix in mortgage origination and a tighter mortgage spread environment. Despite the growth in origination of 36%, most of this growth was for uninsured origination which generally has a lower per unit placement fee. Origination also shifted to an increase of shorter term mortgages than were originated in the third quarter of 2020. The Company also 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 66% quarter over quarter. The decrease is due to lower placement fee revenues as described above offset by compensation expensed to the Company's inhouse underwriters which has remained relatively constant during the period. Identifiable assets increased from those at December 31, 2020 as the Company increased securitized mortgages by about $1.4 billion and mortgages accumulated for securitization of $0.1 billion. These increases were offset by a decrease in hedging related assets of $0.2 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 September 30, 2021, the Company had entered into repurchase transactions with financial institutions to borrow $1.1 billion related to $1.2 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At September 30, 2021, outstanding bank indebtedness was $910.8 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 $977.3 million (December 31, 2020 – $805.7 million) of mortgages accumulated for sale or securitization. At September 30, 2021, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $64.9 million (December 31, 2020 – $62.5 million) and (2) mortgage and loan investments of $236.1 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 September 30, 2021, and now stands at $332.4 million (December 31, 2020 – $275.8 million). This represents a debt-to-equity ratio of approximately 0.52:1. This ratio is higher than the ratio of 0.48:1 at December 31, 2020. In general, the increase was the result of investing $23 million in mortgage and loan investments, primarily related to the Company's commercial bridge loan portfolio, and $81 million of investments in mortgages pledged for securitization. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

Since being approved as an issuer of NHA-MBS, the Company has funded the difference between the mortgages it uses to create NHA-MBS and the debt obligations it assumes upon issuance. In recent years, this requirement has generally been limited to mortgages in arrears where First National does not receive payments from the borrower but is obliged to pay the interest and amortizing principal on the NHA-MBS debt. However, due to the rapid rise in national unemployment pursuant to the COVID-19 pandemic, this funding requirement has 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 September 30, 2021, the Company estimates that it had reduced its NHA MBS debt by approximately $50 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 September 30, 2021, the investment in cash collateral was $101.9 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 September 30, 2021, the Company had $1.0 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund, and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages to be sold to the Company's other securitization vehicles. As at September 30, 2021, the Company had entered into $760 million 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 September 30, 2021, the aggregate notional value of these swaps, maturing between December 2023 and September 2026, was $126 million. During the 2021 third quarter, the value of these swaps decreased by $0.4 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 September 30, 2021, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were approximately $2.0 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 quarter ended September 30, 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 $6.0 million annually, but likely will be higher in 2021 as the Toronto office moves to its new premises and invests in leasehold improvements.

Summary of Contractual Obligations

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

Critical Accounting Policies and Estimates

The Company prepares its financial statements in accordance with IFRS, which requires management to make estimates, judgments and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and other assumptions that it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. The significant accounting policies of First National are described in Note 2 to the Company's annual consolidated financial statements as at December 31, 2020. The policies that First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

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

On a quarterly basis, the Company reviews the estimates used to ensure their appropriateness and monitors the performance statistics of the relevant mortgage portfolios to adjust and improve these estimates. The estimates used reflect the expected performance of the mortgage portfolio over the lives of the mortgages. The method of determining the assumptions underlying the estimates used for the quarter ended September 30, 2021, are consistent with those used for the year ended December 31, 2020 and the quarters ended June and March 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 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 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, ECL has been determined to be $0.4 million for the third quarter of 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.

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

No changes were made in the Company's internal controls over financial reporting during the quarter ended September 30, 2021, that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Risks and Uncertainties Affecting the Business

The business, financial condition and results of operations of the Company are subject to a number of risks and uncertainties and are affected by a number of factors outside the control of management of the Company. In addition to the risks addressed elsewhere in this discussion and the financial statements, these risks include: ability to sustain performance and growth, reliance on sources of funding, concentration of institutional investors including third-party servicing customers, reliance on independent mortgage brokers, changes in interest rates, repurchase obligations and breach of representations and warranties on mortgage sales, risk of servicer termination including the impact of trigger events on cash collateral and retained interests, reliance on multi-unit residential and commercial mortgages, general economic conditions, legislation and government regulation (including regulations imposed by the Department of Finance 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 COVID-19 crisis has been the cause of significant unemployment across the country and widespread economic hardship. During the duration of this crisis, the probability of the risks listed above having a negative impact on the Company has increased. Related losses could be material.

Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as "may", "will", '"should", "expect", "plan", "anticipate", "believe", "intend", "estimate", "predict", "potential", "continue" or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management's future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the "Risk and Uncertainties Affecting the Business" section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the "Risk and Uncertainties Affecting the Business" section, 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 October 26, 2021, 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

With the results of the first three quarters of 2021, management remains positive about the remainder of 2021 and into 2022. In the short term, the expectation for the fourth quarter includes lower year over year new origination due to slowing markets set against the 2020 fourth quarter which was exceptional. Management estimates that residential origination may be as much as 25% lower than the almost $6 billion recorded in the comparative 2020 quarter but still some 20% above the fourth quarter of 2019 before the pandemic led to unusual market activity. Management recognizes that home purchasing in the past 15 months accelerated and that a slowdown was inevitable. However, it is confident that First National will remain competitive and a leader in the marketplace. The commercial segment funded a record volume of $2.6 billion of new mortgages in the fourth quarter of 2020 which included about $1.4 billion in December 2020 alone as property owners sought to close transactions before year end. Management anticipates commercial origination to remain strong in the fourth quarter of 2021 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. In 2021, the Company has adhered to this model and will continue to benefit from record MUA.

The economic effects of COVID-19 are expected to slowly diminish although the duration and impact of the COVID-19 outbreak is unknown at this time, as is the long-term efficacy of the government and central bank interventions. It is 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.

Despite the length of this transition, First National is set up to execute its business plan. In 2021 and into 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. On the funding side, there continues to be 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 continue to provide consistent and reliable funding for the Company.

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 $87 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.