

## MANAGEMENT'S DISCUSSION AND ANALYSIS

*The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of February 28, 2017. 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, 2016. The audited consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").*

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

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

*Additional information relating to the Company is available in First National Financial Corporation's profile on the System for Electronic Data Analysis and Retrieval ("SEDAR") website at [www.sedar.com](http://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 \$100 billion in mortgages under administration ("MUA"), First National is Canada's largest non-bank originator and underwriter of mortgages and is among the top three in market share in the mortgage broker distribution channel.

First National consolidates its interest in First National Mortgage Investment Fund (the "Fund"). Although the Company only owns about 21% of the units issued by the Fund, because of its status as sole seller to the Fund and its rights as promoter, the application of IFRS suggests that First National exercises control over the Fund. The Fund was created to obtain economic exposure to a diversified portfolio of primarily commercial mezzanine mortgages. Through the Fund's consolidation, the Company has effectively taken on a portfolio of about \$42 million (December 31, 2015 - \$47 million) of mortgages. Because of the Company's small proportionate interest in the Fund's units, it has also recorded a \$28 million (December 31, 2015 - \$33 million) non-controlling interest in equity which offsets these assets.

## 2016 Results Summary

Management is pleased with the results of 2016, as First National's long-term strategies produced record profitability. The Company also continued to grow its MUA despite a small decrease in originations and build the value of its portfolio of securitized mortgages.

- MUA grew to \$99.4 billion at December 31, 2016 from \$93.8 billion at December 31, 2015, an increase of 6%; the growth from September 30, 2016, when MUA was \$98.6 billion, represented an annualized increase of 3%;
- The Canadian single-family real estate market remained strong for most of 2016 despite the continued oil-related slowdown evident in western Canada, a new tax regime in British Columbia and tighter mortgage insurance rules announced in early October 2016. Total new single-family mortgage origination was \$12.4 billion in 2016 compared to \$12.9 billion in 2015. The primary reason for the change was a 22% decline in origination from First National's Calgary office. In 2016, the Company also faced increased competition from other lenders, particularly smaller originators. This factor also contributed, to a lesser extent, to lower originations as First National remained focused on profitability and did not endeavor to increase volume at the expense of earnings. The commercial segment had a strong year, increasing origination volumes to \$4.8 billion in 2016 from \$4.4 billion in 2015. The Company attributes this positive performance to its expanded presence in the conventional mortgage market. Overall origination decreased by less than 1% year over year;
- The Company took advantage of opportunities in the year to renew almost \$4.6 billion of single-family mortgages. In 2015, the Company renewed \$4.3 billion of single-family mortgages. The growth is attributable to more mortgages up for renewal than in the prior year. For the commercial segment, renewals increased to \$1.0 billion from \$0.9 billion, in line with the increase in new commercial mortgage origination;
- Revenue for 2016 increased to over \$1.0 billion from \$915.3 million in 2015. The increase of 15% is largely attributable to gains on financial instruments recorded in 2016 as opposed to losses on financial instruments incurred in 2015. The change increased revenue by \$79.9 million year over year. Excluding these gains and losses, revenue grew by 6% as Interest revenue - securitized mortgages, and mortgage servicing grew with higher MUA;
- Income before income taxes increased from \$148.7 million in 2015 to \$274.1 million in 2016. This measure increased largely because of changes in the capital markets, which had a significant effect on the Company's interest rate hedges in both 2016 and 2015. The Company recorded losses of \$52.1 million on financial instruments in 2015 in contrast to gains on financial instruments of \$27.8 million in 2016. The net change in these amounts between 2016 and 2015 increased income before income taxes between the years by \$79.9 million; and
- Without the impact of gains and losses on financial instruments, the Company's earnings before income taxes, depreciation and amortization ("Pre-FMV EBITDA") for the year increased by 21%, from \$209.9 million in 2015 to \$253.5 million in 2016. The increase was due to higher earnings in net placement fees together with continued growth in the servicing and securitization divisions.

Based on 2016 results and the outlook for future years, First National announced that its Board of Directors approved an increase in the dividend on its common shares. Effective with the dividend to be paid on April 17, 2017, the annual dividend rate will be increased from \$1.70 per share to \$1.85 per share, an increase of almost 9%.

## Outstanding Securities of the Corporation

At December 31, 2016 and February 28, 2017, the Corporation had 59,967,429 common shares, 2,887,147 Class A preference shares, Series 1, 1,112,853 Class A preference shares, Series 2, and 175,000 April 2020 notes outstanding.

## Selected Quarterly Information

### Quarterly Results of First National Financial Corporation

(\$000s, except per share amounts)

	Revenue	Net Income (Loss) for the period	Pre-FMV EBITDA for the period <sup>(1)</sup>	Net Income (Loss) per Common Share	Total Assets
<b>2016</b>					
Fourth Quarter	\$290,754	\$71,797	\$61,064	\$1.18	\$30,394,465
Third Quarter	\$273,754	\$51,440	\$67,469	\$0.84	\$30,527,361
Second Quarter	\$253,915	\$41,251	\$68,187	\$0.67	\$31,011,683
First Quarter	\$231,395	\$37,341	\$56,819	\$0.59	\$28,194,301
<b>2015</b>					
Fourth Quarter	\$250,008	\$41,084	\$58,527	\$0.66	\$27,926,732
Third Quarter	\$246,641	\$29,308	\$60,955	\$0.46	\$27,624,359
Second Quarter	\$251,206	\$42,538	\$52,012	\$0.68	\$27,585,945
First Quarter	\$167,460	(\$3,499)	\$38,439	(\$0.09)	\$26,638,048

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

With First National's large portfolio of mortgages pledged under securitization, quarterly revenue is driven primarily by the gross interest earned on the mortgages pledged under securitization. The gross interest on the mortgage portfolio is dependent both on the size of the portfolio of mortgages pledged under securitization as well as weighted average mortgage rates. Although mortgage rates have not changed significantly in the last two years, the Company has steadily increased MUA and its portfolio of securitized mortgages over the last 24 months. Net income is partially dependent on conditions in the debt 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 (primarily conditions in the bond markets). By removing this volatility and analyzing Pre-FMV EBITDA, management believes a more appropriate measurement of the Company's performance can be assessed.

Generally, in the last eight quarters, the Company has grown its origination volumes in order to build its servicing portfolio and to enable it to securitize larger amounts of mortgages in the NHA-MBS market. This longer-term strategy has been successful and Pre-FMV EBITDA has grown steadily. The table above shows a trend of growing income reflecting typical Canadian seasonality: slower first and fourth quarters and stronger mid-year quarters. In the first quarter of 2015, the surprise cut in the Bank of Canada's overnight rate on January 21, 2015, had a large, unfavourable effect on the Company's net income due to the resultant large losses on the fair value of financial instruments as bond yields fell. Although not as large, the third quarter of 2015 also suffered because of such losses. Both the fourth quarter of 2015 and the first quarter of 2016 did not have significant fair value losses and are more consistent with normalized operations of the Company. The fourth quarter of 2016 featured large fair values gains as bond prices decreased as a result of expectations from the results of the US election. This had a large impact on net income. Without these gains, Pre-FMV EBITDA still grew at a healthy 4% compared to the fourth quarter of 2015. With a growing base of income from the securitization portfolio and third-party servicing, the Company is able to grow earnings organically.

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

(\$000s, except per share amounts)

	2016	2015	2014
<b>For the Year ended December 31,</b>			
<b>Income Statement Highlights</b>			
Revenue	1,049,818	915,315	803,107
Interest expense – securitized mortgages	(495,681)	(488,659)	(434,726)
Brokerage fees	(103,719)	(107,045)	(77,105)
Salaries, interest and other operating expenses	(169,129)	(161,821)	(143,062)
Add (deduct): realized and unrealized (gains) losses on financial instruments	(27,750)	52,143	34,916
Pre-FMV EBITDA <sup>(1)</sup>	253,539	209,933	183,130
Amortization of capital assets	(4,660)	(4,114)	(2,909)
Amortization of intangible assets	(2,500)	(5,000)	(5,000)
Add (deduct): realized and unrealized gains (losses) on financial instruments	27,750	(52,143)	(34,916)
Provision for income taxes	(72,300)	(39,245)	(35,840)
Net income	201,829	109,431	104,465
Common share dividends declared	98,946	90,451	88,952
<b>Per Share Highlights</b>			
Net income per common share	3.28	1.71	1.62
Dividends per common share	1.65	1.51	1.48
<b>At Year End</b>			
<b>Balance Sheet Highlights</b>			
Total assets	30,394,465	27,926,732	25,953,914
Total long-term financial liabilities	174,556	174,420	176,418

Notes:

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

## Vision and Strategy

The Company provides mortgage financing solutions to virtually the entire mortgage market in Canada. By offering a full range of mortgage products, with a focus on customer service and superior technology, the Company believes that it is the leading non-bank mortgage lender in the industry. Growth has been achieved while maintaining a relatively conservative risk profile. 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. Although the Company places most of its originations with third parties, FNFLP is perceived 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 fees, mortgage administration fees, renewals and the growth of the customer base for marketing initiatives. As at December 31, 2016, MUA totalled \$99.4 billion, up from \$93.8 billion at December 31, 2015, an increase of 6%. This compares to \$98.6 billion at September 30, 2016, representing an annualized increase of 3%.

### Growth in Origination of Mortgages

#### *Direct origination by the Company*

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. By growing origination, not only can the Company satisfy demand from its institutional customers, but it can also produce volume for its own securitization programs. With the combination of decreased origination of 22% out of its Calgary office and a more competitive market for prime mortgages from smaller lenders, the Company's single-family origination decreased in 2016 by 4%. The commercial segment had a strong year as volume increased 9% over 2015. Together, overall origination for 2016 decreased only marginally or by less than 1% year over year.

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

Early in the third quarter of 2014, the Company entered into an agreement with a large Canadian schedule I bank ("Bank") to provide underwriting and fulfillment processing services for mortgages originated by the Bank through the single-family residential mortgage broker channel. Under the strategic agreement, 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. The new business was launched in Ontario in early 2015, western Canada in April 2015, and finally in Quebec in July 2015. 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 the third quarter of 2015, this business transitioned to profitability as volumes of mortgages underwritten increased with the summer season and operations normalized.

## Raising Capital for Operations

### *Bank Credit Facility*

The Company uses a \$1 billion revolving line of credit with a syndicate of banks. This facility enables the Company to fund the increasing amount of mortgages accumulated for securitization. The entire facility is floating rate and matures in May 2020. The Company has elected to undertake this debt for a number of reasons: (1) the transaction increases the amount of debt available to fund mortgages originated for securitization purposes; (2) the debt is revolving and can be used and repaid as the Company requires, providing more flexibility than the Senior Unsecured Notes, which are fully drawn during their term; (3) the four-year remaining term gives the Company a committed facility for the medium term; and (4) the cost of borrowing reflects the Company's BBB issuer rating.

### *Preferred Share Issuance*

On February 24, 2016, the Company announced that it would not exercise its right to redeem the 4,000,000 Class A Series 1 preference shares issued in 2011. It also advised shareholders of their rights under the shares which allow for a one-for-one conversion from Series 1 shares which have a fixed rate dividend into Series 2 shares which have a floating rate dividend. Pursuant to these rights, a portion of Series 1 shareholders elected to convert 1,112,853 of the Series 1 shares into Series 2 shares. Accordingly, effective April 1, 2016, 1,112,853 Series 1 shares converted to Series 2 shares leaving 2,887,147 Series 1 shares outstanding. The Series 1 shares will continue to trade as FN.PR.A on the TSX, while the Series 2 shares began trading as FN.PR.B on April 1, 2016. The Series 1 shares provide an annual dividend rate of 2.79% effective April 1, 2016. Both the Series 1 and Series 2 shares pay quarterly dividends, subject to Board of Director approval and are redeemable at the discretion of the Company such that after the five-year term ending on March 31, 2021, the Company can choose to extend the shares for another five-year term at a fixed spread (2.07%) over the relevant index (5 year Government of Canada bond yield for any Series 1 shares or the 90 day T-Bill rate for any Series 2 shares). While the investors in these shares have an option on each five-year anniversary to convert their Series 1 preference shares into Series 2 preference shares (or vice versa), there is no provision of redemption rights to these shareholders. As such, the Company considers these shares to represent a permanent source of capital and classifies the shares as equity on its balance sheet. Management believes this capital has provided the Company with the opportunity to pursue its strategy of increased securitization, which requires upfront investment.

## Employing Securitization Transactions to Minimize Funding Costs

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

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

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

Period	Average five year Mortgage Spread for the Period
2006	1.12%
2007	1.50%
2008	2.68%
2009 - 2013	1.79%
2014	1.57%
2015	1.87%
2016	1.76%

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels. In 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. While funding spreads have also moved out, spreads are wide enough to support the Company's securitization program. This trend continued into 2016, as optimism about the economy was mixed such that spreads remained at levels in excess of 1.8% until the third quarter when increased competition tightened spreads even further. In 2016, the Company originated and renewed for securitization purposes approximately \$6.9 billion of single-family mortgages and \$0.8 billion of multi-unit residential mortgages. In the year, the Company securitized through NHA-MBS approximately \$4.5 billion of single-family mortgages and \$0.5 billion of multi-unit residential mortgages.

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

### *Canada Mortgage Bonds Program*

The CMB program is an initiative sponsored by CMHC whereby the CHT issues securities to investors in the form of semi-annual interest-yielding five- and 10-year bonds. Pursuant to the Company's approval as a seller into the CMB, the Company is able to make direct sales into the program. The ability to sell into the CMB has given the Company access to lower costs of funds on both single-family and multi-family mortgage securitizations. Because of the effectiveness of the CMB, many institutions have indicated their desire to participate. As a result, CHT has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is subject to these limitations. Beginning in July 2016, CHT effectively increased the price of the timely payment guarantees which CMB participants are required to purchase with the issuance of each CMB transaction. Although nominally CMB fees were decreased, the new rules require guarantee fees to be levied on the creation of NHA MBS pools being sold to the CMB. Prior to this rule change, the NHA MBS pools to be sold into the CMB were exempt from such fees. In aggregate, guarantee fees have increased between 25 and 50% for CMB participants. This increase translates to approximately 5 basis points of cost over the term of the securitization. At the same time, CMHC has also modified the tiered NHA MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees from \$6.0 billion to \$7.5 billion.

## Key Performance Indicators

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

- Earnings before income taxes, depreciation and amortization, and losses and gains on financial instruments ("Pre-FMV EBITDA" <sup>(1)</sup>); and
- Dividend payout ratio.

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

	Quarter ended		Year ended	
	December 31, 2016	December 31, 2015	December 31, 2016	December 31, 2015
<b>For the Period</b>	(\$ 000's)			
Revenue	290,754	250,008	1,049,818	915,315
Income before income taxes	97,697	56,384	274,129	148,676
Pre-FMV EBITDA <sup>(1)</sup>	61,064	58,527	253,539	209,933
<b>At Period end</b>				
Total assets	30,394,465	27,926,732	30,394,465	27,926,732
Mortgages under administration	99,391,490	93,829,629	99,391,490	93,829,629

Note:

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

Since going public in 2006, First National has been considered a high-yielding dividend paying company. Over this period, the Company has paid almost \$900 million of dividends/distributions to common shareholders/ unitholders. With a large MUA which generates continuing income and cash flow and a business model which is designed to make efficient use of capital, the Company has been able to pay distributions to its shareholders which 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 which have been paid out in dividends. Similar to the performance measure for earnings, the Company also calculates the dividend payout ratio on a basis using after tax Pre-FMV EBITDA.

## Determination of Common Share Dividend Payout Ratio

	Quarter ended		Year ended	
	December 31, 2016	December 31, 2015	December 31, 2016	December 31, 2015
<b>For the Period</b>				
			(\$ 000's)	
Net income attributable to common shareholders	70,639	39,387	196,531	102,468
Dividends paid or declared on common shares	25,486	22,988	98,946	90,451
Common Share Dividend Payout Ratio	36%	58%	50%	88%
After tax Pre-FMV Dividend Payout Ratio <sup>(1)</sup>	60%	59%	56%	64%

Note:

- (1) This non-IFRS measure adjusts the net income used in the calculation of the dividend payout ratio to after tax Pre-FMV earnings so as to eliminate the impact of changes in fair value by adding back losses on the valuation of financial instruments 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, 2016, the common share payout ratio was 50% compared to 88% in the comparative 2015 year. In 2016, the Company recorded gains on account of the changes in fair value of financial instruments. In the 2015 the Company incurred losses on such instruments. Both gains and losses are recorded in the period in which yields on Government of Canada bond yields change; however, the offsetting economic impact is largely reflected in wider/tighter spreads on the mortgages pledged for securitization and will be generally realized in net interest margin over the terms of the mortgages. If the gains and losses on financial instruments in both years are excluded from the above calculations, the dividend payout ratio for 2016 would have been 56% compared to 64% in 2015.

The Company also paid \$3.21 million of dividends on its preferred shares in 2016 compared to \$4.65 million in 2015.

## Revenues and Funding Sources

### *Mortgage Origination*

The Company derives a significant amount of its revenue from mortgage origination activities. Most mortgages originated are funded either by placement with institutional investors or through securitization conduits, in each case with retained servicing. Depending upon market conditions, either an institutional placement or a securitization conduit may be the most cost-effective means for the Company to fund individual mortgages. In general, originations are allocated from one funding source to another depending on market conditions and strategic considerations related to maintaining diversified funding sources. The Company retains servicing rights on virtually all of the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2016, new origination volume decreased from \$17.3 billion to \$17.2 billion, or less than 1%, compared to 2015.

### *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 \$22.8 billion of new originations and renewals for the year ended December 31, 2016, \$7.7 billion was originated for its own securitization programs.

### *Placement Fees and Gain on Deferred Placement Fees*

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as “placement fees”. The present value of additional amounts expected to be received over the remaining life of the mortgage sold (excluding normal market-based servicing fees) is recorded as a “deferred placement fee”. A deferred placement fee arises when mortgages with spreads in excess of a base spread are sold. 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 \$22.8 billion of new originations and renewals in 2016, \$14.6 billion was placed with institutional investors.

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

### *Mortgage Servicing and Administration*

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

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

The Company provides underwriting and fulfilment processing services to a mortgage originator using the mortgage broker distribution channel. The Company earns a fee based on the dollar value of funded mortgages. These fees are recognized at the time a mortgage funds and is included in “Mortgage servicing income” in the consolidated statement of comprehensive 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, 2016	December 31, 2015	December 31, 2016	December 31, 2015
(\$ millions)				
<b>Mortgage Originations by Segment</b>				
New Single-family residential	2,700	2,921	12,424	12,880
New Multi-unit and commercial	1,398	1,266	4,811	4,420
Sub-total	4,098	4,187	17,235	17,300
Single-family residential renewals	1,058	1,246	4,553	4,287
Multi-unit and commercial renewals	349	321	974	923
Total origination and renewals	5,505	5,754	22,762	22,510
<b>Mortgage Originations by Funding Source</b>				
Institutional investors – new residential	1,707	2,224	7,701	8,350
Institutional investors – renew residential	656	436	2,148	1,827
Institutional investors – multi/commercial	1,469	856	4,717	3,327
NHA-MBS/ CMB/ ABCP securitization	1,580	2,122	7,682	8,433
Internal Company resources /CMBS	93	116	514	573
Total	5,505	5,754	22,762	22,510
<b>Mortgages under Administration</b>				
Single-family residential	77,152	73,312	77,152	73,312
Multi-unit residential and commercial	22,239	20,518	22,239	20,518
Total	99,391	93,830	99,391	93,830

Total new mortgage origination volumes decreased in 2016 compared to 2015 by less than 1%. Single-family volumes decreased by 4% and commercial segment volumes increased by 9% year over year as demand for housing and commercial real estate continued but was mitigated by regional disparities. Most of the decrease in the single-family segment is due to 22% lower volumes from the Company's Calgary office where the decline in the price of oil slowed the housing market in Alberta and Saskatchewan. In the other parts of Canada, the Company's volumes were flat to 2015 or increased by as much as 6%. When combined with renewals, total production increased from \$22.5 billion in 2015 to \$22.7 billion in 2016, or by 1%. The low interest rate environment which existed for most of 2015 continued in 2016. Low mortgage rates, which stimulate increased real estate transactions, together with the Company's expertise in mortgage underwriting, drove origination volumes. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volumes of \$7.7 billion in 2016, lower than the \$8.4 billion originated in the 2015 year. The Company used more institutional placements than in 2015 as demand from investors increased and securitization markets exhibited increased volatility as a result of economic uncertainty during 2016.

### *Net Interest - Securitized Mortgages*

Comparing the year ended December 31, 2016 to the year ended December 31, 2015, “net interest - securitized mortgages” increased by 9% to \$144.3 million from \$132.2 million. The increase was due to a larger portfolio of securitized mortgages offset by a slightly tighter weighted-average spreads on the portfolio year over year. The portfolio of mortgages funded through securitization increased by 7% from \$24.5 billion as at December 31, 2015 to \$26.1 billion as at December 31, 2016. Net interest is also affected by the amortization of deferred origination and other costs that are capitalized on securitized mortgages. The charge for this amortization has increased with higher per unit broker fees.

### *Placement Fees*

Placement fee revenue increased by 7% to \$176.9 million from \$165.7 million in 2015. New residential origination volume for institutional customers, excluding renewals, decreased from \$8.3 billion in 2015 to \$7.7 billion in 2016 or by 8%. In both 2016 and 2015, the Company funded large amounts of single family mortgages which were initially funded for the Company’s own securitization programs but ultimately were sold to institutional customers. In 2015, these transactions provided the Company with placement fees per unit that were marginally higher than average placement fee. In 2016, the Company was able to earn higher fees per unit as capital market conditions were more favorable. The Company earned an estimated \$13.6 million in additional placement fees in 2016 compared to the value of the placements in 2015. In 2016, the Company increased commercial segment fees by about \$6.6 million in comparison to 2015 from higher origination volume.

### *Gains on Deferred Placement Fees*

Gains on deferred placement fees revenue increased 47% to \$16.3 million from \$11.1 million. The gains relate to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Volumes for these transactions increased by 15% from 2015 to 2016 and spreads on these transactions widened so that the Company realized higher per unit gains.

### *Mortgage Servicing Income*

Mortgage servicing income increased 12% to \$131.4 million from \$117.1 million. This increase was due to revenue earned on the underwriting and fulfillment processing services business which the Company launched in January 2015. Without this revenue, mortgage servicing income grew in line with the MUA growth of 6%.

### *Mortgage Investment Income*

Mortgage investment income increased 9% to \$57.5 million from \$52.8 million. The increase is due largely to the Company’s securitization program. As the Company elects to securitize, it warehouses mortgages until securitization and earns interest at the face rate of the mortgage in the warehousing period. The amount of mortgages accumulated for sale has increased by 23% from \$1.5 billion at the end of December 2015 to \$1.8 billion at the end of 2016. This growth has been offset by falling mortgage rates. Prevailing interest rates on five year closed mortgages were about 2.99% to begin 2015 compared to rate of approximately 2.50% offered for much of 2016. A loan loss provision of \$3.5 million (2015 - \$2.5 million) on four non-performing related commercial mortgages, reduced mortgage investment income in both years.

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

For First National, this financial statement line item typically consists of two components: (1) gains and losses related to the Company's economic hedging activities, and (2) gains and losses related to holding term assets derived using discounted cash flow methodology. Much like the short bonds that the Company uses for hedging, the term assets are affected by changes in credit markets and Government of Canada bond yields (which form the risk-free benchmarks used to estimate the fair value of the Company's deferred placement fees receivable, and mortgages designated as held for trading). The following table summarizes these gains and losses by category in the periods indicated:

<b>Summary of realized and unrealized gains (losses) on financial instruments</b>	<b>Quarter ended</b>		<b>Year ended</b>	
	<b>December 31, 2016</b>	<b>December 31, 2015</b>	<b>December 31, 2016</b>	<b>December 31, 2015</b>
	(\$ 000's)			
Gains (losses) on short bonds used for the economic hedging program	27,371	(734)	10,897	(35,076)
Gains (losses) on mortgages held at fair value	(14,900)	1,050	(4,597)	18,642
Gains (losses) on interest rate swaps	26,446	(13)	21,915	(36,457)
Gains (losses) on deferred placement fees receivable	(667)	15	(465)	724
Other gains (losses)	(382)	12	—	24
<b>Total gains (losses) on financial instruments</b>	<b>37,868</b>	<b>330</b>	<b>27,750</b>	<b>(52,143)</b>

As 2016 began, economic sentiment was muted and 5-year bond prices increased which meant generally the Company recorded losses on its hedging program. This was the case for most of the year until the American election in November. With the election of the Republican candidate and promises of increased economic stimulus, the bond market moved dramatically and bond prices decreased significantly. The result was First National's short bond position, which is used to economically hedge mortgages, had a large increase in value in the fourth quarter. This change was so large that it swung the Company's overall position to a gain for the year. This is in contrast to 2015 which featured large losses on the Company's short bond position as bond prices increased throughout that period. Accordingly, the Company recorded a large net loss in 2015 compared to the gains described for 2016.

The Company uses short Government of Canada bonds (including CHT-issued bonds) together with repurchase agreements to create synthetic forward interest rate contracts to hedge the interest rate risk associated with fixed rate mortgages originated for its own securitization programs. For accounting purposes, these do not qualify as interest rate hedges as the bonds used are not derivatives but cash-based financial instruments. These gains or losses are recorded in the period in which the bond prices change; however, the offsetting economic gains or losses are not recorded in the same period. Instead, the resulting economic gain (or loss) will be reflected primarily in wider or narrower spreads on the mortgages pledged for securitization and will be realized in net interest margin over the terms of the mortgages and the related debts. In 2016, the Company recorded gains on these instruments of \$10.9 million (2015 - loss of \$35.1 million). While the 2016 gains increased the net income earned in the year, the gross spread on the related portfolio of securitized mortgages going forward will be proportionally tighter as the Company issues securitization-related debt at higher relative interest rates than it would have prior to the movement in bond yields. In order to adequately hedge its interest rate exposure, the Company had almost \$1.2 billion of bonds sold short as at December 31, 2016.

The portion of the Company's mortgages which is held at fair value (primarily those funded through ABCP), was also affected by the large change in bond prices in the fourth quarter of 2016. The higher bond yields reduce the relative value of these mortgages. However, this mortgage portfolio is much smaller than the Company's short bond position, such that the negative impact to earnings is less significant. The mortgages were positively affected by the moderate tightening of mortgage funding credit spreads experienced in the last quarter of 2016. In 2015 these credit spreads widened to offset the large positive impact of lower bond yields on such mortgages. Altogether these mortgages lost \$4.6 million of fair value in 2016 (2015 - \$18.6 million gain). The valuation of interest rate swaps, which are used primarily to manage the interest rate exposure from fixed-rate mortgages in the ABCP portfolio, was positively affected in 2016 by changing bond yields such that unrealized gains of \$21.9 million were earned in 2016 (2015 - \$36.5 million loss).

### *Brokerage Fees Expense*

Brokerage fees expense decreased 3% to \$103.7 million from \$107.0 million. This decrease is explained almost entirely by lower origination volumes of single-family mortgages for institutional investors, which decreased by 8%. This decrease was offset by higher per unit broker fees which increased by about 2% between the years and increased costs of portfolio insurance.

### *Salaries and Benefits Expense*

Salaries and benefits expense increased by 3% to \$87.7 million from \$84.8 million. Salaries were higher as overall headcount increased from 915 employees to 949 as at 2016 year end. The growth in head count was 3% and includes employees working in the third-party underwriting and fulfillment services business which continued to grow but at more modest rates than in 2015 during business start-up. This growth also reflects the need to meet the administrative demand associated with increased MUA, which grew by 6% year over year. Management salaries were paid to the two senior executives (Co-founders) who together control about 74% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO").

### *Interest Expense*

Interest expense increased 7% to \$38.3 million from \$35.9 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 ultimate investor or funding with a securitization vehicle. The Company used the senior unsecured note together with a \$1 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense has increased from the prior period due to higher balances of mortgages accumulated for sale or securitization which required greater use of the Company's credit facilities.

### *Other Operating and Amortization of Intangibles Expenses*

Other operating and amortization of intangibles expenses increased by less than 1% to \$50.3 million from \$50.2 million. The amortization of intangible assets recognized on the IPO had been \$5.0 million per year until mid-2016 when they became fully amortized. Accordingly in 2016 the amortization expense was \$2.5 million for the year compared to \$5.0 million in 2015. Other operating expenses increased by \$2.6 million related to general increases in line with MUA growth of 6% including increased expenses related to the Company's NHA MBS program.

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

Income before income taxes increased 84% to \$274.1 million from \$148.7 million. This change was primarily the result of changing capital markets, which affected the Company's economic interest rate hedges. In 2016, interest rates rose which resulted in the Company earning \$27.8 million in gains on account of the fair value of financial instruments. In 2015, interest rates fell, such that the Company incurred fair value losses of \$52.1 million. The change in these amounts accounts for \$79.9 million of the increase in income before income taxes. Pre-FMV EBITDA, which eliminates the impact of gains and losses on financial instruments, increased 21% to \$253.5 million from \$209.9 million. The increase was due primarily to: 1) higher net interest from securitized mortgages as the Company benefited from a large portfolio built over the past ten years; 2) growth in placement fees and 3) profits from mortgage servicing. In the 2016, the Company continued to earn growing returns from its \$26 billion portfolio of mortgages pledged under securitization and its \$74 billion MUA serviced for institutional customers. Together with the growth in deferred placement fees and net mortgage investment income, the Company was able to obtain double digit growth in earnings performance.

### *Provision for Income Taxes*

The provision for taxes increased by 84% to \$72.3 million from \$39.2 million. The provision is higher due to the higher net income before income taxes earned in 2016. The overall effective tax rate is consistent between the years.

## **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:

	<b>Operating Business Segments</b>			
	<b>Residential</b>		<b>Commercial</b>	
	<b>(\$000's except percent amounts)</b>			
<b>For the year ended</b>	<b>December 31, 2016</b>	<b>December 31, 2015</b>	<b>December 31, 2016</b>	<b>December 31, 2015</b>
Originations and renewals	16,976,808	17,167,524	5,785,378	5,343,080
<i>Percentage change</i>	<i>(1%)</i>		<i>8%</i>	
Revenue	820,029	706,040	229,789	209,275
<i>Percentage change</i>	<i>16%</i>		<i>10%</i>	
Income before income taxes	210,995	100,455	63,134	48,221
<i>Percentage change</i>	<i>110%</i>		<i>31%</i>	
<b>As at</b>	<b>December 31, 2016</b>	<b>December 31, 2015</b>	<b>December 31, 2016</b>	<b>December 31, 2015</b>
Identifiable assets	24,718,010	22,276,053	5,646,679	5,620,903
Mortgages under administration	77,152,605	73,311,858	22,238,885	20,517,771

## **Residential Segment**

Overall residential origination including renewals decreased by 1% between 2016 and 2015, while residential revenues increased by about 16%. A large part of the change in revenue is due to the change in gains and losses on financial instruments. Excluding these changes, revenue increased by 5% as increased revenue from mortgage servicing and mortgage investment income augmented higher placement fees as per unit prices increased on transactions with institutional investors. The increase in normalized revenue also includes growth in gross revenue from the third party underwriting business. The net change in gains and losses on financial instruments for the residential segment of \$78.3 million also affected net

income before income taxes. Without the impact of this fair value change, net income before income taxes for the residential segment would have increased by 22% year over year. This growth is indicative of the revenue growth and increased profitability from the Company's renewal pipeline which affects net margins from securitization and placement transactions. Identifiable assets increased from December 31, 2015, as the Company increased the amount of mortgages accumulated for sale or securitization by more than \$370 million, increased government bonds purchased under resale agreements for hedging purposes by about \$610 million and increased securitization based assets by about \$1.4 billion. These increases are all a consequence of the Company's strategy to invest in increased mortgage commitments for its own securitization programs.

## **Commercial Segment**

2016 commercial revenues increased by about 10% compared to 2015, but increased by 9% if the impacts of changes in gains and losses on the fair value of financial instruments are excluded. This growth is largely due to higher interest revenue on securitized mortgages which has grown by almost \$8 million year over year and higher placement fees as the Company has increased origination and placed a larger portion of mortgages in this segment with institutional investors. Excluding fair value losses, net income before tax increased by 26% year over year as the value of the higher placement fees flowed through to the bottom line. Identifiable assets increased from those at December 31, 2015, as the Company increased the amount of mortgages pledged for securitization by \$320 million and reduced government bonds purchased under resale agreements for hedging purposes by about \$270 million.

## **Liquidity and Capital Resources**

The Company's fundamental liquidity strategy has been to invest in prime Canadian mortgages. Management's belief has always been that these mortgages are considered "AAA" by investors and should always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, when capital markets retreated and only the highest-quality assets were bid. As the Company's results in those years demonstrated, First National had little trouble finding investors to purchase its mortgage origination at profitable margins. Originating prime mortgages also allows the Company to securitize in the capital markets; however, this activity requires significant cash resources to purchase and hold mortgages prior to arranging for term debt through the securitization markets. For this purpose, the Company uses the combination of the \$175 million unsecured notes and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) the origination costs associated with securitization, and (3) mortgage and loan investments. The Company has a credit facility with a syndicate of eleven financial institutions for a total credit of \$1 billion. This facility was extended in May 2015 for a five-year term maturing in May 2020. Bank indebtedness may also include borrowings obtained through overdraft facilities. At December 31, 2016, the Company entered into repurchase transactions with financial institutions to borrow \$1.0 billion related to \$1.0 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At December 31, 2016, outstanding bank indebtedness (excluding indebtedness at the Fund level) was \$622.9 million (December 31, 2015 - \$576.9 million). Together with the unsecured notes of \$175 million (December 31, 2015 - \$175 million), this "combined debt" was used to fund \$800.3 million (December 31, 2015 - \$675.3 million) of mortgages accumulated for sale or securitization. At December 31, 2016, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$43.9 million (December 31, 2015 - \$38.2 million) and (2) mortgage and loan investments of \$255.2 million (December 31, 2015 - \$246.0 million). The difference between "combined debt" and the mortgages accumulated for sale or securitization funded by it, which the Company considers a proxy for "true leverage", has decreased between December 31, 2015 and December 31, 2016, such that there is no true leverage at December 31, 2016 (December 31, 2015 - \$76.0 million). This ratio decreased from December 31, 2015 when it was 0.18 to 1 as, generally, the Company has used retained earnings to reduce debt, particularly in the fourth quarter of 2016 when the Company earned large gains on financial instruments. The Company believes the low ratio demonstrates the conservative nature of the Company's indebtedness.

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 on the day of the advance of the mortgage. 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 term funding through securitization. The Company uses a portion of the committed credit facility with the banking syndicate to fund the mortgages during this warehouse period. The credit facility is designed to be able to fund the highest balance of warehoused mortgages in a month and is normally only partially drawn.

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

The Company has used ABCP as an efficient source of funding primarily for short term insured mortgages. In the May 2013 federal budget, the government announced it was going to take steps to limit the securitization of government insured mortgages to CMHC sponsored programs. As ABCP is not sponsored by CMHC, such a limitation would impact the Company. Almost two years after the announcement, legislation was passed and detailed transition information was published. With the change in the federal government, the legislation was reconfirmed in February 2016 with some delayed application dates. Generally, the regulations make mortgage default insurance invalid for single-family mortgages sold to non-CMHC sponsored securitizations after December 31, 2016. Accordingly, existing single-family mortgages in ABCP conduits as at December 31, 2016 can be funded by ABCP until their maturity, not to exceed 5 years. There is still discussion in the industry concerning the legislation; however if implemented as currently described, the new legislation would mean that the Company must find other funding sources for the insured mortgages it has historically funded with ABCP. The Company is considering various alternatives including whole loan sales and selling short term NHA-MBS pools to ABCP conduits. The Company may also adjust its renewal offering to provide incentives to borrowers to select five year terms as opposed to shorter terms. These alternatives may not be as economical to the Company as ABCP. A portion of the Company's capital has been employed to support its ABCP and NHA-MBS programs, primarily to provide credit enhancements as required by rating agencies. The most significant portion of cash collateral is the investment made on behalf of the Company's ABCP programs. As at December 31, 2016, the investment in cash collateral was \$22.9 million (December 31, 2015 - \$29.2 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 December 31, 2010, are designated as "eligible dividends". Unless stated otherwise, all dividends (and deemed dividends) paid by the Company hereafter are designated as "eligible dividends" for the purposes of such rules. For the preference shares, the Company has elected to pay any tax under Part VI.1 of the *Income Tax Act*, such that corporate holders of the shares will not be required to pay tax under Part VI.1 of the *Income Tax Act* on dividends received on such shares.

## **Financial Instruments and Risk Management**

The Company has elected to treat deferred placement fees receivable, certain mortgages pledged under securitization that have been funded with ABCP and NHA-MBS debt and several mortgages within 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 comprehensive income.

Effectively, these assets are treated much like bonds earning the Company a coupon at the discount rates used by the Company. The discount rates used represent the interest rate associated with a risk-free bond of the same duration plus a premium for the risk/uncertainty of the asset's residual cash flows. As rates in the bond market change, the carrying values of these assets will change. These changes may be significant (favourable and unfavourable) from quarter to quarter. The Company enters into fixed-for-float swaps to manage the interest rate exposure of fixed mortgages sold to ABCP conduits. These instruments will also be treated as fair value through profit or loss. While the Company has attempted to exactly match the principal balances of the fixed mortgages over the next five-year period to the notional swap values for the same period, there will be differences in these amounts. Any favourable or unfavourable amounts will be recorded in the consolidated statement of comprehensive 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. From an accounting perspective, any gains or losses on these instruments are recorded in the current period, as the Company's economic hedging strategy does not qualify as hedging for accounting purposes. The Company uses synthetic bond forwards (consisting of bonds sold short and bonds purchased under resale agreements) to manage interest rate exposure between the time a mortgage rate is committed to the borrower and the time the mortgage is transferred to the securitization vehicle and the matched term debt is arranged. As interest rates change, the value of these short bonds will vary inversely with the value of the related mortgages. As interest rates increase, a gain will be recorded on the bonds, which should be offset by a tighter interest rate spread between the interest rates on mortgages and the securitization debt. This spread will be earned over the term of the related mortgages. For single-family mortgages, primarily mortgages for the Company's own securitization programs, only some of the mortgage commitments issued by the Company eventually fund. The Company must assign a probability of funding to each mortgage in the pipeline and estimate how that probability changes as mortgages move through the various stages of the pipeline. The amount that is actually hedged is the expected value of mortgages funding within the next 120 days (120 days being the standard maximum rate hold period available for the mortgages). As at December 31, 2016, the Company had more than \$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 for transfer to the Company's other securitization vehicles. As at December 31, 2016, the Company had entered into \$115.7 million of notional value forward bond sales for this segment. The total net value of realized and unrealized gains and losses on account of all notional hedges pertaining to the period January 1, 2016 to December 31, 2016 was a \$10.9 million gain. This amount has been included in revenue in the statement of comprehensive income.

The Company is party to three interest rate swaps, two of which were entered into in the third quarter of 2016, that economically hedge the interest rate exposure related to certain CMB transactions in which the Company has replacement obligations. As at December 31, 2016, the aggregate notional value of these swaps was \$10.7 million. During 2016, the value of these swaps increased by \$4.8 million. The swaps mature between 2021 and December 2026.

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

additional unrealized losses or gains related to credit spread movement. Despite entering into effective economic interest rate hedges, the Company's exposure to credit spreads remained. This risk is inherent in the Company's business model and cannot be economically hedged.

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of March 2011 and continuing through the current period, it was priced at a discount to BAs. At the same time the Company has leveraged on changing credit spreads. The success of this approach has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages. As at December 31, 2016, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost \$1.8 billion of mortgages that are susceptible to some degree of changing credit spreads.

### Capital Expenditures

A significant portion of First National's business model consists of the origination and placement or securitization of financial assets. Generally, placement activities do not require much capital investment as the Company acts primarily in the capacity of a broker. On the other hand, the undertaking of securitization transactions may require significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. For fixed assets, the business requires capital expenditures on technology (both software and hardware), leasehold improvements and office furniture. During the year ended December 31, 2016, the Company purchased new computers and office and communications equipment. In the long term, the Company expects capital expenditures on fixed assets will be approximately \$4.5 million annually.

### Summary of Contractual Obligations

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

	<u>Total</u>	<u>0-1 Years</u>	<u>Payments Due By Period</u>		
			<u>1-3 Years</u> ( \$000's)	<u>4-5 Years</u>	<u>After 5 Years</u>
Lease Obligations	18,496	6,965	8,422	2,635	474

### 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, 2016. The policies which First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

The Company uses estimates in valuing its gain or loss on the sale of its mortgages placed with institutions earning a deferred placement fee. Under IFRS, valuing a gain on deferred placement fees requires the use of estimates to determine the fair value of the retained interest (derived from the present value of expected future cash flows) in the mortgages. These retained interests are reflected on the Company's balance sheet as deferred placement fees receivable. The key assumptions used in the valuation of gains on deferred placement fees are prepayment rates and the discount rate used to present value future expected cash flows. The annual rate of unscheduled principal payments is determined by reviewing portfolio prepayment experience on a monthly basis. The Company uses different rates for its various programs, which average approximately 11% for single-family mortgages. 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 assumptions underlying the estimates used for the quarter ended December 31, 2016 continue to be consistent with those used for the year ended December 31, 2015 and the quarters ended September 30, 2016, June 30, 2016 and March 31, 2016.

The Company has elected to treat certain of its financial assets and liabilities, including deferred placement fees receivable, specific mortgages pledged under securitization, some 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. 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 its securitized mortgages has a significant impact on earnings. The Company uses different prepayment rates for its various programs, which average approximately 10% for single-family mortgages. The Company assumes there is virtually no prepayment on multi-unit residential fixed rate mortgages. Actual prepayment experience has been consistent with these assumptions. The Company has also assumed discount rates based on Government of Canada bond yields plus a spread that the Company believes would enable a third party to purchase the mortgages and make a normal profit margin for the risk involved.

## **Future Accounting Changes**

In July 2014, the IASB issued the final version of IFRS 9 – Financial Instrument, replacing IAS 39 and all previous versions of IFRS 9. This final version of IFRS 9 includes a logical model for classification and measurement, a single, forward-looking 'expected loss' impairment model and a substantially-reformed approach to hedge accounting. Under this standard, financial assets are classified and measured based on the business model in which they are held and the characteristics of their contractual cash flows. The accounting model for financial liabilities is largely unchanged from IAS 39 except for the presentation of the impact of own credit risk on financial liabilities which will be recognized in OCI, rather than in profit and loss as under IAS 39. The new general hedge accounting principles under IFRS 9 are aimed to align hedge accounting more closely with risk management. This new standard does not fundamentally change the types of hedging relationships or the requirement to measure and recognize ineffectiveness; however it is expected to provide more hedging strategies that are used for risk management to qualify for hedge accounting and introduce more judgment to assess the effectiveness of a hedging relationship.

IFRS 9 is mandatorily effective for annual periods beginning on or after January 1, 2018. The Company is in process of evaluating the impact of IFRS 9 on the Company's financial statements.

In May 2014, the IASB issued IFRS 15 Revenue from Contracts with Customers, replacing IAS 11 - Construction Contracts, IAS 18 - Revenue, IFRIC 13 - Customer Loyalty Programs, IFRIC 15 - Agreements for the Construction of Real Estate, IFRIC 18 - Transfer of Assets from Customers, and SIC 31 Revenue - Barter Transactions Involving Advertising Services. The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step revenue recognition process to determine the nature, amount, timing and uncertainty of revenue and cash flows from the contracts with customers.

IFRS 15 is effective for fiscal years ending on or after December 31, 2018. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on January 1, 2018 and is currently analyzing the impact on the Company's financial statements.

In January 2016, the IASB issued IFRS 16 - Leases, replacing IAS 17 - Leases. IFRS 16 requires lessees to recognize assets and liabilities for most leases instead of previous categories of finance leases, which are reported on the balance sheet, or operating leases, which are disclosed only in the notes to the financial statements, under IAS 17. IFRS 16 is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted for companies that also adopt IFRS 15. The Company is currently assessing the impact of this standard on the Company's consolidated financial statements.

### *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, 2016, 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, 2016.

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, 2016 and that no material weaknesses have been identified in the Company's internal control over financial reporting as of December 31, 2016. No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

## **Risks and Uncertainties Affecting the Business**

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

## **Forward-Looking Information**

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

Affecting the Business”. In evaluating this information, the reader should specifically consider various factors, including the risks outlined under “Risk and Uncertainties Affecting the Business”, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management’s expectations as of February 28, 2017, and is subject to change after such date. However, management and the Company disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

## Outlook

Management is very pleased with the results of 2016. With the exception of the Calgary office, which is still facing the impact of the oil industry slowdown, the Company was satisfied with single family origination across the rest of Canada in a highly competitive market. With growing MUA and commercial origination, the Company produced record earnings.

In 2017, the Company looks to build on the success of 2016, although with the announcement of new rules on mortgage insurance, rising interest rates and other housing-related legislation, there will be new challenges to manage.

- As described in the third quarter MD&A, new mortgage insurance rules increased the “stress test” for borrowers of five-year fixed rate high ratio mortgages, requiring them to qualify based on an interest rate standard determined by the Bank of Canada. Management feels that while not overly significant, this will slow the high ratio insured market activity by some 5-10%, all other factors being equal;
- The new mortgage rules also eliminate the insurability on refinance transactions of conventional mortgages. Management believes such transactions were significant across Canada and this rule change will reduce mortgages available for securitization for the Company’s NHA-MBS and CMB programs. Although these mortgages can be underwritten on a conventional basis for the Company’s institutional investors, placement is generally not as profitable as securitization for First National. As well, the introduction of these rules may reduce the overall availability of insured mortgages across the country and may result in tighter mortgage spreads and higher origination costs as lenders in the securitization industry compete for the remaining insured mortgage volume. Such an outcome would decrease net securitization margins;
- New capital rules for mortgage portfolio default insurance were introduced in 2017. One of the results of these rules is that the insurers have increased premiums associated with portfolio insurance by over 200%, effective in the first quarter of 2017. The higher cost of such insurance will have a direct impact on net interest margin on any conventional mortgage that the Company elects to insure and securitize; and
- Regional issues, particularly in oil-dependent areas of the country, had a negative effect on 2016 origination volumes. Recently, real estate companies have reported slowing sales in British Columbia, perhaps associated with the foreign ownership tax. The Company originates about 20% of its single-family mortgages from its Vancouver office. Accordingly, slowing sales there or other regional issues could have a negative impact on origination volumes in 2017.

In the face of these challenges in the residential market for new mortgage originations, the Company will endeavor to grow its commercial segment business, focus on the significant value of single family renewal opportunities and continue to generate cash flow from its \$26 billion portfolio of mortgages pledged under securitization and \$74 billion servicing portfolio.