FIRST NATIONAL

FINANCIAL CORPORATION

# Report to Shareholders

# Period Ended June 30, 2018

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

FIRST NATIONAL

FINANCIAL CORPORATION

**Fellow Shareholders**

The second quarter of 2018 (three months ended June 30) was highly productive for First National in single family and commercial mortgage lending with both segments generating solid growth in originations and mortgage renewals. Total originations together with renewals amounted to $7.3 billion, up 18% from Q2 2017, while Mortgages under Administration increased 4% to a record $103.6 billion. This performance is broadly positive for future financial performance and illustrates that First National is responding well to market conditions.

Despite this growth, revenue of $290.9 million was 1% lower than a year ago. This reflected changing interest rates and their impact on gains on financial instruments. Together with the adoption of hedge accounting on January 1, 2018, which reduces the gains reported in earnings, gains on financial instruments were higher in the 2017 quarter of $17.7 million. Excluding these factors, revenue would have been 6% higher year over year.

Earnings, adjusted for fair value considerations, were lower by 18% compared to last year. The change reflected tighter mortgage spreads as well as increased securitization, which defers the earnings process until securitization cash flows come in over five and 10-year terms.

From a bottom line perspective, second quarter net income was $0.76 per share ($1.13 per share a year ago), which provided good coverage for common share dividends. The adjusted dividend payout ratio as a percentage of net income attributable to common shareholders was 70% in Q2 2018.

The Company is optimistic that the trend in originations established in the second quarter will continue in the third quarter but also expects the continuation of a tight interest spread environment.

Going forward, the Company will continue to generate income and cash flow from its $29 billion portfolio of mortgages pledged under securitization and $72 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 July 24, 2018. 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 June 30, 2018. The unaudited condensed consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").*

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

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

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

## General Description of the Company

First National Financial Corporation is the parent company of First National Financial LP ("FNFLP"), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over $103 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.

## Second Quarter 2018 Results Summary

Management is pleased with the results for the second quarter of 2018. Despite new mortgage insurance rules announced in late 2016 and tighter underwriting on uninsured mortgages required under OSFI's revised B-20 guidelines for 2018 which the Company has adopted, single family origination increased 5% year over year in the second quarter of 2018. Combined with higher commercial segment origination and steady renewals, First National increased its total origination by 17% in the quarter compared to the second quarter in 2017. Unfortunately with tighter mortgage spreads and a trend toward increased securitization, normalized earnings (Pre-FMV EBITDA) were lower by about 18%.

- MUA grew to $103.6 billion at June 30, 2018 from $99.5 billion at June 30, 2017, an increase of 4%; the growth from March 31, 2018, when MUA was $102.2 billion, was 5% on an annualized basis;
- Total new single-family mortgage origination was $3.4 billion in the second quarter of 2018 compared to $3.3 billion in 2017 comparative quarter, an increase of 5%. The Company attributes this to the relaunch of its Excalibur program (as discussed on page 6) and steady growth across the country except for the Calgary office which was down 9% year over year. The Montreal office experienced a 24% increase as recent competitive pressures were alleviated. The commercial segment continued to grow with origination up 17% as volumes increased to $1.7 billion in the second quarter of 2018 from $1.5 billion in the second quarter of 2017. The Company attributes this positive performance to its expanded presence in the conventional market. Overall new origination increased by 9%;
- The Company took advantage of opportunities in the quarter to renew $1.9 billion of single-family mortgages. In 2017 second quarter, the Company renewed $1.3 billion of single-family mortgages. For the commercial segment, renewals increased to $299 million from $225 million;
- Revenue for the second quarter of 2018 decreased by less than 1% to $290.9 million from $292.2 million in the 2017 comparative quarter. The decrease is related to lower revenue from gains on financial instruments. Because of changing interest rates and the adoption of hedge accounting in 2018, this revenue was lower by $17.7 million year over year. Without this component of revenue, revenue increased by 6%. This was influenced favorably by higher interest revenue on securitized mortgages which is the result of a larger portfolio of mortgages pledged under securitization as well as a rising interest rate environment in which mortgage coupons are higher. Placement revenues were lower in the 2018 quarter as the Company elected to securitize a greater portion of its origination;
- Income before income taxes decreased from $93.1 million in the second quarter of 2017 to $63.0 million in the comparative 2018 quarter. This measure decreased significantly because of changing capital markets conditions and the manner in which such gains and losses are accounted for. In the second quarter of 2017, interest rates rose quickly creating large gains on financial instruments. At that time the Company's hedging instruments did not qualify for hedge accounting and the gains were fully included in income. In the second quarter of 2018, the Company recorded revenue of $8.3 million on account of financial instruments compared to $26.0 million in the 2017 quarter; and
- The Company's earnings before income taxes, depreciation and amortization and gains and losses on financial instruments ("Pre-FMV EBITDA") for the quarter decreased by 18%, from $68.3 million in the 2017 quarter to $56.0 million in the 2018 quarter. These earnings are lower in the 2018 quarter due to tighter mortgage spreads and increased securitization which delays the earning's process in comparison to placement fees which create earnings in the same period as origination.

## Selected Quarterly Information

*Quarterly Results of First National Financial Corporation*

($000s, except per share amounts)

| | Revenue | Net Income for the period | Pre-FMV EBITDA for the period [(1)] | Net Income per Common Share | Total Assets |
|---|---|---|---|---|---|
| **2018** | | | | | |
| Second Quarter | $290,935 | $46,347 | $56,048 | $0.76 | $35,794,066 |
| First Quarter | $256,701 | $35,902 | $50,368 | $0.59 | $33,846,283 |
| **2017** | | | | | |
| Fourth Quarter | $270,015 | $45,948 | $61,093 | $0.75 | $32,776,278 |
| Third Quarter | $284,315 | $58,809 | $51,826 | $0.96 | $31,548,130 |
| Second Quarter | $292,200 | $68,768 | $68,275 | $1.13 | $30,832,883 |
| First Quarter | $232,238 | $36,127 | $53,084 | $0.58 | $29,901,289 |
| **2016** | | | | | |
| 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 |

(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 mortgage rates. Because mortgage rates and MUA have both increased, revenue has also increased. Net income is partially dependent on conditions in bond markets, which affect the value of gains and losses on financial instruments arising from the Company's interest rate hedging program. Accordingly, the movement of this measurement between quarters is related to factors external to the Company's core business. By removing this volatility and analyzing Pre-FMV EBITDA, management believes a more appropriate measurement of the Company's performance can be assessed.

Generally, in the years after the credit crisis in 2008, the Company grew its origination volumes which provided larger servicing and securitization portfolios. To the extent the Company employed securitization strategies, net interest margins were locked in for five and ten year terms. These margins were wide in 2008 as financial institutions maintained mortgage rates despite a significant drop in the cost of funds. Since 2008, such margins have steadily declined with competitive pressures and new securitizations are at much tighter spreads. For the Company this has meant that as high spread securitization transactions have matured and been replaced with new securitizations, profitability has decreased. This trend is evident in the Pre-FMV EBITDA figures above. In the third quarter 2017, Pre-FMV EBITDA decreased compared to the third quarter of 2016 as placement fees were negatively affected by a rising interest rate environment. By adjusting this measure and adding the $14.4 million which was recorded as a gain on holding short bonds in the second quarter 2017, the amount is more consistent with the Pre-FMV EBITDA recorded in third quarter 2016. Earnings are lower in the second quarter of 2018 compared to the second quarter of 2017 due to tighter mortgage spreads and more securitization which delays the earning's process in comparison to placement fees which are earned in the same period as origination.

## Outstanding Securities of the Corporation

At June 30, 2018 and July 24, 2018, 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 Annual Financial Information and Reconciliation to Pre-FMV EBITDA

($000s, except per share amounts)

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| **For the Year ended December 31,**<br>Income Statement Highlights | | | |
| Revenue | 1,078,768 | 1,049,818 | 915,315 |
| Interest expense – securitized mortgages | (511,939) | (495,681) | (488,659) |
| Brokerage fees | (83,260) | (103,719) | (107,045) |
| Salaries, interest and other operating expenses | (193,032) | (169,129) | (161,821) |
| Add (deduct): realized and unrealized (gains) losses on financial instruments | (56,259) | (27,750) | 52,143 |
| Pre-FMV EBITDA[(1)] | 234,278 | 253,539 | 209,933 |
| Amortization of capital assets | (5,135) | (4,660) | (4,114) |
| Amortization of intangible assets | — | (2,500) | (5,000) |
| Add (deduct): realized and unrealized gains (losses) on financial instruments | 56,259 | 27,750 | (52,143) |
| Provision for income taxes | (75,750) | (72,300) | (39,245) |
| Net income | 209,652 | 201,829 | 109,431 |
| Common share dividends declared | 184,400 | 98,946 | 90,451 |
| Per Share Highlights | | | |
| Net income per common share | 3.42 | 3.28 | 1.71 |
| Dividends per common share | 3.08 | 1.65 | 1.51 |
| **At Year End**<br>Balance Sheet Highlights<br>Total assets | 32,776,278 | 30,394,465 | 27,926,732 |
| Total long-term financial liabilities | 174,693 | 174,556 | 174,420 |

Notes:

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

## Vision and Strategy

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

## Key Performance Drivers

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

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

## Growth in Portfolio of Mortgages under Administration

Management considers the growth in MUA to be a key element of the Company's performance. The portfolio grows in two ways: through mortgages originated by the Company and through third-party mortgage servicing contracts. Mortgage originations not only drive revenues from placement and interest from securitized mortgages, but perhaps more importantly, longer-term value from servicing fees, mortgage administration fees, renewals and the growth of the customer base for marketing initiatives. As at June 30, 2018, MUA totalled $103.6 billion, up from $99.5 billion at June 30, 2017, an increase of 4%. This compares to $102.2 billion at March 31, 2018, representing an annualized increase of 5%.

## Growth in Origination of Mortgages

### *Direct origination by the Company*

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. Increased origination satisfies demand from its institutional customers and produces volume for the Company's own securitization programs. In the second quarter of 2018, the Company's single-family origination grew at a steady rate. Whether it is the effect of OSFI guideline B-20 or gaining market share in the mortgage broker channel, the Company experienced higher origination across the country except for its Calgary office which continues to suffer from regional issues: Toronto (+4%), Vancouver (+5%), Calgary (-9%) and Montreal (+24%). In aggregate, the Company's single-family origination increased in the second quarter of 2018 by 5%. The commercial segment continued to show strong growth as volume increased 17% over 2017's second quarter. Together, overall new origination for the second quarter of 2017 increased 9% year over year.

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

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

### *Relaunch of Excalibur Mortgage Products*

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

## Raising Capital for Operations

### *Bank Credit Facility*

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

### *Preferred Share Issuance*

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

## Employing Securitization Transactions to Minimize Funding Costs

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

The Company has 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% |
| 2017 | 1.36% |
| Q1 2018 | 1.27% |
| Q2 2018 | 1.27% |

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels; however, in 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. This trend continued into 2016, as optimism about the economy was mixed such that spreads remained at levels in excess of 1.8% until the third quarter when increased competition made for tighter spreads. With the recent strength in the economy and tougher mortgage rules, competition has further increased and spreads have tightened significantly. While funding spreads have also improved, generally the advantage of securitization compared to placement with investors is not as distinct as it was in the previous 10-year period. In the second quarter of 2018, the Company originated and renewed for securitization purposes approximately $3.2 billion of single-family mortgages and $0.2 billion of multi-unit residential mortgages. In the quarter, the Company securitized through NHA-MBS approximately $2.5 billion of single-family mortgages and $0.1 billion of multi-unit residential mortgages.

In August 2013, CMHC announced that it would be limiting the amount of guarantees it would provide on NHA-MBS pools created for sale to the "market". CMHC indicated that the amount of guarantees it was providing for such market pools (generally any pool not sold to the Canada Housing Trust ("CHT") for the CMB) was growing significantly. To better control the absolute amount of risk that it takes on in this respect, CMHC has implemented policies to allocate the amount of guarantees to issuers. The maximum amount allocated under the process has exceeded First National's requirements in every quarter since inception. The process was amended in July 2016 to combine both NHA MBS 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, these rules require guarantee fees to be levied on the creation of NHA MBS pools being sold to the CMB. Prior to this rule change, the NHA MBS pools to be sold into the CMB were exempt from such fees. In aggregate, guarantee fees have increased between 25% and 50% for CMB participants. This increase translates to approximately five basis points of cost over the term of the securitization. Since 2016, CMHC also modified the tiered NHA MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees from $7.5 billion to $9.0 billion. In the second quarter of 2018, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), issued its first NHA MBS pool for $25 million and securitized the pool in the 5 year CMB issued by CHT in June 2018.

## Adoption of New IFRS Accounting Standards

IFRS 9 – Financial Instruments

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

*Classifications and Measurement*

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

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

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

*Impairment*

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

The Company's ECL model has been built on an unbiased and probability-weighted method, determined by evaluating a range of possible outcomes. The model will consider the time value of money. Upon application of the ECL model, there has been no impact on the Company's earnings due to the high proportion of government insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends.

*Hedge Accounting*

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

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

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

IFRS 15 – Revenue from Contracts with Customers

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

revenue recognition process to determine the nature, amount, timing and uncertainty of revenue and cash flows from the contracts with customers.

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

## Key Performance Indicators

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

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

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

| | Quarter ended | | Six months ended | |
|---|---|---|---|---|
| | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| **For the Period** | | ($ 000's) | | |
| Revenue | 290,935 | 292,200 | 547,636 | 524,438 |
| Income before income taxes | 63,017 | 93,078 | 112,289 | 142,235 |
| Pre-FMV EBITDA (1) | 56,048 | 68,275 | 106,416 | 121,359 |
| **At Period end** | | | | |
| Total assets | 35,794,066 | 30,832,883 | 35,794,066 | 30,832,883 |
| Mortgages under administration | 103,574,915 | 99,533,430 | 103,574,915 | 99,533,430 |

Note:

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

Since going public in 2006, First National has been considered a high-yielding dividend paying company. With a large MUA 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 | | Six months ended | |
|---|---|---|---|---|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| **For the Period** | | ($000s) | | |
| Net income attributable to common shareholders | 45,621 | 67,640 | 80,818 | 102,570 |
| Total dividends paid or declared on common shares | 27,735 | 27,735 | 55,470 | 53,971 |
| Total Common Share Dividend Payout Ratio | 61% | 41% | 69% | 53% |
| After-tax Pre-FMV Dividend Payout Ratio [(1)] | 70% | 57% | 74% | 63% |

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 (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 June 30, 2018, the common share payout ratio was 61% compared to 41% in the 2017 quarter. In both the 2018 and 2017 quarters, the Company recorded gains on account of changes in the fair value of financial instruments. These revenues are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact will likely be reflected in narrower spreads in the future once the mortgages are pledged for securitization. Accordingly, management does not consider this revenue to increase the ability of the Company to pay dividends. If the gains on financial instruments in the two quarters are excluded from the above calculations, the dividend payout ratio for the 2018 second quarter would have been 70% compared to 57% in the 2017 quarter.

The Company also paid $0.7 million of dividends on its preferred shares in both the second quarter of 2018 and the second quarter of 2017.

## Revenues and Funding Sources

### *Mortgage Origination*

The Company derives a significant amount of its revenue from mortgage origination activities. Most mortgages originated are funded either by placement with institutional investors or through securitization conduits, in each case with retained servicing. Depending upon market conditions, either an institutional placement or a securitization conduit may be the most cost-effective means for the Company to fund individual mortgages. In general, originations are allocated from one funding source to another depending on market conditions and strategic considerations related to maintaining diversified funding sources. The Company retains servicing rights on virtually all of the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the quarter ended June 30, 2018, new origination volume increased from $4.7 billion to $5.1 billion, or about 9%, compared to the 2017 second 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 $7.3 billion of new originations and renewals for the quarter ended June 30, 2018, $3.4 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 $7.3 billion of new originations and renewals in the second quarter of 2018, $3.7 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 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 | | Six months ended | |
|---|---|---|---|---|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| | ($ millions) | | | |
| **Mortgage Originations by Segment** | | | | |
| New single-family residential | 3,423 | 3,253 | 5,593 | 5,189 |
| New multi-unit and commercial | 1,710 | 1,460 | 2,911 | 2,405 |
| Sub-total | 5,133 | 4,713 | 8,504 | 7,594 |
| Single-family residential renewals | 1,909 | 1,313 | 2,932 | 2,361 |
| Multi-unit and commercial renewals | 299 | 225 | 451 | 557 |
| Total origination and renewals | 7,341 | 6,251 | 11,887 | 10,512 |
| **Mortgage Originations by Funding Source** | | | | |
| Institutional investors – new residential | 1,197 | 2,043 | 1,923 | 3,128 |
| Institutional investors – renew residential | 816 | 809 | 1,177 | 1,108 |
| Institutional investors – multi/commercial | 1,659 | 1,282 | 2,579 | 2,368 |
| NHA-MBS/ CMB/ABCP securitization | 3,429 | 1,925 | 5,766 | 3,592 |
| Internal Company resources/CMBS | 240 | 192 | 442 | 316 |
| Total | 7,341 | 6,251 | 11,887 | 10,512 |
| **Mortgages under Administration** | | | | |
| Single-family residential | 78,025 | 77,197 | 78,025 | 77,197 |
| Multi-unit residential and commercial | 25,550 | 22,336 | 25,550 | 22,336 |
| Total | 103,575 | 99,533 | 103,575 | 99,533 |

Total new mortgage origination volumes increased in the second quarter of 2018 compared to 2017 by 9%. Single-family volumes increased by 5% and commercial segment volumes increased by 17% year over year. The increase in the single-family segment is evident across the country except for the Company's Calgary office, which experienced a 9% decrease in volume. When combined with renewals, total production increased from $6.3 billion in the 2017 second quarter to $7.3 billion in the second quarter of 2018, or by 17%. The Company believes higher new single-family origination is partially the result the relaunch of its Excalibur program which has added origination volume where there was none in 2017. Overall volumes were also affected favorably by a 24% increase in the Quebec market. Some of the mortgage rate pressure in this region subsided so as to make the Company's products more competitive. The low interest rate environment together with the Company's expertise in mortgage underwriting drove higher commercial segment origination volumes. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of $3.4 billion in the second quarter of 2018. The Company used such securitization funding to a greater degree than institutional placements in 2018. Generally, the Company maintained a balance between these funding sources despite the reduction in profitability of securitization in a tight spread environment. The Company's long-term strategy has always been to maintain diverse funding sources.

### *Net Interest - Securitized Mortgages*

Comparing the quarter ended June 30, 2018 to the quarter ended June 30, 2017, "net interest – securitized mortgages" increased by 3% to $35.5 million from $34.4 million. The increase was due to a larger portfolio of securitized mortgages offset by a slightly tighter weighted-average spread on the portfolio year over year. The portfolio of securitized mortgages increased by 13% from $26.0 billion at June 30, 2017 to $29.3 billion by the end of June 2018. The increase in the securitized portfolio has been offset by the effect of the accounting related to the Company's hedging program. Prior to the adoption of IFRS 9 in 2018, the Company recorded the changing value of its interest rate hedges in the period in which bond prices changed. The offsetting change in value of the related mortgages was then recognized in wider or narrower spreads in the securitization transactions over the term of the mortgages. The Company experienced both large losses and gains on financial instruments from 2014 through 2017 – however with interest rates rising at the end of 2017, more gains were recorded than losses. This means that there was a decrease in the values of the related mortgages which will affect earnings for the next 5 and ten years periods as the mortgages perform. The Company estimates that in the second quarter of 2018, net interest – securitized mortgages was negatively affected by this accounting by approximately $2.9 million. This is largely the impact of 2017 when the Company recorded $56 million of gains on financial instruments of which about $40 million pertained to the value of securitized mortgages. The amortization of deferred origination and other costs that are capitalized on securitized mortgages also have an effect on net interest – securitized mortgages.

### *Placement Fees*

Placement fee revenue decreased by 41% to $31.0 million from $52.9 million in 2018. The decrease is explained largely by new residential origination volume for institutional customers, excluding renewals, which decreased from $2.0 billion in the second quarter of 2017 to $1.2 billion in the 2018 quarter or by 41%.

### *Gains on Deferred Placement Fees*

Gains on deferred placement fees revenue was $2.4 million in both comparative quarters. The gains relate to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Although volumes for these transactions increased by 18% from 2017, spreads on these transactions tightened such that the Company realized lower per unit gains.

### *Mortgage Servicing Income*

Mortgage servicing income increased 4% to $37.1 million from $35.7 million. This increase was largely due to the MUA growth which was 4% from June 30, 2017.

### *Mortgage Investment Income*

Mortgage investment income increased 31% to $21.2 million from $16.2 million. The increase is due primarily to an increase in the Company's commercial bridge loan program. The commercial bridge loan portfolio grew by about $118 million or by 46% from April 1, 2017 to April 1, 2018 providing more investment income. The Company recorded mark to market losses of $1.0 million (2017 – credit losses of $0.2 million) regarding four non-performing properties in the commercial bridge portfolio in the 2018 second quarter. These are recorded as losses on financial instruments in 2018. In addition, the interest rates associated with the Company's mortgages warehoused prior to securitization were higher this quarter such that more interest income was earned during the warehousing period.

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

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

| | Quarter ended | | Six months ended | |
|---|---|---|---|---|
| **Summary of realized and unrealized gains (losses) on financial instruments** | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| | | **($000s)** | | |
| Gains (losses) on short bonds used for the economic hedging program | 8,614 | 19,635 | 9,390 | 16,169 |
| Losses on mortgages held at fair value | (1,000) | (11,111) | (2,000) | (6,327) |
| Gains (losses) on interest rate swaps | (340) | 17,471 | (907) | 13,418 |
| Net gains (losses) on financial instruments | 7,274 | 25,995 | 6,483 | 23,260 |

In the second quarter of 2017, economic data turned positive and interest rates jumped higher with the expectations of a Bank of Canada increase in overnight rates. This meant that 5-year bond prices decreased so that generally the Company recorded large gains on its hedging program. In the second quarter of 2018, bond yields increased to start the quarter but began to retreat in mid-quarter. By quarter end there was only a very small increase in bond yields. However the Company's hedging program has grown significantly this year. With hedging amounts approaching $2.4 billion notional values, changes in interest rates have a bigger impact on gains and losses on financial instruments.

In the second quarter of 2018, the Company recorded gains on these instruments of $8.6 million (2017 – $19.6 million). On its commercial segment hedges, the value of the Company's hedges increased by $5.2 million; however because of the designation of a hedge relationship, virtually the entire amount was recorded in Other Comprehensive Income. This amount will be amortized into the Company's regular income over the terms of the related securitization and placement transactions. For the residential segment, the Company has designated hedge relationships to protect the fair value of funded mortgages prior to securitization or placement. The $8.6 million gain above reflects the increase in value of short bonds used to hedge the Company's commitments for which the Company does not attempt to document a hedge relationship. The change in value of the mortgages that were hedged effectively in the quarter has been deferred on the Company's balance sheet.

### *Brokerage Fees Expense*

Brokerage fees expense decreased 55% to $12.7 million from $28.0 million. This decrease is explained almost entirely by lower origination volumes of single-family mortgages for institutional investors, which decreased by 41%. Generally, per unit broker fees for single family mortgages were higher in the second quarter of 2017 as the Company increased broker fees for insured mortgages with increased competition. In the second quarter of 2018, as the Company securitized a significant amount of its insured single-family volume, such that the higher fees associated with insured mortgages were capitalized. These fees are then amortized into income against net interest – securitized mortgages.

### *Salaries and Benefits Expense*

Salaries and benefits expense increased by 2% to $25.3 million from $24.9 million. Salaries were higher despite overall headcount not changing significantly (937 employees as at June 30, 2017 and 936 at June 30, 2018). Although overall headcount is the same, the change represents standard cost of living increases and the addition of higher paying roles in place of lower paying which the Company has eliminated through automation. Management salaries were paid to the two senior executives (Co-founders) who together control about 74% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO") in 2006.

### *Interest Expense*

Interest expense increased 73% to $17.0 million from $9.8 million. As discussed in the "Liquidity and Capital Resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the investor or funding with a securitization vehicle. The Company used the senior unsecured notes together with a $1.25 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense has increased from the prior period due to higher short-term interest rates pursuant to Bank of Canada announcements which have increased short-term borrowing rates by 0.75% beginning in the third quarter of 2017. The Company also held higher balances of mortgages accumulated for securitization and mortgage and loan investments in the 2018 quarter, which required greater use of the Company's credit facilities.

### *Other Operating Expenses*

Other operating expenses increased by 48% to $17.5 million from $11.8 million. Other operating expenses increased by $4.2 million related to higher hedge expenses which increased in step with higher bond yields and a larger hedge book. Because of more mortgages originated for securitization, the Company increased notional hedges by over $1 billion between June 2017 and June 2018. In addition, the rising interest rate environment has created a steeper yield curve which makes it more expensive to carry the short bonds the Company employs to mitigate interest rate risk associated with the Company's commitment and funded warehouse pipeline. The remaining increase in other operating expenses of $1.5 million reflects costs to support a growing business including information technology and the relaunch of the Excalibur program.

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

Income before income taxes decreased by 32% to $63.0 million from $93.1 million. This decrease was affected by changing capital markets. In the second quarter of 2018, the Company recorded $8.3 million of gains on financial instruments. In the 2017 comparative quarter, the Company recorded $26.0 million of gains on financial instruments. The change in these values accounts for a $17.7 million decrease in comparative income before income taxes. Pre-FMV EBITDA, which eliminates the impact of gains and losses on financial instruments, decreased by 18% to $56.0 million from $68.3 million. The decrease was due largely to the Company's increased securitization program. By securitizing mortgages instead of placing them with institutional investors, the Company delays the earning's process: placement fee

revenues are reduced and the costs of hedging and interest during the warehousing period are increased. In addition, tight mortgage spreads have reduced the profitability of securitization such that net interest – securitization mortgages has not grown in step with the growth in mortgages pledged for securitization.

### *Provision for Income Taxes*

The provision for taxes decreased by 31% to $16.7 million from $24.3 million. The provision decreased proportionately with net income before income taxes. The overall effective tax rate is a marginally higher in 2018 as a provincial tax rate increased by 1% at the start of 2018.

### *Other Comprehensive Income*

Beginning January 1, 2018, the Company adopted IFRS 9. As a part of this transition the Company began accounting for some of its interest rate risk mitigation strategies as hedges for reporting purposes. For the commercial segment, the Company hedges the interest rate risk associated with insured multi-residential mortgages. This hedging begins on commitment and ends when the Company either securitizes the mortgages (primarily through CMB funding) or places the mortgage with an institutional investor. As the Company has determined that these hedges were effective, the Company recorded $5.2 million of gains on such hedges in the second quarter of 2018 that would have been recorded in gains on financial instruments under the previous IFRS standard. During the second quarter, the Company amortized $2.8 million of such gains earned year to date into its Net Income. The remaining OCI amount has been tax affected at the Company’s effective tax rate.

## 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** | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| Originations and renewals | 5,331,841 | 4,565,676 | 2,008,815 | 1,685,339 |
| *Percentage change* | *17%* | | *19%* | |
| Revenue | 224,955 | 228,099 | 65,980 | 64,101 |
| *Percentage change* | *(1%)* | | *3%* | |
| Income before income taxes | 47,400 | 73,448 | 15,617 | 19,630 |
| *Percentage change* | *(35%)* | | *(20%)* | |
| **As at** | **June 30, 2018** | **December 31, 2017** | **June 30, 2018** | **December 31, 2017** |
| Identifiable assets | 28,512,260 | 25,653,160 | 7,252,030 | 7,093,342 |
| Mortgages under administration | 78,024,945 | 77,422,655 | 25,549,970 | 24,166,498 |

## Residential Segment

Overall residential origination including renewals increased by 17% between the 2018 and 2017 second quarters while residential revenues decreased by about 1%. Revenues in the 2017 quarter were affected by large gains of fair value associated with rising interest rates. If such revenues are excluded from both quarters, revenue increased by 4%. Revenue growth trailed the growth in origination as the Company elected to securitize a greater portion of its origination as opposed to placing it with institutional customers. This delays the earnings process from the current period to the term of the securitized

mortgages. Net income before tax was also affected by fair value related amounts. Without the impact of these revenues, net income before tax decreased from $53.2 million to $39.1 million or by 26%. This is also the result of the Company's decision to securitize as opposed to placing a larger portion of its residential origination in the quarter. The costs of underwriting, hedging and warehousing these mortgages are significant and there is an only marginal amount of revenue earned on new transactions in the quarter. Net securitization margin also suffered from tighter securitization spreads the result of a competitive marketplace as well as the amortization of large debt discounts created by interest rate movements in 2016 and 2017. Identifiable assets increased from December 31, 2017, as the Company increased its investment in mortgages pledged under securitization by about $0.5 billion, its investment in mortgages accumulated for securitization by $0.8 billion and its bonds purchased under resale agreements for hedging purposes by $0.6 billion.

## Commercial Segment

Second quarter 2018 commercial revenues increased by about 3% compared to 2017. Without the impact of gains and losses on account of fair value, revenue increased by 15% year over year reflecting increased origination. Income before income taxes was also affected by fair value considerations. By excluding fair value gains and losses, this measure would have increased by 19% year over year in line with origination and revenue increases. Identifiable assets increased from those at December 31, 2017, as the Company increased its investment mortgages pledged for securitization by $455 million but reduced its investment in mortgage investments and mortgages accumulated for securitization in the six month period.

## Liquidity and Capital Resources

The Company's fundamental liquidity strategy has been to invest in prime Canadian mortgages. Management's belief has always been that these mortgages are considered "AAA" by investors and should always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, when capital markets faltered and only the highest-quality assets were bid. As the Company's results in those years demonstrated, First National had little trouble finding investors to purchase its mortgage origination at profitable margins. Originating prime mortgages also allows the Company to securitize in the capital markets; however, this activity requires significant cash resources to purchase and hold mortgages prior to arranging for term debt through the securitization markets. For this purpose, the Company uses the combination of the $175 million unsecured notes and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) the origination costs associated with securitization, and (3) mortgage and loan investments. The Company has a credit facility with a syndicate of ten financial institutions for a total credit of $1.25 billion. This facility was extended in May 2018 for a five-year term maturing in March 2023. At June 30, 2018, the Company entered into repurchase transactions with financial institutions to borrow $1.5 billion related to $1.5 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At June 30, 2018, outstanding bank indebtedness was $1,050 million (December 31, 2017 - $643.8 million). Together with the unsecured notes of $175 million (December 31, 2017 – $175 million), this "combined debt" was used to fund $947.4 million (December 31, 2017 - $556.1 million) of mortgages accumulated for sale or securitization. At June 30, 2018, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $41.5 million (December 31, 2017 – $41.3 million) and (2) mortgage and loan investments of $332.5 million (December 30, 2017 - $379.7 million). The difference between "combined debt" and the mortgages accumulated for sale or securitization funded by it, which the Company considers a proxy for "true leverage", has increased between December 31, 2017 and June 31, 2018, and now stands at $277.5 million (December 31, 2017 – $262.4 million). This represents a debt-to-equity ratio of approximately 0.48:1. This remained constant from December 31, 2017 when the ratio was also 0.48:1. In general, the Company used the repayment of $47 million of mortgage and loan investments to invest in $48 million of broker fees, portfolio insurance and other capitalized securitization costs included in mortgages pledged under securitization. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

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

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

The Company has used ABCP as an efficient source of funding primarily for short-term insured mortgages. In the May 2013 federal budget, the government announced it was going to take steps to limit the securitization of government insured mortgages to CMHC sponsored programs. As ABCP is not sponsored by CMHC, such a limitation would impact the Company. Almost two years after the announcement, legislation was passed and detailed transition information was published. With the change in the federal government, the legislation was reconfirmed in February 2016 with some delayed application dates. Generally, the regulations make mortgage default insurance invalid for any single-family mortgages with maturity dates beyond December 31, 2021 in a non-CMHC sponsored securitization vehicle. Accordingly, existing single-family mortgages in ABCP conduits can be funded by ABCP until their maturity, not to exceed 5 years and new insured single-family mortgages can be sold in as long as the maturity date of the mortgage is prior to January 1, 2022. As this date approaches, the Company must find other funding sources for the insured mortgages it has historically funded with ABCP. The Company is considering various alternatives including whole loan sales and selling short-term NHA-MBS pools to ABCP conduits. The Company may also adjust its renewal offering to provide incentives to borrowers to select five year terms as opposed to shorter terms. These alternatives may not be as economical to the Company as ABCP. A portion of the Company's capital has been employed to support its ABCP and NHA-MBS programs, primarily to provide credit enhancements as required by rating agencies. The most significant portion of cash collateral is the investment made on behalf of the Company's ABCP programs. As at June 30, 2018, the investment in cash collateral was $81.9 million (December 31, 2017 - $66.4 million).

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

## Financial Instruments and Risk Management

The Company has recorded mortgages accumulated for sale and mortgage and loan investments, as financial assets measured at "fair value through profit or loss" such that changes in market value are recorded in the consolidated statement of income. The mortgages accumulated for sale are held for very short periods and any change in value due to changing interest rates is the obligation of the ultimate institutional investor. Accordingly the Company believes there will be little, if any, effect on its income

related to the change in fair value of these mortgages. The majority of mortgages in mortgage and loan investments are uninsured commercial segment bridge loans. These are primarily floating rate loans that have mortgages terms of eighteen months or less. As the mortgages do not conform to conventional mortgage lending, there are few active quoted markets available to determine the fair value of these assets. The Company estimates fair value based upon: benchmark interest rates, credit spreads for similar products, creditworthiness and status of the borrower, valuation of the underlying real property, payment history, and other conditions specific to the rationale for the loan. Any favourable or unfavourable amounts will be recorded in the statement of income each quarter.

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. Prior to 2018, the Company did not attempt to adopt hedge accounting; however with the introduction of IFRS 9 on January 1, 2018, the Company began designating hedging relationships such that the results of any effective hedging will not affect the Company's statement of income. See previous discussion in this MD&A under "Realized and Unrealized Gains (Losses) on Financial Instruments". As at June 30, 2018, the Company had more than $2.1 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund, and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages to be sold to the Company's other securitization vehicles. As at June 30, 2018, the Company had entered into $0.3 billion of notional value forward bond sales for this segment.

The Company is 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 June 30, 2018, the aggregate notional value of these swaps was $16.4 million. During the second quarter of 2018, the value of these swaps decreased by $0.3 million. The swaps mature between June 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 June 2011 and continuing through the current period, it was priced at a discount to BAs. At the same time the Company has leveraged on changing credit spreads. The success of this approach has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages. As at June 30, 2018, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost $2.5 billion of mortgages that are susceptible to some degree of changing credit spreads.

## Capital Expenditures

A significant portion of First National's business model consists of the origination and placement or securitization of financial assets. Generally, placement activities do not require much capital investment as the Company acts primarily in the capacity of a broker. On the other hand, the undertaking of securitization transactions may require significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. For fixed assets, the business requires capital expenditures on technology (both software and hardware), leasehold improvements, and office furniture. During the quarter ended June 30, 2018, the Company purchased new computer equipment and software. In the long term, the Company expects capital expenditures on fixed assets will be approximately $5.0 million annually.

## Summary of Contractual Obligations

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

## 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, 2017. The policies which First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

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

On a quarterly basis, the Company reviews the estimates used to ensure their appropriateness and monitors the performance statistics of the relevant mortgage portfolios to adjust and improve these estimates. The estimates used reflect the expected performance of the mortgage portfolio over the lives of the mortgages. The method of determining the assumptions underlying the estimates used for the quarter ended June 30, 2018 continue to be consistent with those used for the year ended December 31, 2017 and the quarter ended March 31, 2018.

Effective January 1, 2018, the Company has elected to treat certain of its financial assets and liabilities, including mortgages accumulated for sale, mortgage and loan investments and bonds sold short, at fair value through profit or loss. Essentially, this policy requires the Company to record changes in the fair value of these instruments in the current period's earnings. If the bonds sold short are designated as an effective hedge, a portion of the change it the short bonds fair value may be recorded in Other Comprehensive Income or deferred against hedge assets. This accounting should reduce the volatility in current earnings as changes in the value on short bonds should be better matched to the change in value of the hedged items (mortgages). The Company's assets and liabilities are such that the Company must use valuation techniques based on assumptions that are not fully supported by observable market prices or rates in most cases. Much like the valuation of deferred placement fees receivable described above, the Company's method of determining the fair value of the assets listed above are subject to Company estimates. The most significant would be implicit in the valuation of mortgage and loan investments. These are generally non-homogeneous mortgages and other loans where it is difficult to find independent valuation comparatives. The Company uses information in its underwriting files, regional real estate information and other internal measures to determine the fair value of these assets.

As a mortgage lender, the Company invests in uninsured mortgages. When it funds these mortgages through securitization debt, it continues to be liable for any credit losses. The Company's ECL model has been built on an unbiased and probability-weighted method, determined by evaluating a range of possible outcomes. The model will consider the time value of money. Upon application of the ECL model, there has been no impact on the Company's earnings due to the high proportion of government insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends.

## Future Accounting Changes

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

IFRS 16 – *Leases*

In January 2016, the IASB issued IFRS 16 – Leases, replacing IAS 17 – Leases. IFRS 16 requires lessees to recognize assets and liabilities for most leases instead of previous categories of finance leases, which are reported on the balance sheet, or operating leases, which are disclosed only in the notes to the financial statements, under IAS 17. IFRS 16 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.

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 June 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

## Risks and Uncertainties Affecting the Business

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

## Forward-Looking Information

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

assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the ''Risk and Uncertainties Affecting the Business'' section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the ''Risk and Uncertainties Affecting the Business'' section, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management's expectations as of July 24, 2018, and is subject to change after such date. However, management and the Company disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

## Outlook

Management is pleased with the results of the second quarter of 2018. Despite additional government regulation introduced in 2018, B-20 guidelines, on top of the existing October 2016 mortgage insurance rules announced by the Department of Finance, the Company's single-family origination increased by 5%. In addition, the Company benefitted from increased commercial mortgage origination and steady single-family renewals. Altogether, origination including renewals was up 17%. While earnings, adjusted for fair value considerations, were lower by 18%, a large part of this was the outcome of shifting mortgages to the securitization programs from placement transactions. By securitizing mortgages instead of placing them with institutional investors, the Company delays the earning's process: placement fee revenues are reduced and the costs of hedging during the warehousing period are increased. A second drag on earnings in the quarter is the result of the accounting used for interest rate hedges prior to 2018. In fiscal 2017, the Company recognized $56 million related to the change in fair value of financial instruments. Some of the offsetting loss in value implicit in the hedged mortgages was realized in 2017, but the majority of the value will be recognized in tighter securitization spreads over the terms of these mortgages.

Going into the third quarter of 2018, the Company is optimistic that the trend established in the second quarter will continue. The 5% year-over-year increase in new single-family origination represents a return to more normalized markets after the disruption in the second half of 2017 resulting from the increase in qualifying rates for insured mortgages. Despite the impact of new qualifying mortgage rules under B-20 and higher interest rates, 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. While the Company expects growth in origination in the third quarter of 2018, it also expects a tight interest spread environment similar to what existed in the second quarter of 2018.

The Company will continue to generate income and cash flow from its $29 billion portfolio of mortgages pledged under securitization and $72 billion servicing portfolio, and focus on the value inherent in its significant single-family renewal book.

Interim condensed consolidated financial statements

# First National Financial Corporation

[Unaudited]
Second quarter 2018

**First National Financial Corporation**

# Interim condensed consolidated statements of financial position

[Unaudited – in thousands of Canadian dollars]

As at

| | June 30, 2018 $ | December 31, 2017 $ |
|---|---|---|
| **Assets** | | |
| Restricted cash *[note 3]* | **779,704** | 561,470 |
| Cash held as collateral for securitization *[note 3]* | **81,949** | 66,413 |
| Accounts receivable and sundry | **149,519** | 144,159 |
| Securities purchased under resale agreements | **2,649,735** | 2,185,362 |
| Mortgages accumulated for sale or securitization *[note 5]* | **2,455,796** | 1,789,765 |
| Mortgages pledged under securitization *[note 3]* | **29,254,202** | 27,566,677 |
| Deferred placement fees receivable *[note 4]* | **41,451** | 41,273 |
| Mortgage and loan investments *[note 6]* | **332,503** | 379,713 |
| Income taxes recoverable | **8,332** | — |
| Other assets | **40,875** | 41,446 |
| **Total assets** | **35,794,066** | 32,776,278 |
| **Liabilities and equity** | | |
| **Liabilities** | | |
| Bank indebtedness *[note 8]* | **1,050,118** | 643,828 |
| Obligations related to securities and mortgages sold under repurchase agreements | **1,460,079** | 1,200,135 |
| Accounts payable and accrued liabilities | **124,882** | 118,081 |
| Securities sold short | **2,641,078** | 2,180,253 |
| Debt related to securitized and participation mortgages *[note 9]* | **29,689,090** | 27,834,080 |
| Senior unsecured notes | **174,761** | 174,693 |
| Income taxes payable | **—** | 7,191 |
| Deferred tax liabilities | **81,650** | 74,750 |
| **Total liabilities** | **35,221,658** | 32,233,011 |
| **Equity attributable to shareholders** | | |
| Common shares *[note 10]* | **122,671** | 122,671 |
| Preferred shares *[note 10]* | **97,394** | 97,394 |
| Retained earnings | **348,547** | 323,202 |
| Accumulated other comprehensive income | **3,796** | — |
| **Total equity** | **572,408** | 543,267 |
| **Total liabilities and equity** | **35,794,066** | 32,776,278 |

*See accompanying notes*

On behalf of the Board:

John Brough

Robert Mitchell

**First National Financial Corporation**

# Interim condensed consolidated statements of income

[Unaudited – in thousands of Canadian dollars]

| | Three months ended | | Six months ended | |
|---|---|---|---|---|
| | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| | $ | $ | $ | $ |
| **Revenue** | | | | |
| Interest revenue – securitized mortgages | **190,941** | 158,944 | **374,411** | 319,588 |
| Interest expense – securitized mortgages | **(155,462)** | (124,529) | **(300,598)** | (247,996) |
| Net interest – securitized mortgages *[note 3]* | **35,479** | 34,415 | **73,813** | 71,592 |
| Placement fees | **30,952** | 52,950 | **50,701** | 79,575 |
| Gains on deferred placement fees *[note 4]* | **2,384** | 2,448 | **5,852** | 6,132 |
| Mortgage investment income | **22,245** | 16,187 | **42,185** | 30,056 |
| Mortgage servicing income | **37,139** | 35,676 | **68,004** | 65,827 |
| Realized and unrealized gains on financial instruments | **7,274** | 25,995 | **6,483** | 23,260 |
| | **135,473** | 167,671 | **247,038** | 276,442 |
| **Expenses** | | | | |
| Brokerage fees | **12,747** | 28,040 | **21,223** | 42,309 |
| Salaries and benefits | **25,281** | 24,925 | **49,158** | 48,063 |
| Interest | **16,976** | 9,793 | **31,170** | 19,367 |
| Other operating | **17,452** | 11,835 | **33,198** | 24,468 |
| | **72,456** | 74,593 | **134,749** | 134,207 |
| **Income before income taxes** | **63,017** | 93,078 | **112,289** | 142,235 |
| Income tax expense | **16,670** | 24,310 | **30,040** | 37,340 |
| **Net income for the period** | **46,347** | 68,768 | **82,249** | 104,895 |
| **Net income attributable to** | | | | |
| Shareholders | **46,347** | 68,320 | **82,249** | 103,930 |
| Non-controlling interests | **—** | 448 | **—** | 965 |
| | **46,347** | 68,768 | **82,249** | 104,895 |
| **Earnings per share** | | | | |
| Basic *[note 10]* | **0.76** | 1.13 | **1.35** | 1.71 |

*See accompanying notes*

**First National Financial Corporation**

## Interim condensed consolidated statements of comprehensive income

[Unaudited – in thousands of Canadian dollars]

| | Three months ended | | Six months ended | |
|---|---|---|---|---|
| | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| | $ | $ | $ | $ |
| **Net income for the period** | **46,347** | 68,768 | **82,249** | 104,895 |
| **Other comprehensive income items that may be subsequently reclassified to income** | | | | |
| Net unrealized gains from change in fair value of cash flow hedges | **5,223** | — | **10,432** | — |
| Reclassification of net gains to income | **(2,788)** | — | **(5,256)** | — |
| | **2,435** | — | **5,176** | — |
| Income tax expense | **(650)** | — | **(1,380)** | — |
| Total other comprehensive income | **1,785** | — | **3,796** | — |
| **Total comprehensive income** | **48,132** | 68,768 | **86,045** | 104,895 |

*See accompanying notes*

**First National Financial Corporation**

# Interim condensed consolidated statements of changes in equity

[Unaudited – in thousands of Canadian dollars]

| | Common shares $ | Preferred shares $ | Retained earnings $ | Accumulated other comprehensive income $ | Total equity $ |
|---|---|---|---|---|---|
| Balance as at January 1, 2018 | **122,671** | **97,394** | **323,202** | **—** | **543,267** |
| Net income | **—** | **—** | **82,249** | **—** | **82,249** |
| Other comprehensive income, net of tax | **—** | **—** | **—** | **3,796** | **3,796** |
| Dividends paid or declared | **—** | **—** | **(56,904)** | **—** | **(56,904)** |
| **Balance as at June 30, 2018** | **122,671** | **97,394** | **348,547** | **3,796** | **572,408** |

| | Common shares $ | Preferred shares $ | Retained earnings $ | Non-controlling interests $ | Total equity $ |
|---|---|---|---|---|---|
| Balance as at January 1, 2017 | 122,671 | 97,394 | 302,271 | 27,961 | 550,297 |
| Net income | — | — | 103,930 | 965 | 104,895 |
| Dividends paid or declared | — | — | (55,331) | (899) | (56,230) |
| Redemption by non-controlling interests | — | — | — | (4,260) | (4,260) |
| **Balance as at June 30, 2017** | 122,671 | 97,394 | 350,870 | 23,767 | 594,702 |

*See accompanying notes*

**First National Financial Corporation**

## Interim condensed consolidated statements of cash flows

[Unaudited – in thousands of Canadian dollars]

| | Three months ended | | Six months ended | |
|---|---|---|---|---|
| | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| | $ | $ | $ | $ |
| **Operating activities** | | | | |
| Net income for the period | **46,347** | 68,768 | **82,249** | 104,895 |
| Add (deduct) items | | | | |
| Deferred income taxes | **4,750** | 4,100 | **5,520** | 4,400 |
| Non-cash portion of gains on deferred placement fees | **(2,220)** | (2,268) | **(5,557)** | (5,843) |
| Decrease (increase) in restricted cash | **(229,132)** | (69,931) | **(218,234)** | 69,330 |
| Net investment in mortgages pledged under securitization | **(885,805)** | 131,962 | **(1,687,525)** | 95,807 |
| Net increase (decrease) in debt related to securitized mortgages | **1,088,468** | (49,223) | **1,855,027** | (156,043) |
| Provision for loan loss | **—** | 1,000 | **—** | 2,000 |
| Amortization of deferred placement fees receivable | **2,702** | 2,783 | **5,379** | 5,612 |
| Amortization of property, plant and equipment | **1,305** | 1,192 | **2,610** | 2,384 |
| Amortization of purchased mortgage service rights | **—** | 418 | **—** | 664 |
| Unrealized gains on financial instruments | **(1,072)** | (27,131) | **(13,738)** | (17,245) |
| | **25,343** | 61,670 | **25,731** | 105,961 |
| Net change in non-cash working capital balances related to operations | **(701,588)** | (494,534) | **(679,166)** | (294,544) |
| **Cash used in operating activities** | **(676,245)** | (432,864) | **(653,435)** | (188,583) |
| **Investing activities** | | | | |
| Additions to property, plant and equipment | **(1,208)** | (687) | **(2,039)** | (3,110) |
| Investment in cash held as collateral for securitization | **(11,731)** | (1,850) | **(15,536)** | (777) |
| Investment in mortgage and loan investments | **(225,213)** | (155,111) | **(363,432)** | (254,988) |
| Repayment of mortgage and loan investments | **284,204** | 100,840 | **408,642** | 132,440 |
| **Cash provided by (used in) investing activities** | **46,052** | (56,808) | **27,635** | (126,435) |
| **Financing activities** | | | | |
| Dividends paid | **(28,440)** | (28,843) | **(56,876)** | (55,464) |
| Obligations related to securities and mortgages sold under repurchase agreements | **418,530** | 312,123 | **259,944** | 232,582 |
| Decrease in debt related to participation mortgages | **(8)** | (7,838) | **(17)** | (2,986) |
| Securities purchased under resale agreements and owned, net | **(178,247)** | (416,028) | **(464,373)** | (193,614) |
| Securities sold under repurchase agreements and sold short, net | **168,397** | 421,952 | **480,832** | 187,839 |
| Redemption by non-controlling interests | **—** | (4,210) | **—** | (4,260) |
| **Cash provided by financing activities** | **380,232** | 277,156 | **219,510** | 164,097 |
| **Net increase in bank indebtedness during the period** | **(249,961)** | (212,516) | **(406,290)** | (150,921) |
| Bank indebtedness, beginning of period | **(800,157)** | (566,927) | **(643,828)** | (628,522) |
| **Bank indebtedness, end of period** | **(1,050,118)** | (779,443) | **(1,050,118)** | (779,443) |
| **Supplemental cash flow information** | | | | |
| Interest received | **229,228** | 192,574 | **447,487** | 385,098 |
| Interest paid | **132,011** | 121,611 | **279,068** | 248,896 |
| Income taxes paid | **16,523** | 15,875 | **40,043** | 53,750 |

*See accompanying notes*

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

## 1. General organization and business of First National Financial Corporation

First National Financial Corporation [the "Corporation" or "Company"] is the parent company of First National Financial LP ["FNFLP"], a Canadian-based originator, underwriter and servicer of predominantly prime single-family, multi-residential and commercial mortgages. With over $103 billion in mortgages under administration as at June 30, 2018, FNFLP is an originator and underwriter of mortgages and a significant participant in the mortgage broker distribution channel.

The Corporation is incorporated under the laws of the Province of Ontario, Canada and has its registered office and principal place of business located at 100 University Avenue, Toronto, Ontario. The Corporation's common and preferred shares are listed on the Toronto Stock Exchange under the symbols FN, FN.PR.A and FN.PR.B, respectively.

## 2. Significant accounting policies

### Basis of preparation

The interim condensed consolidated financial statements have been prepared in accordance with IAS 34 – *Interim Financial Reporting* under International Financial Reporting Standards, as issued by the International Accounting Standards Board. Except as indicated below, the interim condensed consolidated financial statements have been prepared using the same accounting policies used in the preparation of the audited annual consolidated financial statements for the year ended December 31, 2017.

These interim condensed consolidated financial statements should be read in conjunction with the audited annual consolidated financial statements and are presented in Canadian dollars with all values rounded to the nearest thousand, except when otherwise indicated. The interim condensed consolidated financial statements were authorized for issue by the Board of Directors on July 24, 2018.

### Changes in accounting policies

IFRS 9 – *Financial Instruments*

On January 1, 2018, the Company adopted IFRS 9 – *Financial Instruments* ["IFRS 9"]. As permitted by the transition provisions of IFRS 9, the Company elected not to restate comparative period results. All comparative period information is presented in accordance with the accounting policies as described in the annual consolidated financial statements for the year ended December 31, 2017.

*Classification and measurement of financial assets*

IFRS 9 requires that all financial assets are measured at either fair value through profit or loss ["FVTPL"], fair value through OCI ["FVOCI"], or amortized cost.

The Company originates and underwrites single-family residential mortgages and multi-unit residential commercial mortgages. Subsequent to origination, the mortgages are either placed with third party investors [mortgages accumulated for sale] or securitized through various securitization vehicles [mortgages accumulated for securitization]. When mortgages are securitized, typically they do not meet de-recognition criteria, and continue to be held on the Company's balance sheet. The Company moves these mortgages to mortgages

pledged under securitization on the balance sheet and continues to classify the mortgages at amortized cost, earning "Interest revenue – securitized mortgages" over their term to maturity.

The Company also invests in commercial bridge mortgages and other miscellaneous loans using its own internal funding sources. These assets are classified as FVTPL and are presented as mortgage and loan investments on its balance sheet.

Based on its business models as described above, the Company has determined the classification of its financial assets as below:

| | IAS 39 | IFRS 9 |
|---|---|---|
| Mortgages accumulated for securitization | Loans and Receivables | Amortized Cost |
| Mortgages accumulated for sale | FVTPL | FVTPL |
| Mortgages pledged under securitization | FVTPL or Loan and Receivables | Amortized Cost |
| Mortgage and loan investments | Loans and Receivable | FVTPL |
| Deferred placement fees receivable | FVTPL | Amortized Cost |

As at December 31, 2017, the difference resulting from the change in accounting classification of the assets was insignificant; accordingly, no adjustment to opening retained earnings was recorded.

*Classifications and measurement of financial liabilities*

The Company classifies its financial liabilities as either amortized cost or at FVTPL as summarized below:

| | IAS 39 | IFRS 9 |
|---|---|---|
| Securities sold short | FVTPL | FVTPL |
| Debt related to securitized mortgages | Amortized Cost | Amortized Cost |
| Servicing liabilities | Amortized Cost | Amortized Cost |
| Senior unsecured notes | Amortized Cost | Amortized Cost |

*Impairment*

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

The Company assesses the credit risk of the mortgages based on the expected repayments of principal and interest. All mortgages with arrears that are less than 30 days past due are included in Stage 1 whereas mortgages with principal in arrears between 31 to 90 days are included in Stage 2. Mortgages in these two

stages are not considered to be impaired, and the Company recognizes a 12-month ECL for Stage 1 mortgages and a lifetime ECL for Stage 2 mortgages. When a mortgage is in arrears for over 90 days or has a legal demand for repayment, there is an expectation of a detrimental impact on the estimated cash flows and therefore the Company considers the mortgages as impaired and includes in Stage 3.

The Company's ECL model is built on an unbiased and probability-weighted method, determined by evaluating a range of possible outcomes and discounted to reflect the time value of money. The key inputs in the measurement of ECL include Probability of Default, Loss Given Default and forecast of future economic conditions which involves significant judgment.

*Hedge Accounting*

On January 1, 2018, the Company adopted hedge accounting within IFRS 9 for certain mortgage commitments and funded mortgages. Hedge accounting is applied prospectively.

The Company uses a combination of short Government of Canada bonds and bond repo agreements to manage exposure to interest rate risk. The Company documents a hedging relationship between the hedging instrument and the hedged item at inception when the relationship is established. The Company also assesses the effectiveness of the hedges at both the hedge inception and on an ongoing basis. Any ineffectiveness of any hedging relationship is recognized immediately in the interim condensed consolidated statements of income.

*Cash flow hedges*

The Company applies cash flow hedge accounting for the anticipated funding of its multi-unit residential commercial segment mortgages. At the time of mortgage commitment, the Company shorts Government of Canada bonds as the hedging instrument to hedge the cash flows on the anticipated future debt to be arranged through securitization on these mortgages obtained through the Canada Mortgage Bond Program ["CMB"] disclosed as debt related to securitized mortgages. The effective portion of the change in the fair value of the designated hedging instrument qualifying as a cash flow hedge is recognized in other comprehensive income ["OCI"] in the interim condensed consolidated statements of comprehensive income. When the hedge relationship is terminated, the cumulative amounts recognized in OCI are amortized into interest expense – securitized mortgages over the term of the securitized debt. Any change in fair value of the hedge determined as ineffective is recognized immediately in regular income.

*Fair value hedges*

The Company enters into interest rate swaps to protect against changes in the fair value of fixed rate mortgages funded by Asset-backed Commercial Paper ["ABCP"] debt. The Company also shorts Government of Canada bonds to manage interest rate exposure for a portion of single-family mortgage commitments and funded residential mortgages accumulated for securitization. The Company applies hedge accounting for the swaps. For the short bond hedges, the Company documents a hedging relationship during the period when the mortgages are funded until the date they are securitized or placed with an arm's length investor. The Company does not apply hedge accounting to the short bonds used to mitigate interest risk on single-family mortgage commitments.

In the case of the swaps and short bonds used to hedge funded mortgages, changes in fair value of the hedged item, to the extent that the hedging relationship is effective, are offset by changes in the fair value of the hedging

instrument, both of which are recognized in regular income. At hedge unwind, the realized change in the value of the hedging instrument is adjusted to the carrying value of the hedged mortgages, and amortized into interest revenue over the term of the hedged mortgages. Any changes in the fair value of an ineffective hedge will be immediately recorded in regular income.

IFRS 15 – *Revenue from Contracts with Customers*

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

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

## 3. Mortgages pledged under securitization

The Company securitizes residential and commercial mortgages in order to raise debt to fund these mortgages. Most of these securitizations consist of the transfer of fixed and floating rate mortgages into securitization programs, such as ABCP, NHA-MBS, and CMB programs. In these securitizations, the Company transfers the assets to structured entities for cash, and incurs interest-bearing obligations typically matched to the term of the mortgages. These securitizations do not qualify for derecognition, although the structured entities and other securitization vehicles have no recourse to the Company's other assets for failure of the mortgages to make payments when due.

As part of the ABCP transactions, the Company provides cash collateral for credit enhancement purposes as required by the rating agencies. Credit exposure to securitized mortgages is generally limited to this cash collateral. The principal and interest payments on the securitized mortgages are paid to the Company by the structured entities monthly over the term of the mortgages. The full amount of the cash collateral is recorded as an asset and the Company anticipates full recovery of these amounts. NHA-MBS securitizations may also require cash collateral in some circumstances. As at June 30, 2018, the cash held as collateral for securitization was $81,949 [December 31, 2017 – $66,413].

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

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

| | June 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | **Carrying amount of securitized mortgages** | **Carrying amount of associated liabilities** | **Carrying amount of securitized mortgages** | **Carrying amount of associated liabilities** |
| | $ | $ | $ | $ |
| Securitized mortgages | **29,095,449** | **29,795,517** | 27,427,239 | 27,914,097 |
| Capitalized origination costs | **158,753** | **—** | 139,438 | — |
| Debt discounts | — | **(106,733)** | — | (80,340) |
| | **29,254,202** | **29,688,784** | 27,566,677 | 27,833,757 |
| **Add** | | | | |
| Principal portion of payments held in restricted cash | **729,311** | **—** | 514,793 | — |
| Participation debt | **—** | **306** | — | 323 |
| | **29,983,513** | **29,689,090** | 28,081,470 | 27,834,080 |

The principal portion of payments held in restricted cash represents payments on account of mortgages pledged under securitization which have been received at period end but have not been applied to reduce the associated debt. This cash is applied to pay down the debt in the month subsequent to period end. In order to compare the components of mortgages pledged under securitization to securitization debt, this amount is added to the carrying value of mortgages pledged under securitization in the above table.

Mortgages pledged under securitization have been classified as amortized cost and are carried at par plus adjustment for unamortized origination costs.

The changes in capitalized origination costs for the three months ended June 30 are as follows:

| | **2018** | **2017** |
|---|---|---|
| | $ | $ |
| **Opening balance, March 31** | **145,560** | 139,826 |
| Add: new origination costs capitalized in the period | **31,277** | 8,277 |
| Less: amortization in the period | **(18,084)** | (17,396) |
| **Ending balance, June 30** | **158,753** | 130,707 |

# Notes to interim condensed consolidated financial statements

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



The following table summarizes the mortgages pledged under securitization that are past due:

| | **June 30, 2018** $ | **December 31, 2017** $ |
|---|---|---|
| **Arrears days** | | |
| 31 to 60 | **10,319** | 35,652 |
| 61 to 90 | **8,836** | 5,841 |
| Greater than 90 | **26,083** | 28,707 |
| | **45,238** | 70,200 |

All the mortgages listed above are insured, except for three mortgages which are uninsured and have a principal balance of $892 as at June 30, 2018 [December 31, 2017 – $289]. Within mortgages pledged under securitization, the Company's exposure to credit loss is limited to uninsured mortgages with principal balances totaling $1,227,898 [December 31, 2017 – $1,106,796], before consideration of the value of underlying collateral. All such mortgages are conventional prime single-family mortgages, with an 80% or less loan to value at origination, and verified borrower income. Accordingly, the expected credit loss related to these mortgages is insignificant.

**Allowance for expected credit losses**

The following table illustrates the movement in ECL changes related to mortgages pledged under securitization:

| | **Stage 1** $ | **Stage 2** $ | **Stage 3** $ | **Total** $ |
|---|---|---|---|---|
| **Balance as at March 31, 2018** | — | — | 116 | 116 |
| ECL transfers from Stage 2 to Stage 3 | — | — | — | — |
| **Balance as at June 30, 2018** | — | — | **116** | **116** |

## 4. Deferred placement fees receivable

The Company enters into transactions with institutional investors to sell primarily fixed rate mortgages in which placement fees are received over time as well as at the time of the mortgage placement. These mortgages are derecognized when substantially all of the risks and rewards of ownership are transferred and the Company has minimal exposure to the variability of future cash flows from these mortgages. The investors have no recourse to the Company's other assets for failure of mortgagors to make payments when due.

During the three months ended June 30, 2018, $575,160 [2017 – $487,177] of mortgages were placed with institutional investors which created gains on deferred placement fees of $2,384 [2017 – $2,448]. Cash receipts on deferred placement fees receivable for the three months ended June 30, 2018 were $3,201 [2017 – $3,213].

Deferred placement fees receivable is classified as amortized cost, and has been calculated initially based on the present value of the anticipated future stream of placement fees. An assumption of no credit losses was used, commensurate with the credit quality of the investors. An assumption of no prepayment for the commercial segment was used, as borrowers cannot refinance for financial advantage without paying the Company a fee commensurate with its investment in the mortgage. The effect of variations between actual experience and assumptions will be recorded in future statements of income.

## 5. Mortgages accumulated for sale or securitization

Mortgages accumulated for sale or securitization consist of mortgages the Company has originated for its own securitization programs together with mortgages funded in advance of settlement with institutional investors.

Mortgages originated for the Company's own securitization programs are classified as amortized cost and are recorded at par plus adjustment for unamortized origination costs. Mortgages funded for placement with institutional investors are designated as FVTPL and are recorded at fair value. The fair values of mortgages classified as FVTPL approximate their carrying values as the time period between origination and sale is short. The following table summarizes the components of mortgages according to their classification:

| | **June 30, 2018** | **December 31, 2017** |
|---|---|---|
| | $ | $ |
| Mortgages accumulated for securitization | **2,452,963** | 1,770,275 |
| Mortgages accumulated for sale | **2,833** | 19,490 |
| | **2,455,796** | 1,789,765 |

The Company's exposure to credit loss is limited to $599,638 [December 31, 2017 – $569,571] of principal balances of uninsured mortgages within mortgages accumulated for sale or securitization, before consideration of the value of underlying collateral. These are conventional prime single-family mortgages similar to the mortgages described in note 3. Accordingly the expected credit loss related to these mortgages is insignificant.

## 6. Mortgage and loan investments

Mortgage and loan investments consist primarily of commercial first and second mortgages held for various terms, the majority of which mature within one year.

The portfolio contains $9,767 [December 31, 2017 – $15,145] of insured mortgages and $322,736 [December 31, 2017 – $364,568] of uninsured mortgage and loan investments as at June 30, 2018. Of the uninsured mortgages, approximately $50,892 [December 31, 2017 – $49,693] have principal balance in arrears. Three of these mortgages are non-performing and the Company has stopped interest on accrual. These mortgages had a total original principal balance of $50,035 and are recorded at fair value of $35,562 as at June 30, 2018 [December 31, 2017 – four mortgages, original principal balance of $48,600, and fair value of $32,001].

Mortgage and loan investments are classified as FVTPL and are recorded on a fair value basis. Any changes in fair value are immediately recognized in income. The Company recorded a fair value loss of $1,000 for the

quarter ended June 30, 2018. The mortgages were classified as loans and receivables prior to the interim condensed adoption of IFRS 9, and a $1,000 credit loss was recorded as an offset to mortgage investment income on the consolidated statement of income for the quarter ended June 30, 2017.

### 7. Mortgages under administration

As at June 30, 2018, the Company managed mortgages under administration of $103,574,915 [December 31, 2017 – $101,589,153], including mortgages held on the Company's interim condensed consolidated statements of financial position. Mortgages under administration are serviced for financial institutions such as banks, insurance companies, pension funds, mutual funds, trust companies, credit unions and securitization vehicles. As at June 30, 2018, the Company administered 303,647 mortgages [December 31, 2017 – 301,492] for 108 institutional investors [December 31, 2017 – 103] with an average remaining term to maturity of 40 months [December 31, 2017 – 41 months].

Mortgages under administration are serviced as follows:

| | **June 30, 2018** | **December 31, 2017** |
|---|---|---|
| | $ | $ |
| Institutional investors | **58,475,673** | 59,601,263 |
| Mortgages accumulated for sale or securitization and mortgage and loan investments | **2,795,131** | 2,190,393 |
| Deferred placement investors | **12,034,047** | 11,125,228 |
| Mortgages pledged under securitization | **29,095,449** | 27,427,239 |
| CMBS conduits | **1,174,615** | 1,245,030 |
| | **103,574,915** | 101,589,153 |

The Company's exposure to credit loss is limited to mortgage and loan investments as described in note 6, securitized mortgages as described in note 3 and uninsured mortgages held in mortgages accumulated for securitization as described in note 5. As at June 30, 2018, the Company has included in accounts receivable and sundry $17,121 [December 31, 2017 – $17,799] of uninsured non-performing mortgages.

The Company maintains trust accounts on behalf of the investors it represents. The Company also holds municipal tax funds in escrow for mortgagors. Since the Company does not hold a beneficial interest in these funds, they are not presented on the interim condensed consolidated statements of financial position. The aggregate of these accounts as at June 30, 2018 was $783,185 [December 31, 2017 – $670,259].

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

## 8. Bank indebtedness

Bank indebtedness includes a revolving credit facility of $1,250,000 [December 31, 2017 – $1,060,000] maturing in March 2023. At June 30, 2018, $1,050,118 [December 31, 2017 – $643,828] was drawn against which the following have been pledged as collateral:

[a] a general security agreement over all assets, other than real property, of the Company; and

[b] a general assignment of all mortgages owned by the Company.

The credit facility bears a variable rate of interest based on prime and bankers' acceptance rates.

## 9. Debt related to securitized and participation mortgages

Debt related to securitized mortgages represents the funding for mortgages pledged under the NHA-MBS, CMB and ABCP programs. As at June 30, 2018, debt related to securitized mortgages was $29,688,785 [December 31, 2017 – $27,833,757], net of unamortized discounts of $106,604 [December 31, 2017 – $80,340]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

As at June 30, 2018, debt related to participation mortgages was $305 [December 31, 2017 – $323].

Debt related to securitized and participation mortgages is reduced on a monthly basis when the principal payments received from the mortgages are applied. Debt discounts and premiums are amortized over the term of each debt on an effective yield basis. Debt related to securitization mortgages had a similar contractual maturity profile as the associated mortgages in mortgages pledged under securitization.

## 10. Shareholders' equity

### [a] Authorized

Unlimited number of common shares
Unlimited number of cumulative 5-year rate reset preferred shares, Class A Series 1
Unlimited number of cumulative 5-year rate reset preferred shares, Class A Series 2

### [b] Capital stock activities

| | Common shares | | Preferred shares | |
|---|---|---|---|---|
| | # | $ | # | $ |
| Balance, December 31, 2017 and June 30, 2018 | **59,967,429** | **122,671** | **4,000,000** | **97,394** |

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

**[c] Earnings per share**

| | Three months ended | | Six months ended | |
|---|---|---|---|---|
| | **June 30, 2018** | **June 30, 2017** | **June 30, 2018** | **June 30, 2017** |
| | $ | $ | $ | $ |
| Net income attributable to shareholders | **46,347** | 68,320 | **82,249** | 103,930 |
| Less: dividends declared on preferred shares | **(729)** | (680) | **(1,434)** | (1,360) |
| Net earnings attributable to common shareholders | **45,618** | 67,640 | **80,815** | 102,570 |
| Number of common shares outstanding | **59,967,429** | 59,967,429 | **59,967,429** | 59,967,429 |
| Basic earnings per common share | **0.76** | 1.13 | **1.35** | 1.71 |

Basic earnings per common share for the three months ended June 630, 2018 is calculated on earnings that are affected by the adoption of hedge accounting under IFRS 9 on January 1, 2018. Hedge accounting is applied prospectively.

## 11. Financial instruments and risk management

**Fair value measurement**

The Company uses the following hierarchy for determining and disclosing the fair value of financial instruments recorded at fair value in the interim condensed consolidated statements of financial position:

Level 1 quoted market price observed in active markets for identical instruments;
Level 2 quoted market price observed in active markets for similar instruments or other valuation techniques for which all significant inputs are based on observable market data; and
Level 3 valuation techniques in which one or more significant inputs are unobservable.

**Valuation methods and assumptions**

The Company uses valuation techniques to estimate fair values, including reference to third-party valuation service providers using proprietary pricing models and internal valuation models such as discounted cash flow analysis. The valuation methods and key assumptions used in determining fair values for the financial assets and financial liabilities are as follows:

[a] Mortgage and loan investments

The fair value of mortgage and loan investments is determined by either projected cash flows using market industry pricing practices or external or internal appraised value, where applicable.

[b] Securities sold short

The fair values of securities sold short used by the Company to hedge its interest rate exposure are determined by quoted prices.

[c] Servicing liabilities and deferred placement fees receivables

The fair values of the servicing liability and deferred placement fees receivable are determined by internal valuation models using market data inputs, where possible. The fair values are determined by discounting the expected future cost related to the servicing or deferred placement fees of explicit mortgages at market interest rates. The expected future cash flows are estimated based on certain assumptions which are not supported by observable market data.

[d] Mortgages pledged under securitization

The fair value of mortgages pledged under securitization is determined by discounting projected cash flows using market industry pricing practices. Discount rates used are determined by comparison to similar term loans made to borrowers with similar credit. This methodology will reflect changes in interest rates which have occurred since the mortgages were originated. Impaired mortgages are recorded at net realizable value.

[e] Other financial assets and financial liabilities

The fair values of mortgages accumulated for sale or securitization, cash held as collateral for securitization, restricted cash and bank indebtedness correspond to the respective outstanding amounts due to their short-term maturity profiles.

**Carrying value and fair value of selected financial instruments**

The fair value of the financial assets and financial liabilities of the Company approximates its carrying value, except for mortgages pledged under securitization, which has a carrying value of $29,254,202 [December 31, 2017 – $27,566,677] and a fair value of $29,701,998 [December 31, 2017 – $27,557,542], debt related to securitized and participation mortgages, which has a carrying value of $29,689,090 [December 31, 2017 – $27,834,080] and a fair value of $29,456,331 [December 31, 2017 – $27,748,498], and senior unsecured notes, which have a carrying value of $174,761 [December 31, 2017 – $174,693] and a fair value of $176,152 [December 31, 2017 – $176,372]. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3].

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

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

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | $ | $ | $ | $ |
| **Financial assets** | | | | |
| Mortgages accumulated for sale | — | **2,833** | — | **2,833** |
| Mortgage and loan investments | — | — | **332,503** | **332,503** |
| Interest rate swaps | — | **62,100** | — | **62,100** |
| **Total financial assets** | — | **64,933** | **332,503** | **397,436** |
| **Financial liabilities** | | | | |
| Securities sold short | — | **2,641,078** | — | **2,641,078** |
| Interest rate swaps | — | **7,032** | — | **7,032** |
| **Total financial liabilities** | — | **2,648,110** | — | **2,648,110** |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | $ | $ | $ | $ |
| **Financial assets** | | | | |
| Mortgages accumulated for sale | — | 19,490 | — | 19,490 |
| FVTPL mortgages | — | — | 2,986,097 | 2,986,097 |
| Deferred placement fees receivable | — | — | 41,273 | 41,273 |
| Interest rate swaps | — | 63,689 | — | 63,689 |
| **Total financial assets** | — | 83,179 | 3,027,370 | 3,110,549 |
| **Financial liabilities** | | | | |
| Securities sold short | — | 2,180,253 | — | 2,180,253 |
| Interest rate swaps | — | 6,124 | — | 6,124 |
| **Total financial liabilities** | — | 2,186,377 | — | 2,186,377 |

In estimating the fair value of financial assets and financial liabilities using valuation techniques or pricing models, certain assumptions are used including those that are not fully supported by observable market prices or rates [Level 3]. The amount of the change in fair value recognized by the Company in net income for the three months ended June 30, 2018 that was estimated using a valuation technique based on assumptions that are not fully supported by observable market prices or rates, was a loss of $1,000 [2017 – $11,111]. Although the Company's management believes that the estimated fair values are appropriate as at the date of the interim condensed consolidated statements of financial position, those fair values may differ if other reasonably possible alternative assumptions are used.

Transfers between levels in the fair value hierarchy are deemed to have occurred at the beginning of the period in which the transfer is made. Transfers between levels can occur as a result of additional or new information regarding valuation inputs and changes in their observability. During the quarter, there were no transfers between levels.

The following table presents changes in the fair values including realized gains of $12,781 [2017 – loss of $1,135] of the Company's financial assets and financial liabilities for the three months ended June 30, 2018 and 2017, all of which have been classified as FVTPL:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2018** | **2017** | **2018** | **2017** |
| | $ | $ | $ | $ |
| FVTPL mortgages | **(1,000)** | (11,111) | **(2,000)** | (6,327) |
| Securities sold short | **8,614** | 19,635 | **9,390** | 16,169 |
| Interest rate swaps | **(340)** | 17,471 | **(907)** | 13,418 |
| | **7,274** | 25,995 | **6,483** | 23,260 |

The above table excludes the unrealized fair value loss on the mortgage loan and investments, which has been included in the mortgage investment income on the interim condensed consolidated statements of income. The mortgages classified as FVTPL in 2017 have now been classified as amortized cost with the transition to IFRS 9. Accordingly, there is no gain or loss reported in the table above.

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

The following tables show the movement in Level 3 financial instruments in the fair value hierarchy for the three months ended June 30, 2018 and 2017, including changes due to reclassification following the adoption of IFRS 9. The Company classifies financial instruments as Level 3 when there is reliance on at least one significant unobservable input in the valuation models.

| | **Fair value as at March 31, 2018** | **Investments** | **Unrealized losses recorded in income** | **Payment and amortization** | **Fair value as at June 30, 2018** |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| **Financial assets** | | | | | |
| Mortgage and loan investments | **392,494** | **107,162** | **(1,000)** | **(166,153)** | **332,503** |

# Notes to interim condensed consolidated financial statements

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



| | Fair value as at March 31, 2017 | Investments | Unrealized gains recorded in income | Payment and amortization | Fair value as at June 30, 2017 |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| **Financial assets** | | | | | |
| FVTPL mortgages | 2,571,030 | 450,379 | (11,111) | (390,735) | 2,619,563 |
| Deferred placement fees receivable | 44,679 | 2,268 | — | (2,783) | 44,164 |
| Mortgage and loan investments | 42,219 | 4,350 | — | (9,859) | 36,710 |
| | 2,657,928 | 456,997 | (11,111) | (403,377) | 2,700,437 |

## 12. Capital management

The Company's objective is to maintain a strong capital base so as to maintain investor, creditor and market confidence and sustain future development of the business. Management defines capital as the Company's equity, long-term debt and retained earnings. The Company has a minimum capital requirement as stipulated by its bank credit facility. The agreement limits the debt under bank indebtedness together with the unsecured notes to four times FNFLP's equity. As at June 30, 2018, the ratio was 2.00:1 [December 31, 2017 – 1.39:1]. The Company was in compliance with the bank covenant throughout the period.

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

## 13. Earnings by business segment

The Company operates principally in two business segments, Residential and Commercial. These segments are organized by mortgage type and contain revenue and expenses related to origination, underwriting, securitization and servicing activities. Identifiable assets are those used in the operations of the segments.

| | Three months ended June 30, 2018 | | | Six months ended June 30, 2018 | | |
|---|---|---|---|---|---|---|
| | Residential | Commercial | Total | Residential | Commercial | Total |
| | $ | $ | $ | $ | $ | $ |
| **Revenue** | | | | | | |
| Interest revenue – securitized mortgages | **146,086** | **44,855** | **190,941** | **286,860** | **87,551** | **374,411** |
| Interest expense – securitized mortgages | **(118,342)** | **(37,120)** | **(155,462)** | **(228,058)** | **(72,540)** | **(300,598)** |
| Net interest – securitized mortgages | **27,744** | **7,735** | **35,479** | **58,802** | **15,011** | **73,813** |
| Placement and servicing | **55,125** | **15,350** | **70,475** | **94,962** | **29,595** | **124,557** |
| Mortgage investment income | **15,472** | **6,773** | **22,245** | **27,685** | **14,500** | **42,185** |
| Realized and unrealized gains (losses) on financial instruments | **8,272** | **(998)** | **7,274** | **8,494** | **(2,011)** | **6,483** |
| | **106,613** | **28,860** | **135,473** | **189,943** | **57,095** | **247,038** |
| **Expenses** | | | | | | |
| Amortization | **1,100** | **205** | **1,305** | **2,201** | **409** | **2,610** |
| Interest | **13,240** | **3,736** | **16,976** | **23,046** | **8,124** | **31,170** |
| Other operating | **44,873** | **9,302** | **54,175** | **81,742** | **19,227** | **100,969** |
| | **59,213** | **13,243** | **72,456** | **106,989** | **27,760** | **134,749** |
| **Income before income taxes** | **47,400** | **15,617** | **63,017** | **82,954** | **29,335** | **112,289** |
| Identifiable assets | **28,512,260** | **7,252,030** | **35,764,290** | **28,512,260** | **7,252,030** | **35,764,290** |
| Goodwill | **—** | **—** | **29,776** | **—** | **—** | **29,776** |
| **Total assets** | **28,512,260** | **7,252,030** | **35,794,066** | **28,512,260** | **7,252,030** | **35,794,066** |
| **Capital expenditures** | **845** | **363** | **1,208** | **1,427** | **612** | **2,039** |

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

| | Three months ended June 30, 2017 | | | Six months ended June 30, 2017 | | |
|---|---|---|---|---|---|---|
| | Residential | Commercial | Total | Residential | Commercial | Total |
| | $ | $ | $ | $ | $ | $ |
| **Revenue** | | | | | | |
| Interest revenue – securitized mortgages | 120,989 | 37,955 | 158,944 | 243,885 | 75,703 | 319,588 |
| Interest expense – securitized mortgages | (92,905) | (31,624) | (124,529) | (185,574) | (62,422) | (247,996) |
| Net interest – securitized mortgages | 28,084 | 6,331 | 34,415 | 58,311 | 13,281 | 71,592 |
| Placement and servicing | 76,382 | 14,692 | 91,074 | 122,814 | 28,720 | 151,534 |
| Mortgage investment income | 10,444 | 5,743 | 16,187 | 20,284 | 9,772 | 30,056 |
| Realized and unrealized gains on financial instruments | 20,284 | 5,711 | 25,995 | 17,046 | 6,214 | 23,260 |
| | 135,194 | 32,477 | 167,671 | 218,455 | 57,987 | 276,442 |
| **Expenses** | | | | | | |
| Amortization | 998 | 194 | 1,192 | 1,997 | 387 | 2,384 |
| Interest | 8,034 | 1,759 | 9,793 | 16,250 | 3,117 | 19,367 |
| Other operating | 52,714 | 10,894 | 63,608 | 92,909 | 19,547 | 112,456 |
| | 61,746 | 12,847 | 74,593 | 111,156 | 23,051 | 134,207 |
| **Income before income taxes** | 73,448 | 19,630 | 93,078 | 107,299 | 34,936 | 142,235 |
| Identifiable assets | 24,881,179 | 5,921,928 | 30,803,107 | 24,881,179 | 5,921,928 | 30,803,107 |
| Goodwill | — | — | 29,776 | — | — | 29,776 |
| **Total assets** | 24,881,179 | 5,921,928 | 30,832,883 | 24,881,179 | 5,921,928 | 30,832,883 |
| **Capital expenditures** | 481 | 206 | 687 | 2,177 | 933 | 3,110 |

# Notes to interim condensed consolidated financial statements

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

June 30, 2018

## 14. Related party and other transactions

The Company has servicing contracts in connection with several originated commercial mezzanine mortgages subsequently sold to various entities controlled by a senior executive and shareholder of the Company. The Company services these mortgages during their terms at market commercial servicing rates. During the quarter, the Company originated $74,696 of new mortgages for the related parties. The related parties also funded several progress draws totaling $5,556 on existing mortgages originated by the Company. All such mortgages, which are administered by the Company, have a balance of $143,895 as at June 30, 2018 [December 31, 2017 – $61,034]. As at June 30, 2018, three of the mortgages are secured by real estate in which the Company is also a subordinate mortgage lender.

A senior executive and shareholder of the Company has a significant investment in a mortgage default insurance company. In the ordinary course of business, the insurance company provides insurance policies to the Company's borrowers at market rates. In addition, the insurance company has also provided the Company with portfolio insurance at market premiums. The total bulk insurance premium paid by the Company during the three months ended June 30, 2018 was $437 [2017 – $224], net of third-party investor reimbursement. The insurance company has also engaged the Company to service a portfolio of mortgages at market servicing rates. As at June 30, 2018, the portfolio's balance was $3,747 [December 31, 2017 – $3,822].

## 15. Comparative unaudited interim condensed consolidated financial statements

The comparative unaudited interim condensed consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2018 unaudited interim condensed consolidated financial statements.

# First National Financial Corporation

## Shareholder Information

**Corporate Office**
100 University Avenue
North Tower, Suite 700
Toronto, Ontario
M5J 1V6
Phone: 416-593-1100
Fax: 416-593-1900

**Transfer Agent and Registrar**
Computershare Investor Services Inc.
Toronto, Ontario
Phone: 1-800-564-6253

**Auditors**
Ernst & Young LLP
100 Adelaide Street West
Toronto, Ontario
M5H 0B3

**TSX Symbols**
FN, FN.PR.A, FN.PR.B

**Investor Relations**

Rob Inglis
Chief Financial Officer
First National Financial LP
Tel: 416-593-1100
Email: rob.inglis@firstnational.ca

Ernie Stapleton
President
Fundamental Creative Inc.
Tel: 905.648.9354
Email: ernie@fundamental.ca