

FIRST NATIONAL

FINANCIAL CORPORATION



Report to Shareholders

Period Ended September 30, 2017

FIRST NATIONAL

FINANCIAL CORPORATION



Fellow Shareholders:

During the three months ended September 30, 2017, First National surpassed \$100 billion in Mortgages Under Administration (“MUA”), reflecting our Company’s prominence as a leading provider of mortgage capital, expertise and service to Canada’s single family and commercial real estate markets. We are proud of our team for reaching this milestone, and doing so profitably, particularly in a period where new mortgage insurance rules and rising interest rates rapidly changed our marketplace.

These new dynamics had the largest impact on our single-family lending business, as evidenced by a 12% reduction in third quarter originations, and will continue to mute growth in the coming quarters. As the market digests these and other rule changes on the horizon, it will be First National’s scope and scale, strategic alignment with the mortgage broker community, market diversification and disciplined method of capital allocation that will act as the catalysts for our performance for the remainder of this year and into 2018.

The performance highlights for the quarter compared to the same period last year were as follows: MUA increased 2% to \$100.2 billion from \$98.6 billion at September 30, 2016; total new mortgage originations increased 2% to \$4.9 billion from \$4.8 billion as the 12% decline in single family was more than offset by a 47% increase in commercial originations; revenue increased 4% to \$284.3 million from \$273.8 million; net income increased 14% to \$58.8 million (\$0.96 per common share) compared to \$51.4 million (\$0.84 per common share); and, Pre-FMV EBITDA, a non-IFRS measure, declined 23% to \$51.8 million compared to \$67.5 million.

The Company’s Board of Directors announced a special common share dividend in the amount of \$1.25 per share, payable on December 15, 2017 to shareholders of record on November 30, 2017. This payment reflects the Board’s determination that the Company has generated excess capital in the past several years and that the capital needed for near-term growth can be generated from current operations. This will be in addition to our regular monthly common share dividend payments which are currently \$1.85 per share on an annualized basis.

Looking ahead and in the face of the challenges presented by a changing marketplace, the Company will continue to generate income and cash flow from its \$26 billion portfolio of mortgages pledged under securitization and \$74 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.

Yours sincerely,

Stephen Smith
Chairman and Chief Executive Officer

Moray Tawse
Executive Vice President

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of October 24, 2017. This discussion should be read in conjunction with the unaudited condensed consolidated financial statements and accompanying notes of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the three months (the "period") ended September 30, 2017. 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 \$100 billion in mortgages under administration ("MUA"), First National is Canada's largest non-bank originator and underwriter of mortgages and is among the top three in market share in the mortgage broker distribution channel.

First National consolidates its interest in First National Mortgage Investment Fund (the "Fund"). Although the Company only owns about 23% of the units issued by the Fund, because of its status as sole seller to the Fund and its rights as promoter, the application of IFRS suggests that First National exercises control over the Fund. The Fund was created to obtain economic exposure to a diversified portfolio of primarily commercial mezzanine mortgages. Through the Fund's consolidation, the Company has effectively taken on a portfolio of about \$32 million (December 31, 2016 - \$42 million) of mortgages. Because of the Company's small proportionate interest in the Fund's units, it has also recorded a \$24 million (December 31, 2016 - \$28 million) non-controlling interest in equity which offsets these assets.

Third Quarter 2017 Results Summary

Management is pleased with the results for the third quarter of 2017. Despite a decline in new single family origination as a result of the new mortgage insurance rules announced in late 2016, overall origination including renewals increased 12%. As described in the previous quarter's MD&A, the large gains on account of financial instruments recorded in the second quarter would negatively impact the income in future periods. Because the Company elected to place \$770 million of mortgages originally funded for its own securitization program with institutional investors in the 2017 third quarter, placement fees and earnings in that quarter were both negatively affected by about \$14.4 million.

- MUA grew to \$100.2 billion at September 30, 2017 from \$98.6 billion at September 30, 2016, an increase of 2%; the growth from June 30, 2017, when MUA was \$99.5 billion, represented an annualized increase of 3%. The sequential increase is the result of higher origination in the seasonally strong third quarter offset by the maturity of several CMBS transactions originally included in MUA in 2007. Because of scheduled maturities in this portfolio, CMBS MUA in the commercial segment is down by over \$1.0 billion since the 2016 year end;
- Total new single-family mortgage origination was \$3.2 billion in third quarter 2017 compared to \$3.6 billion in the 2016 comparative quarter, a decrease of 12%. The Company believes this is a result of several regulatory changes including the new mortgage insurance rules announced in October 2016, increases in the cost of portfolio insurance and regional measures such as the foreign buyer tax in southern Ontario. The entire insured mortgage market shrank across the country and First National was affected to some extent in all regions. The commercial segment continued to grow with origination up 47% as volumes increased to \$1.7 billion in the 2017 quarter from \$1.2 billion in 2016. The Company attributes this positive performance to its expanded presence in the conventional market. Overall new origination increased by 2%;
- The Company took advantage of opportunities in the quarter to renew \$1.7 billion of single-family mortgages. In the third quarter of 2016, the Company renewed \$1.3 billion of single family mortgages. For the commercial segment, renewals increased to \$313 million from \$167 million;
- Revenue for the third quarter of 2017 increased to \$284.3 million from \$273.8 million in the 2016 comparative quarter. The increase of 4% is largely attributable to gains on financial instruments which were much larger in the 2017 quarter compared to those in 2016. The change increased revenue by \$25.9 million year over year. Excluding these gains and losses, revenue decreased by 2% as lower volume and the reversal of Q2 gains on financial instruments resulted in lower placement fees;
- Income before income taxes increased from \$69.8 million in third quarter 2016 to \$80.0 million in the 2017 third quarter. This measure increased largely because of changing capital markets conditions, which affected the Company's economic interest rate hedges. In the third quarter of 2017 the Company recorded \$25.9 million additional gains on financial instruments compared to the third quarter of 2016; 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 23%, from \$67.5 million in 2016 to \$51.8 million in 2017. The decrease was the result of lower placement fees revenue negatively affected by capital market conditions. The Company calculates that placement fees were \$14.4 million less than they would have been in a static interest rate environment. Because these transactions were economically hedged in Q2 2017, the lower fees are effectively offset by a \$14.4 million portion of the gains on financial instruments recorded in Q2 2017. Adjusting for this item, Q3 2017 Pre-FMV EBITDA was lower by 2% year over year on tighter mortgage spreads and higher broker fees.

The Company's Board of Directors announced a special common share dividend in the amount of \$1.25 per share, payable on December 15, 2017 to shareholders of record on November 30, 2017. This payment reflects the Board's determination that the Company has generated excess capital in the past several years and that the capital needed for near-term growth can be generated from current operations.

Selected Quarterly Information

Quarterly Results of First National Financial Corporation

(\$000s, except per share amounts)

	Revenue	Net Income for the period	Pre-FMV EBITDA for the period ⁽¹⁾	Net Income per Common Share	Total Assets
2017					
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
Second Quarter	\$253,915	\$41,251	\$68,187	\$0.67	\$31,011,683
First Quarter	\$231,395	\$37,341	\$56,819	\$0.59	\$28,194,301
2015					
Fourth Quarter	\$250,008	\$41,084	\$58,527	\$0.66	\$27,926,732

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

With First National's large portfolio of mortgages pledged under securitization, quarterly revenue is driven primarily by the gross interest earned on the mortgages pledged under securitization. The gross interest on the mortgage portfolio is dependent both on the size of the portfolio of mortgages pledged under securitization as well as weighted average mortgage rates. Although mortgage rates have not changed significantly in the last two years, the Company has generally increased MUA and its portfolio of securitized mortgages over the last 24 months. Net income is partially dependent on conditions in the debt markets, which affect the value of gains and losses on financial instruments arising from the Company's interest rate hedging program. Accordingly, the movement of this measurement between quarters is related to factors external to the Company's core business (primarily conditions in the bond markets). By removing this volatility and analyzing Pre-FMV EBITDA, management believes a more appropriate measurement of the Company's performance can be assessed.

Generally, in the quarters prior to 2017, the Company has grown its origination volumes in order to build its servicing portfolio and to enable it to securitize larger amounts of mortgages in the NHA-MBS market. This longer-term strategy has been successful and Pre-FMV EBITDA has trended upwards. The table above shows a trend of growing income reflecting typical Canadian seasonality: slower first and fourth quarters and stronger mid-year quarters. The fourth quarter of 2015 and the first quarters of 2017 and 2016 did not have significant fair value gains or losses and are more consistent with normalized operations of the Company. The fourth quarter of 2016 and second and third quarters of 2017 featured large fair values gains as bond prices decreased as a result of positive economic expectations. This had a large impact on net income. By excluding fair value gains and losses, Pre-FMV EBITDA for Q3 2017 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 primarily recorded as a gain on holding short bonds in Q2 2017, the amount is more consistent with the Pre-FMV EBITDA recorded in Q3 2016.

Outstanding Securities of the Corporation

At September 30, 2017 and October 24, 2017, the Corporation had 59,967,429 common shares, 2,887,147 Class A preference shares, Series 1, 1,112,853 Class A preference shares, Series 2, and 175,000 April 2020 notes outstanding.

Selected Annual Financial Information and Reconciliation to Pre-FMV EBITDA

(\$000s, except per share amounts)

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

Notes:

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

Vision and Strategy

The Company provides mortgage financing solutions to 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 September 30, 2017, MUA totalled \$100.2 billion, up from \$98.6 billion at September 30, 2016, an increase of 2%. This compares to \$99.5 billion at June 30, 2017, representing an annualized increase of 3% despite the maturity of \$92 million of CMBS mortgages within the third quarter of 2017 which had been in MUA since 2007 and slower single family originations than typical for the third quarter.

Growth in Origination of Mortgages

Direct origination by the Company

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. By growing origination, not only can the Company satisfy demand from its institutional customers, but it can also produce volume for its own securitization programs. In the third quarter of 2017, the Company continued to feel the impact of the new mortgage insurance rules in October 2016. Generally this meant a shrinking availability of insured mortgages particularly because of the limitations on insurance for refinance transactions and the more onerous qualification rules. For the Company this meant lower origination across the country with decreases from volumes in the third quarter of 2016 in its Vancouver (21%), Calgary (11%) and Montreal offices (32%). The Toronto office had better results and was only down 5% from 2016. In total, the Company's single-family origination decreased in the third quarter of 2017 by 12%. The commercial segment continued to show strong growth as volume increased 47% over the third quarter of 2016. Together, overall origination for the third quarter of 2017 increased by 2% year over year.

Third Party Mortgage Underwriting and Fulfillment Processing Services

Early 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.

Raising Capital for Operations

Bank Credit Facility

The Company uses a \$1.06 billion revolving line of credit with a syndicate of banks. This facility enables the Company to fund the large amounts of mortgages accumulated for securitization. In the first quarter of 2017, the Company extended the term of the facility by almost two years such that the new maturity is in March 2022. In the 2017 third quarter, the Company added another bank lender to the syndicate, increasing the commitment under the facility by \$60 million. The facility bears interest at floating rates. The Company has elected to undertake this debt for a number of reasons: (1) the facility provides the amount of debt available to fund mortgages originated for securitization purposes; (2) the debt is revolving and can be used and repaid as the Company requires, providing more flexibility than the senior unsecured notes, which are fully drawn during their term; (3) the 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

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

Employing Securitization Transactions to Minimize Funding Costs

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

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

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

Period	Average five year Mortgage Spread for the Period
2006	1.12%
2007	1.50%
2008	2.68%
2009 - 2013	1.79%
2014	1.57%
2015	1.87%
2016	1.76%
Q1 2017	1.68%
Q2 2017	1.54%
Q3 2017	1.45%

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels. In 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. 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 increased even further and spreads 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 third quarter of 2017, the Company originated and renewed for securitization purposes approximately \$1.9 billion of single-family mortgages and \$0.2 billion of multi-unit residential mortgages. In the quarter, the Company securitized through NHA-MBS approximately \$1.6 billion of single-family mortgages and \$0.2 billion of multi-unit residential mortgages.

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

Canada Mortgage Bonds Program

The CMB program is an initiative sponsored by CMHC whereby the CHT issues securities to investors in the form of semi-annual interest-yielding five- and 10-year bonds. Pursuant to the Company’s approval as a seller into the CMB, the Company is able to make direct sales into the program. The ability to sell into the CMB has given the Company access to lower costs of funds on both single-family and multi-family mortgage securitizations. Because of the effectiveness of the CMB, many institutions have indicated their desire to participate. As a result, CHT has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is subject to these limitations. Beginning in July 2016, CHT effectively increased the price of the timely payment guarantees which CMB participants are required to purchase with the issuance of each CMB transaction. Although nominally CMB fees were decreased, the new rules require guarantee fees to be levied on the creation of NHA MBS

pools being sold to the CMB. Prior to this rule change, the NHA MBS pools to be sold into the CMB were exempt from such fees. In aggregate, guarantee fees have increased between 25 and 50% for CMB participants. This increase translates to approximately 5 basis points of cost over the term of the securitization. At the same time, CMHC has also modified the tiered NHA MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees from \$6.0 billion to \$7.5 billion.

In the third quarter of 2017, the Company was approved by CMHC as a “small repo counterparty” for the CMB program. Essentially this allows the Company more flexibility when investing the cash held in trust by CHT and likely will increase the return the Company receives when it reinvests funds in replacement accounts associated with its CMB transactions.

Key Performance Indicators

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

- Earnings before income taxes, depreciation and amortization, and losses and gains on financial instruments (“Pre-FMV EBITDA” ⁽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 and prior to capital expenditures. Pre-FMV EBITDA should not be construed as an alternative to net income determined in accordance with IFRS or to cash flows from operating, investing and financing activities. The Company’s method of calculating Pre-FMV EBITDA may differ from other issuers and, accordingly, Pre-FMV EBITDA may not be comparable to measures used by other issuers.

	Quarter ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
For the Period	(\$ 000’s)			
Revenue	284,315	273,754	808,753	759,064
Income before income taxes	80,009	69,840	222,244	176,432
Pre-FMV EBITDA ⁽¹⁾	51,826	67,469	173,185	192,475
At Period end				
Total assets	31,548,130	30,527,361	31,548,130	30,527,361
Mortgages under administration	100,176,720	98,572,334	100,176,720	98,572,334

Note:

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

Since going public in 2006, First National has been considered a high-yielding dividend paying company. Over this period, the Company has paid more than \$975 million of dividends/distributions to common shareholders/ unitholders. With a large MUA which generates continuing income and cash flow and a business model which is designed to make efficient use of capital, the Company has been able to pay distributions to its shareholders which represent a relatively large ratio of its earnings. The Company calculates the dividend payout ratio as dividends declared on common shares over net income attributable to common shareholders. This measure is useful to shareholders as it indicates the percentage of earnings which have been paid out in dividends. Similar to the performance measure for earnings, the Company also calculates the dividend payout ratio on a basis using after tax Pre-FMV EBITDA.

Determination of Common Share Dividend Payout Ratio

	Quarter ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
For the Period	(\$ 000's)			
Net income attributable to common shareholders	57,789	50,274	160,359	125,892
Dividends paid or declared on common shares	27,735	25,486	81,706	73,460
Common Share Dividend Payout Ratio	48%	51%	51%	58%
After tax Pre-FMV Dividend Payout Ratio ⁽¹⁾	77%	53%	67%	55%

Note:

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

For the quarter ended September 30, 2017, the common share payout ratio was 48% compared to 51% in the comparative 2016 quarter. In the third quarter of 2017, the Company recorded large gains on account of the changes in fair value of financial instruments. The gains are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact is largely to be reflected in narrower spreads in the future from the mortgages pledged for securitization. Accordingly management does not consider this revenue to be available for dividend payment. If the gains on financial instruments in the two quarters are excluded from the above calculations, the dividend payout ratio for 2017 would have been 77% compared to 53% in 2016.

The Company also paid \$0.69 million of dividends on its preferred shares in the third quarters of 2017 and 2016.

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 September 30, 2017, new origination volume increased from \$4.8 billion to \$4.9 billion, or about 2%, compared to the third quarter of 2016.

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 \$6.9 billion of new originations and renewals for the quarter ended September 30, 2017, \$2.2 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 \$6.9 billion of new originations and renewals in the third quarter of 2017, \$4.6 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

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

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

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

Results of Operations

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

	Quarter ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
(\$ millions)				
Mortgage Originations by Segment				
New Single-family residential	3,157	3,607	8,346	9,724
New Multi-unit and commercial	1,720	1,172	4,125	3,413
Sub-total	4,877	4,779	12,471	13,137
Single-family residential renewals	1,734	1,256	4,095	3,495
Multi-unit and commercial renewals	313	167	870	625
Total origination and renewals	6,924	6,202	17,436	17,257
Mortgage Originations by Funding Source				
Institutional investors – new residential	1,858	2,491	4,986	5,994
Institutional investors – renew residential	1,016	384	2,124	1,492
Institutional investors – multi/commercial	1,703	1,166	4,071	3,248
NHA-MBS/ CMB/ ABCP securitization	2,158	1,971	5,750	6,102
Internal Company resources /CMBS	189	190	505	421
Total	6,924	6,202	17,436	17,257
Mortgages under Administration				
Single-family residential	77,123	76,823	77,213	76,823
Multi-unit residential and commercial	23,054	21,749	23,054	21,749
Total	100,177	98,572	100,177	98,572

Total new mortgage origination volumes increased in the third quarter of 2017 compared to 2016 by 2%. Single-family volumes decreased by 12% and commercial segment volumes increased by 47% year over year. The decrease in the single-family segment is evident across the country as the Company's Vancouver, Calgary and Montreal offices reported an average decrease of about 19% over 2016 third quarter volumes. In the Ontario and the Maritimes, the Company's volume was down 5% for the quarter. When combined with renewals, total production increased from \$6.2 billion in the 2016 third quarter to \$6.9 billion in 2017, or by almost 12%. The Company believes lower new single family origination is the result of the new mortgage insurance rules which has reduced the amount of insured mortgages available in the overall market. 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 \$2.2 billion in the third quarter of 2017. The Company used securitization funding to a similar extent in the third quarter of 2017 when compared to Q3 2016. The remainder was funded primarily through institutional placements. Generally with narrower securitization spreads, the Company elected to use funding through institutions as the profit provided by direct securitization was not materially different than a placement transaction.

Net Interest - Securitized Mortgages

Comparing the quarter ended September 30, 2017 to the quarter ended September 30, 2016, “net interest – securitized mortgages” increased by 7% to \$36.5 million from \$34.1 million. The increase is due to the rising interest rate environment. Interest expense – securitized mortgages is affected by the cost of indemnities payable to debtholders when mortgages prepay prior to their scheduled maturity date. The indemnities are calculated so as to make whole debtholders who are assumed to reinvest the prepayment principal at risk free reinvestment rates. With the recent increase in interest rates, the cost of such indemnity has decreased significantly. The Company calculates that because of the decrease in indemnity costs, that it has earned an additional \$4.4 million in net interest margin. This increase has been offset by the effect of the Company’s hedging program. As gains and losses are recorded in the period in which bond prices change, the offsetting economic impact is reflected in wider or narrower spreads on the mortgages pledged for securitization and are realized in net interest margin over the terms of the mortgages. In 2014 and 2015, the Company recorded large losses on financial instruments totaling \$87 million. This implies that wider securitization spreads than anticipated will be earned as the related mortgages are securitized. The Company estimates that in the third quarter of 2016, net interest – securitized mortgages benefitted from this timing issue by an amount of approximately \$3.3 million. This trend reversed in 2016 and large gains related to short bonds were realized in the fourth quarter of 2016 and the second and third quarters of 2017. To the extent these gains pertain to securitized mortgages, the offset will be narrower securitization spreads earned on future securitizations. The Company estimates that in the third quarter of 2017, there was perhaps a slight loss in interest – securitized mortgages from the aggregate impact of all previous gains and losses. Accordingly, the accounting treatment of gains and losses on hedging activity suggest a \$3.3 million decrease in this item. The amortization of deferred origination and other costs that are capitalized on securitized mortgages also have an effect on net interest. The Company has recently securitized more single family renewals which do not have such costs and create wider spreads which positively impacted this quarter’s net interest margin.

Placement Fees

Placement fee revenue decreased by 40% to \$31.2 million from \$52.1 million in 2016. New residential origination volume for institutional customers, excluding renewals, decreased from \$2.5 billion in the third quarter of 2016 to \$1.9 billion in the 2017 quarter or by 25%. Placement fees per unit were lower due to the interest rate environment. With interest rates rising steadily over the past six months, the value of mortgages held for securitization decreased during the holding period between origination and placement. Accordingly when these mortgages were sold to institutional investors in the third quarter of 2017, the per unit fee was lower than in an otherwise static interest rate period. Although, the Company economically hedged the exposure to such movements in interest rates, the benefit of these contracts is recorded in “realized and unrealized gains (losses) on financial instruments.” Management believes that the two transactions should be regarded together in order to determine the financial result of its decision making. For the third quarter, the Company has calculated that approximately \$10.9 million of revenue recorded as gains on financial instruments economically pertain to residential placement transactions recorded in the 2017 third quarter. For the commercial segment this amount was \$3.5 million. By adding the aggregate of \$14.4 million, placement fee revenue for Q3 2017 becomes \$45.6 million or just 12% lower than in Q3 2016. Placement fees also benefitted from larger amounts of renewed mortgages such that the Company earned \$4.1 million of additional fees in Q3 2017 than in the comparative quarter. Although the commercial segment had significant origination growth in the quarter, revenue in placement fees increased by just 10% as the Company originated more for its own securitization programs and spreads were tighter in a more competitive market.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue decreased 49% to \$2.2 million from \$4.3 million. The gains relate to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Although volumes for these transactions decreased by just 15% from the third quarter of 2016, spreads on these transactions tightened such that the Company realized lower per unit gains.

Mortgage Servicing Income

Mortgage servicing income increased 8% to \$38.7 million from \$35.7 million. This increase was due to revenue earned on the underwriting and fulfillment processing services business which the Company launched in January 2015 and has successfully grown in the past 12 months. Without this revenue, mortgage servicing income grew in line with the MUA growth.

Mortgage Investment Income

Mortgage investment income increased 10% to \$18.6 million from \$16.9 million. The increase is due largely to an increase in the Company's commercial bridge loan program offset by an increased loan loss provision. The commercial bridge loan portfolio grew by about \$60 million from September 2016 to September 2017 providing more investment income. The Company provided for losses of another \$1.5 million (2016 - \$1.0 million) regarding four non-performing properties in the commercial bridge portfolio in third quarter of 2017. In addition, the interest rates associated with the Company's mortgages warehoused prior to securitization are higher this quarter such that more interest income is earned during the warehousing period than in the 2016 quarter.

Realized and Unrealized Gains (Losses) on Financial Instruments

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

Summary of realized and unrealized gains (losses) on financial instruments	Quarter ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
			(\$ 000's)	
Gains (losses) on short bonds used for the economic hedging program	17,916	(677)	34,084	(16,473)
Gains (losses) on mortgages held at fair value	(11,814)	3,291	(18,140)	10,302
Gains (losses) on interest rate swaps	24,439	912	37,857	(4,148)
Other gains (losses)	(1,167)	(10)	(1,167)	201
Total gains (losses) on financial instruments	29,374	3,516	52,634	(10,118)

As 2016 began, economic sentiment was uncertain and 5-year bond prices increased which meant generally the Company recorded losses on its hedging program. In the fourth quarter of 2016, with the promise of increased economic stimulus from the election of the Republican candidate in the United States, the bond market moved dramatically and bond prices decreased significantly. This momentum subsided in the first quarter of 2017 and bond prices increased such that the result was First National's

short bond position, which is used to economically hedge mortgages, had a small decrease in value in the quarter. From the end of the first quarter, the bond markets were relatively flat until the last few weeks of June 2017, when economic data turned more positive and there were signs that the Bank of Canada might increase short term interest rates shortly. This caused bond yields to increase and 5-year bond prices to decrease. This occurred again in September 2017 with another increase in the overnight rate by the Bank of Canada. The consequences for the Company were large gains on the Company's short bond position.

The Company uses short Government of Canada bonds (including CHT-issued bonds) together with repurchase agreements to create synthetic forward interest rate contracts to hedge the interest rate risk associated with fixed rate mortgages originated for its own securitization programs. For accounting purposes, these do not qualify as interest rate hedges as the bonds used are not derivatives but cash-based financial instruments. These gains or losses are recorded in the period in which the bond prices change; however, the offsetting economic gains or losses are generally not recorded in the same period. Instead, the resulting economic gain (or loss) is usually reflected in wider or narrower spreads on the mortgages pledged for securitization and will be realized in net interest margin over the terms of the mortgages and the related debts. On occasion, the Company will place mortgages initially originated for securitization with institutional customers. In these cases the economic value of any gains or losses on account of financial instruments will be offset in the same period as the placement fee to the institution is determined with reference to the current interest rate environment. In the third quarter of 2017, the Company recorded gains on these instruments of \$17.9 million (2016 - loss of \$0.7 million). While the gains increased net income earned in the quarter, there will be an offsetting negative impact to revenues as the hedged mortgages are placed or securitized in the future. For placement transactions, the impact will be immediate as the mortgages are placed with institutional investors. This was evident in the third quarter results. The effect on earnings for mortgages which are securitized will be more prolonged. Generally the Company will issue securitization-related debt at higher relative interest rates than it would have prior to the movement in bond yields. Accordingly the negative impact will be realized over the full term of the securitization. In order to adequately hedge its interest rate exposure, the Company had more than \$1.8 billion of bonds sold short as at September 30, 2017.

The portion of the Company's mortgages which is held at fair value (primarily those funded through ABCP), are also affected by changes in bond prices. Generally, higher bond yields decrease the relative value of these mortgages. However, this mortgage portfolio is much smaller than the Company's short bond position, such that the impact to earnings is typically lower. The mortgages were positively affected by a moderate tightening of mortgage funding credit spreads experienced in the third quarter of 2017. In the 2016 quarter these credit spreads widened to offset the positive impact of lower bond yields on such mortgages. Altogether these mortgages lost \$11.8 million of fair value in the third quarter of 2017 (2016 - \$3.3 million gain). The valuation of interest rate swaps, which are used to augment the Company's short Canada hedging program as well as to manage the interest rate exposure from fixed-rate mortgages in the ABCP portfolio, was positively affected in third quarter 2017 by changing bond yields such that unrealized gains of \$24.4 million were recorded in the third quarter of 2017 (2016 - \$0.9 million).

Brokerage Fees Expense

Brokerage fees expense decreased 24% to \$24.7 million from \$32.7 million. This decrease is explained almost entirely by lower origination volumes of single-family mortgages for institutional investors, which decreased by 25%. The Company also changed the allocation of broker costs on securitization such that a more appropriate amount of broker costs were capitalized in the 2017 third quarter than in the comparative quarter. This allocation reduces the amount of broker fees expensed.

Salaries and Benefits Expense

Salaries and benefits expense increased by 11% to \$24.2 million from \$21.8 million. Salaries were higher as overall headcount increased by 1% from 913 employees at the end of September 2016 to 921 as at the end of September 2017. This increase in overall costs relates primarily to higher compensation earned by commercial sales staff on higher volumes which accounts for \$1.8 million or 8% of the 11% increase. The regular cost of living increases between the quarters also had an impact. Management salaries were paid to the two senior executives (Co-founders) who together control about 74% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO").

Interest Expense

Interest expense increased 22% to \$13.3 million from \$10.9 million. As discussed in the "Liquidity and Capital Resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the ultimate investor or funding with a securitization vehicle. The Company used the senior unsecured notes together with a \$1.06 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 effectively increased borrowing rates by 0.50% in the third quarter of 2017. The Company also held marginally higher balances of mortgages accumulated for sale or securitization which required greater use of the Company's credit facilities.

Other Operating and Amortization of Intangibles Expenses

Other operating expenses increased by 23% to \$14.2 million from \$11.5 million. Other operating expenses increased by \$2.0 million related to higher hedge expenses which increased in step with higher bond yields. The higher interest rates makes it more expensive to carry the short bonds required to mitigate interest rate risk associated with the Company's commitment and funded warehouse pipeline. Information technology costs also increased by \$0.6 million year over year as the Company continued to invest in technology.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes increased 15% to \$80.0 million from \$69.8 million. This change was primarily the result of changing capital markets, which affected the Company's economic interest rate hedges. In the third quarter of 2017 the Company recorded \$29.4 million of gains on financial instruments as bond prices fell. This is in contrast to the third quarter of 2016, when bond prices were stable and the Company recorded gains on account of financial instruments of just \$3.5 million. The change in these amounts accounts for a \$25.9 million increase in income before income taxes. Pre-FMV EBITDA, which eliminates the impact of gains and losses on financial instruments, decreased by 23% to \$51.8 million from \$67.5 million. The decrease was due primarily to the movement of interest rates through the second and third quarters of 2017. The Company calculates that \$14.4 million of gains recorded in Q2 2017 relate to placement fees transactions entered into in the third quarter of 2017. By allocating such income to match the economics of the transactions, as opposed to the required accounting convention, management considers the Q3 2017 comparative to the 2016 quarter's pre-FMV EBITDA to be approximately \$66.2 million or down 2% from the prior quarter. This normalized decrease generally pertains to tighter spreads on deferred placement fees and higher hedging expenses.

Provision for Income Taxes

The provision for taxes increased by 15% to \$21.2 million from \$18.4 million. The provision is higher due to the higher net income before income taxes earned in the 2017 third quarter. The overall effective tax rate is consistent between the quarters.

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	
	(\$000's except percent amounts)			
For the quarter ended	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Originations and renewals	4,891,266	4,861,390	2,033,216	1,339,293
<i>Percentage change</i>	<i>1%</i>		<i>52%</i>	
Revenue	220,692	215,694	63,623	58,060
<i>Percentage change</i>	<i>2%</i>		<i>10%</i>	
Income before income taxes	62,695	52,873	17,314	16,967
<i>Percentage change</i>	<i>19%</i>		<i>2%</i>	
As at	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016
Identifiable assets	25,443,257	24,718,010	6,075,099	5,646,679
Mortgages under administration	77,122,719	77,152,605	23,054,000	22,238,885

Residential Segment

Overall residential origination including renewals increased by 1% between the third quarters of 2017 and 2016, while residential revenues increased by about 2%. A large part of the change in revenue is due to the change in gains and losses on financial instruments. Excluding these changes, revenue decreased by 4% as rising interest rates decreased placement fees by an estimated \$10.9 million. The net change in gains and losses on financial instruments for the residential segment of \$23.0 million also affected net income before income taxes. Without the impact of this fair value change, net income before income taxes for the residential segment decreased by 18% year over year. This is also a function of rising interest rates as lower placement revenue directly affected earnings. With the exception of the issue on placement fees, the Company increased securitization income and mortgage servicing such that income before would have grown 5% year over year. Identifiable assets increased from December 31, 2016, as the Company increased its investment in mortgages accumulated for securitization and bonds purchased under resale agreements for hedging purposes by \$500 million each. This growth is offset by a decrease in mortgages pledged under securitization by about \$300 million.

Commercial Segment

Third quarter 2017 commercial revenues increased by about 10% compared to 2016, but decreased by 3% if the impact of changes in gains and losses on the fair value of financial instruments is excluded. Generally lower deferred placement fees revenue on tighter spreads and the impact of rising rates have resulted in the drop in revenue. Excluding fair value gains and losses, net income before tax was 39% lower than in the 2016 quarter but 20% lower if adjusted for the \$3.5 million impact from rising rates on placement fees as described previously. This change represents a decrease of about \$3.6 million comprising \$2.1 lower deferred placement fees, \$2.0 million of higher sales compensation and brokerage fees on higher origination volume, and \$0.5 million additional provision for loan loss offset by \$1.0 million on higher placement fees on higher volumes. Identifiable assets increased from those at December 31, 2016, as the Company invested about \$75 million in net new mortgage investments and \$350 million in mortgages pledged for securitization.

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 eleven financial institutions for a total credit of \$1.06 billion. This facility was extended in March 2017 for a five-year term maturing in March 2022. In September, another bank joined the syndicate with a commitment of \$60 million. At September 30, 2017, the Company entered into repurchase transactions with financial institutions to borrow \$1.3 billion related to \$1.4 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At September 30, 2017, outstanding bank indebtedness was \$779.4 million (December 31, 2016 - \$622.9 million). Together with the unsecured notes of \$175 million (December 31, 2016 - \$175 million), this "combined debt" was used to fund \$898.1 million (December 31, 2016 - \$800.3 million) of mortgages accumulated for sale or securitization. At September 30, 2017, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$42.2 million (December 31, 2016 - \$43.9 million) and (2) mortgage and loan investments of \$329.4 million (December 31, 2015 - \$255.2 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, 2016 and September 30, 2017, and now stands at \$55.9 million (December 31, 2016 - no true leverage). This represents a debt-to-equity ratio of approximately 0.09 : 1. This has increased from December 31, 2016 when there was no "debt", as generally, the Company invested \$75 million in net new mortgage and loan investments. The Company believes the ratio is low 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 on the day of the advance of the mortgage. On specified days, the Company aggregates all mortgages warehoused to date for an institutional investor and transacts a settlement with that institutional investor. A similar process occurs prior to arranging for term funding through securitization. The Company uses a portion of the committed credit facility with the banking syndicate to fund the mortgages during this warehouse period. The credit facility is designed to be able to fund the highest balance of warehoused mortgages in a month and is normally only partially drawn.

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

The Company has used ABCP as an efficient source of funding primarily for short term insured mortgages. In the May 2013 federal budget, the government announced it was going to take steps to limit the securitization of government insured mortgages to CMHC sponsored programs. As ABCP is not sponsored by CMHC, such a limitation would impact the Company. Almost two years after the

announcement, legislation was passed and detailed transition information was published. With the change in the federal government, the legislation was reconfirmed in February 2016 with some delayed application dates. Generally, the regulations make mortgage default insurance invalid for 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 as at December 31, 2016 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 September 30, 2017, the investment in cash collateral was \$37.9 million (December 31, 2016 - \$22.9 million).

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

Financial Instruments and Risk Management

The Company has elected to treat deferred placement fees receivable, certain mortgages pledged under securitization that have been funded with ABCP and NHA-MBS debt and several mortgages within mortgage and loan investments, as financial assets measured at "fair value through profit or loss" such that changes in market value are recorded in the consolidated statement of comprehensive income. Effectively, these assets are treated much like bonds earning the Company a coupon at the discount rates used by the Company. The discount rates used represent the interest rate associated with a risk-free bond of the same duration plus a premium for the risk/uncertainty of the asset's residual cash flows. As rates in the bond market change, the carrying values of these assets will change. These changes may be significant (favourable and unfavourable) from quarter to quarter. The Company enters into fixed-for-float swaps to manage the interest rate exposure of fixed mortgages sold to ABCP conduits. These instruments will also be treated as fair value through profit or loss. While the Company has attempted to exactly match the principal balances of the fixed mortgages over the next five-year period to the notional swap values for the same period, there will be differences in these amounts. Any favourable or unfavourable amounts will be recorded in the statement of comprehensive income each quarter.

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. From an accounting perspective, any gains or losses on these instruments are recorded in the current period, as the Company's economic hedging strategy does not qualify as hedging for accounting purposes. The Company uses synthetic bond forwards (consisting of bonds sold short and bonds purchased under resale agreements) to manage interest rate exposure between the time a mortgage rate is committed to the borrower and the time the mortgage is transferred to the securitization vehicle and the matched term debt is arranged. As interest rates change, the value of these short bonds will vary inversely with the value of the related mortgages. As interest rates increase, a gain will be recorded on the bonds, which should be offset by a tighter interest rate spread between the interest rates on mortgages and the securitization debt. This spread will

be earned over the term of the related mortgages. For single-family mortgages, primarily mortgages for the Company's own securitization programs, only some of the mortgage commitments issued by the Company eventually fund. The Company must assign a probability of funding to each mortgage in the pipeline and estimate how that probability changes as mortgages move through the various stages of the pipeline. The amount that is actually hedged is the expected value of mortgages funding within the next 120 days (120 days being the standard maximum rate hold period available for the mortgages). As at September 30, 2017, the Company had more than \$1.6 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages for transfer to the Company's other securitization vehicles. As at September 30, 2017, the Company had entered into \$211 million of notional value forward bond sales for this segment. The total net value of realized and unrealized gains and losses on account of all notional hedges pertaining to the period July 1, 2017 to September 30, 2017 was a \$17.9 million gain. This amount has been included in revenue in the statement of comprehensive income.

The Company is party to three interest rate swaps that economically hedge the interest rate exposure related to certain CMB transactions in which the Company has replacement obligations. As at September 30, 2017, the aggregate notional value of these swaps was \$15.5 million. During the third quarter of 2017, the value of these swaps decreased by \$1.1 million. The swaps mature between 2021 and December 2026.

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

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of 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 September 30, 2017, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost \$2.3 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 September 30, 2017, the Company purchased new computer equipment and leasehold improvements. 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 premises leases for its six offices across Canada, and its obligations for the ongoing servicing of mortgages sold to securitization conduits and mortgages related to purchased servicing rights. The Company sells its mortgages to securitization conduits on a fully-serviced basis, and is responsible for the collection of the principal and interest payments on behalf of the conduits, including the management and collection of mortgages in arrears.

Critical Accounting Policies and Estimates

The Company prepares its financial statements in accordance with IFRS, which requires management to make estimates, judgments and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and other assumptions that it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. The significant accounting policies of First National are described in Note 2 to the Company’s annual consolidated financial statements as at December 31, 2016. The policies which First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

The Company uses estimates in valuing its gain or loss on the sale of its mortgages placed with institutions earning a deferred placement fee. Under IFRS, valuing a gain on deferred placement fees requires the use of estimates to determine the fair value of the retained interest (derived from the present value of expected future cash flows) in the mortgages. These retained interests are reflected on the Company’s balance sheet as deferred placement fees receivable. The key assumptions used in the valuation of gains on deferred placement fees are prepayment rates and the discount rate used to present value future expected cash flows. The annual rate of unscheduled principal payments is determined by reviewing portfolio prepayment experience on a monthly basis. The Company uses different rates for its various programs, which average approximately 11% for single-family mortgages. The Company assumes there is virtually no prepayment on multi-unit residential fixed rate mortgages.

On a quarterly basis, the Company reviews the estimates used to ensure their appropriateness and monitors the performance statistics of the relevant mortgage portfolios to adjust and improve these estimates. The estimates used reflect the expected performance of the mortgage portfolio over the lives of the mortgages. The method of determining the assumptions underlying the estimates used for the quarter ended September 30, 2017 continue to be consistent with those used for the year ended December 31, 2016 and the quarters ended June 30 and March 31, 2017.

The Company has elected to treat certain of its financial assets and liabilities, including deferred placement fees receivable, specific mortgages pledged under securitization, some mortgage and loan investments and bonds sold short, at fair value through profit or loss. Essentially, this policy requires the Company to record changes in the fair value of these instruments in the current period’s earnings. The Company’s assets and liabilities are such that the Company must use valuation techniques based on assumptions that are not fully supported by observable market prices or rates in most cases. Much like the valuation of deferred placement fees receivable described above, the Company’s method of determining the fair value of its securitized mortgages has a significant impact on earnings. The

Company uses different prepayment rates for its various programs, which average approximately 10% for single-family mortgages. The Company assumes there is virtually no prepayment on multi-unit residential fixed rate mortgages. Actual prepayment experience has been consistent with these assumptions. The Company has also assumed discount rates based on Government of Canada bond yields plus a spread that the Company believes would enable a third party to purchase the mortgages and make a normal profit margin for the risk involved.

Future Accounting Changes

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

IFRS 9 is mandatorily effective for annual periods beginning on or after January 1, 2018. The Company is in process of evaluating the impact of IFRS 9 on the Company’s financial statements. In the third quarter the Company has consulted with experts on financial instruments and in particular, hedge accounting. Based on the nature of the Company’s assets and operations, the Company has made some high level decisions. In summary, most of the mortgages on its balance sheet will be classified as fair value through other comprehensive income (“OCI”). These will be accounted for at fair value with any changes being recorded in OCI. The exception to this rule is related to the portfolio of mortgage and loan investments which will be classified at fair value through profit and loss such that any changes in market value will be recorded in ordinary income. Generally the Company is also planning to adopt hedge accounting for a significant portion of its mortgage assets. It is hoped that with such accounting, the volatility evidenced in large gains and losses in financial instruments in the last five years will be significantly reduced. Effectively these gains and losses will be recorded in OCI and amortized into earnings over the term of the hedged item. If successful, there will be lower gains and losses from holding short bond positions and net interest margin on securitized mortgages will be more normalized. The Company has commenced designing the hedging documentation and policies to prepare for the transition in early 2018

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

IFRS 15 is effective for fiscal years ending on or after December 31, 2018. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on January 1, 2018 and has begun its analysis. It has determined that most of its servicing contracts are inherently linked to mortgage purchase agreements such that placement fee and servicing revenue are interdependent. Therefore, the Company must determine the appropriate allocation of compensation between current period earnings and future period earnings from these contracts when the underlying mortgages are placed initially. The Company is assessing if the current allocation of revenue from these contracts for these two components which may change under IFRS 15.

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 September 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Risks and Uncertainties Affecting the Business

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

Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as “may”, “will”, “should”, “expect”, “plan”, “anticipate”, “believe”, “intend”, “estimate”, “predict”, “potential”, “continue” or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management’s future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined under “Risk and Uncertainties Affecting the Business”. In evaluating this information, the reader should specifically consider various factors, including the risks outlined under “Risk and Uncertainties Affecting the Business”, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management’s expectations as of October 24, 2017, and is subject to change after such date. However, management and the Company disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Outlook

Management is pleased with the results of the third quarter of 2017. As expected the market for high ratio insured mortgages slowed as a result of the October 2016 mortgage insurance rules announced by the Department of Finance. Although single family mortgage origination for the Company was down 12% from the same quarter in 2016, commercial mortgage origination increased by 47% and single family renewals grew by 38% to \$1.7 billion. All together origination including renewals was up 12% and earnings, adjusted for fair value considerations, were lower by just 2%. The combination of consistent revenue from both securitization and servicing departments and value inherent in the Company’s renewal opportunities continued to support earnings.

For the remainder of 2017 and into 2018, the Company anticipates continued lower seasonal origination in the residential segment pursuant to the impact of new mortgage insurance rules announced in October 2016. Together with rising interest rates following the two overnight rate increases announced by the Bank of Canada in July and September, higher costs of portfolio insurance, additional underwriting restrictions recently proposed by OSFI and regional issues including foreign buyer’s taxes, the Company believes new single-family origination will continue to be lower by a similar proportion as experienced in its second and third quarter. Although the Company sees growth in single-family renewals, a rising rate environment and increased competition may impact origination in the commercial segment. In order to

take advantage of the seasonally strong summer market, the Company introduced various temporary promotions that increased broker fee compensation for new single family originations. As the mortgages originated under these promotions fund, the higher costs will be capitalized against securitized mortgages or recorded as broker fees expense for mortgages placed with institutional investors.

The Company earned almost \$53 million in gains on financial instruments in the nine months ended September 30 2017. While this revenue has increased current period net income, the offsetting economic impact will be felt in the Company's future earnings. Net securitization margins will be lower on new securitizations as the Company issues mortgage backed securities with coupons that will be higher than the period when the securitized mortgages were initially funded. The negative impact will be recognized over the five and ten year terms of the securitization. However, to the extent that the funded mortgages are placed with institutional customers, as the Company did in the third quarter of 2017, the impact will be immediate with lower placement fees in current period earnings. Depending on how the Company elects to fund these mortgage assets, the negative impact associated with the large gains recorded to date in 2017 could be spread over 5 or ten year term or it could be realized in the upcoming fiscal quarters.

Despite these challenges the Company will continue to generate income and cash flow from its \$26 billion portfolio of mortgages pledged under securitization and \$74 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]

Third quarter 2017

First National Financial Corporation

Interim condensed consolidated statements of financial position

[Unaudited – in thousands of Canadian dollars]

As at

	September 30, 2017	December 31, 2016
	\$	\$
Assets		
Restricted cash <i>[note 3]</i>	599,159	685,347
Cash held as collateral for securitization <i>[note 3]</i>	39,311	22,877
Accounts receivable and sundry <i>[note 7]</i>	133,265	91,701
Securities purchased under resale agreements and owned	1,925,640	1,307,801
Mortgages accumulated for sale or securitization <i>[note 5]</i>	2,272,233	1,837,916
Mortgages pledged under securitization <i>[note 3]</i>	26,164,656	26,106,664
Deferred placement fees receivable <i>[note 4]</i>	42,198	43,933
Mortgage and loan investments <i>[note 6]</i>	329,430	255,230
Other assets	42,238	42,996
Total assets	31,548,130	30,394,465
Liabilities and equity		
Liabilities		
Bank indebtedness <i>[note 8]</i>	779,353	628,522
Obligations related to securities and mortgages sold under repurchase agreements	1,348,361	1,009,572
Accounts payable and accrued liabilities	121,779	122,499
Securities sold under repurchase agreements and sold short	1,930,083	1,308,483
Debt related to securitized and participation mortgages <i>[note 9]</i>	26,493,899	26,514,181
Senior unsecured notes	174,659	174,556
Income taxes payable	2,788	23,255
Deferred tax liabilities	72,500	63,100
Total liabilities	30,923,422	29,844,168
Equity attributable to shareholders		
Common shares <i>[note 10]</i>	122,671	122,671
Preferred shares <i>[note 10]</i>	97,394	97,394
Retained earnings	380,924	302,271
	600,989	522,336
Non-controlling interests	23,719	27,961
Total equity	624,708	550,297
Total liabilities and equity	31,548,130	30,394,465

See accompanying notes

On behalf of the Board



John Brough



Robert Mitchell

First National Financial Corporation

Interim condensed consolidated statements of comprehensive income

[Unaudited – in thousands of Canadian dollars, except per share amounts]

	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
	\$	\$	\$	\$
Revenue				
Interest revenue – securitized mortgages	164,296	161,193	483,884	476,885
Interest expense – securitized mortgages	(127,835)	(127,078)	(375,831)	(369,794)
Net interest – securitized mortgages <i>[note 3]</i>	36,461	34,115	108,053	107,091
Placement fees	31,194	52,116	110,769	140,058
Gains on deferred placement fees <i>[note 4]</i>	2,186	4,305	8,318	12,397
Mortgage investment income	18,550	16,888	48,606	42,032
Mortgage servicing income	38,715	35,736	104,542	97,810
Realized and unrealized gains (losses) on financial instruments	29,374	3,516	52,634	(10,118)
	156,480	146,676	432,922	389,270
Expenses				
Brokerage fees	24,667	32,705	66,976	81,245
Salaries and benefits	24,238	21,756	72,301	65,823
Interest	13,344	10,923	32,711	28,168
Other operating	14,222	11,452	38,690	35,102
Amortization of intangible assets	—	—	—	2,500
	76,471	76,836	210,678	212,838
Income before income taxes	80,009	69,840	222,244	176,432
Income tax expense	21,200	18,400	58,540	46,400
Net income and comprehensive income for the period	58,809	51,440	163,704	130,032
Net income and comprehensive income attributable to				
Shareholders	58,475	50,961	162,405	128,420
Non-controlling interests	334	479	1,299	1,612
	58,809	51,440	163,704	130,032
Earnings per share				
Basic <i>[note 10]</i>	0.96	0.84	2.67	2.10

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	Non- controlling interests	Total equity
	\$	\$	\$	\$	\$
Balance as at January 1, 2017	122,671	97,394	302,271	27,961	550,297
Comprehensive income	—	—	162,405	1,299	163,704
Dividends paid or declared	—	—	(83,752)	(1,281)	(85,033)
Redemption by non-controlling interests	—	—	—	(4,260)	(4,260)
Balance as at September 30, 2017	122,671	97,394	380,924	23,719	624,708

	Common shares	Preferred shares	Retained earnings	Non- controlling interests	Total equity
	\$	\$	\$	\$	\$
Balance as at January 1, 2016	122,671	97,394	204,686	32,779	457,530
Comprehensive income	—	—	128,420	1,612	130,032
Dividends paid or declared	—	—	(75,988)	(1,509)	(77,497)
Redemption by non-controlling interests	—	—	—	(4,943)	(4,943)
Balance as at September 30, 2016	122,671	97,394	257,118	27,939	505,122

See accompanying notes

First National Financial Corporation

Interim condensed consolidated statements of cash flows

[Unaudited – in thousands of Canadian dollars]

	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
	\$	\$	\$	\$
Operating activities				
Net income for the period	58,809	51,440	163,704	130,032
Add (deduct) items				
Deferred income taxes	5,000	4,100	9,400	(2,700)
Non-cash portion of gains on deferred placement fees	(2,073)	(4,153)	(7,916)	(11,910)
Decrease (increase) in restricted cash	16,858	238,516	86,188	(172,243)
Net investment in mortgages pledged under securitization	(171,940)	(934,024)	(76,133)	(1,293,545)
Net increase (decrease) in debt related to securitized mortgages	144,640	685,900	(14,515)	1,479,383
Provision for loan loss	1,500	1,000	3,500	2,500
Amortization of deferred placement fees receivable	2,872	2,496	8,484	7,269
Amortization of purchased mortgage servicing rights	—	172	664	492
Amortization of property, plant and equipment	1,191	1,145	3,575	3,425
Amortization of intangible assets	—	—	—	2,500
Unrealized gains on financial instruments	(10,663)	(11,019)	(27,908)	(387)
	46,194	35,573	149,043	144,816
Net change in non-cash working capital balances related to operations	(168,426)	584,429	(459,858)	(524,383)
Cash provided by (used in) operating activities	(122,232)	620,002	(310,815)	(379,567)
Investing activities				
Additions to property, plant and equipment	(371)	(1,912)	(3,481)	(3,462)
Investment in cash held as collateral for securitization	(15,657)	(7,635)	(16,434)	1,737
Investment in mortgage and loan investments	(47,433)	(84,109)	(302,421)	(176,561)
Repayment of mortgage and loan investments	92,281	92,540	224,721	152,483
Cash provided by (used in) investing activities	28,820	(1,116)	(97,615)	(25,803)
Financing activities				
Dividends paid	(28,819)	(26,615)	(84,283)	(77,225)
Obligations related to securities and mortgages sold under repurchase agreements	106,207	(364,305)	338,789	337,649
Decrease in debt related to participation mortgages	(2,781)	(8)	(5,767)	(14,556)
Securities purchased under resale agreements and owned, net	(424,225)	579,021	(617,839)	(567,726)
Securities sold under repurchase agreements and sold short, net	443,120	(576,511)	630,959	560,880
Redemption by non-controlling interests	—	—	(4,260)	(4,943)
Cash provided by (used in) financing activities	93,502	(388,418)	257,599	234,079
Net decrease (increase) in bank indebtedness during the period				
	90	230,468	(150,831)	(171,291)
Bank indebtedness, beginning of period	(779,443)	(984,732)	(628,522)	(582,973)
Bank indebtedness, end of period	(779,353)	(754,264)	(779,353)	(754,264)
Supplemental cash flow information				
Interest received	200,498	198,928	585,596	572,725
Interest paid	121,173	122,610	370,069	362,925
Income taxes paid	15,856	9,728	69,606	41,172

See accompanying notes

First National Financial Corporation

Notes to interim condensed consolidated financial statements

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

September 30, 2017

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 residential [single family and multi-unit] and commercial mortgages. With over \$100 billion in mortgages under administration as at September 30, 2017, FNFLP is 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. 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, 2016.

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 October 24, 2017.

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 Asset-backed Commercial Paper [“ABCP”], NHA-MBS, and the Canada Mortgage Bonds [“CMB”] program. 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. The Company’s credit exposure to securitized mortgages is generally limited to this cash collateral. The principal and interest payments on the securitized mortgages are paid by the Company to 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 September 30, 2017, the cash held as collateral for securitization was \$39,311 [December 31, 2016 – \$22,877].

First National Financial Corporation

Notes to interim condensed consolidated financial statements

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

September 30, 2017

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

	September 30, 2017		December 31, 2016	
	Carrying amount of securitized mortgages \$	Carrying amount of associated liabilities \$	Carrying amount of securitized mortgages \$	Carrying amount of associated liabilities \$
Securitized mortgages at face value	26,033,152	26,567,580	25,946,355	26,565,848
Mark-to-market adjustment	(69)	—	21,369	—
Capitalized origination costs	131,573	—	138,940	—
Debt discounts	—	(74,012)	—	(57,765)
	26,164,656	26,493,568	26,106,664	26,508,083
Add				
Principal portion of payments held in restricted cash	555,144	—	636,763	—
Participation debt	—	331	—	6,098
	26,719,800	26,493,899	26,743,427	26,514,181

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 yet 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.

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

	2017 \$	2016 \$
Opening balance, July 1	130,707	128,457
Add: new origination costs capitalized in the period	18,847	23,621
Less: amortization in the period	(17,981)	(17,019)
Ending balance, September 30	131,573	135,059

Mortgages pledged under securitization have been classified as loans and receivables, except for approximately \$2.7 billion [December 31, 2016 – \$2.7 billion] of fair valued mortgages included in fair value through profit or loss ["FVTPL"] mortgages. The mortgages classified as loans and receivables are carried at par plus adjustment for unamortized origination costs.

First National Financial Corporation

Notes to interim condensed consolidated financial statements

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

September 30, 2017

Within mortgages pledged under securitization, the Company's exposure to credit loss is limited to uninsured mortgages with principal balances totaling \$508,751 [December 31, 2016 – \$125,092], before consideration of the value of the underlying collateral. None of these mortgages have principal and interest payments in arrears as at September 30, 2017 or December 31, 2016. All such mortgages are conventional prime single-family mortgages, with an 80% or less loan to value, and verified borrower income. Accordingly, the Company considers there to be a very small risk of loss, and no provision for credit loss has been recorded related to these mortgages.

The Company uses various assumptions to value the FVTPL mortgages, which are set out in the table below, including the rate of unscheduled prepayment. Accordingly, FVTPL mortgages are subject to measurement uncertainty. The effect of variations between actual experience and assumptions will be recorded in future statements of comprehensive income. Key economic weighted average assumptions and the sensitivities of the current carrying values to immediate 10% and 20% adverse changes in those assumptions are as follows:

	September 30, 2017	
	Commercial mortgages	Residential mortgages
	\$	\$
FVTPL mortgages	60,803	2,604,452
Average life [in months] ^[1]	29	23
Prepayment speed assumption [annual rate]	0%	11.0%
Impact on fair value of 10% adverse change	—	117
Impact on fair value of 20% adverse change	—	232
Discount rate [annual rate]	2.6%	2.4%
Impact on fair value of 10% adverse change	374	9,712
Impact on fair value of 20% adverse change	744	19,345
	<hr/>	
	December 31, 2016	
	Commercial mortgages	Residential mortgages
	\$	\$
FVTPL mortgages	84,777	2,578,979
Average life [in months] ^[1]	28	21
Prepayment speed assumption [annual rate]	0.1%	10.7%
Impact on fair value of 10% adverse change	—	192
Impact on fair value of 20% adverse change	—	383
Discount rate [annual rate]	2.0%	1.8%
Impact on fair value of 10% adverse change	402	7,152
Impact on fair value of 20% adverse change	799	14,262

[1] The weighted average life of prepayable assets in periods [for example, months or years] can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

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These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in carrying value based on a 10% or 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another [for example, increases in market interest rates may result in lower prepayments], which might magnify or counteract the sensitivities.

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 September 30, 2017, \$469,241 [2016 – \$554,181] of mortgages were placed with institutional investors, which created gains on deferred placement fees of \$2,186 [2016 – \$4,305]. Cash receipts on deferred placement fees receivable for the three months ended September 30, 2017 were \$3,295 [2016 – \$2,851].

The Company uses various assumptions to value the deferred placement fees receivable, which are set out in the table below. Accordingly, the deferred placement fees receivable are subject to measurement uncertainty. As at September 30, 2017, the fair value of deferred placement fees receivable is \$42,198 [December 31, 2016 – \$43,933]. 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 comprehensive income. Key economic weighted average assumptions and the sensitivity of the current carrying value of residual cash flows to immediate 10% and 20% adverse changes in those assumptions are summarized as follows:

	September 30, 2017	December 31, 2016
Average life [in months] ^[1]	61	63
Residual cash flows discount rate [annual rate]	5.0%	3.9%
Impact on fair value of 10% adverse change	\$517	\$435
Impact on fair value of 20% adverse change	\$1,022	\$863

[1] The weighted average life of prepayable assets in periods [for example, months or years] can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in carrying value based on a 10% or 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear.

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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 loans and receivables and are recorded at amortized cost. 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. The following table summarizes the components of mortgages according to their classification:

	September 30, 2017	December 31, 2016
	\$	\$
Mortgages accumulated for securitization	2,261,419	1,797,321
Mortgages accumulated for sale	10,814	40,595
	2,272,233	1,837,916

The Company's exposure to credit loss is limited to \$595,598 [December 31, 2016 – \$345,179] of principal balances of uninsured mortgages within mortgages accumulated for sale or securitization, before consideration of the value of the underlying collateral. These are conventional prime single-family mortgages similar to the mortgages described in note 3. For the same rationale, the Company has not recorded any provision for credit loss related to these mortgages.

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.

Mortgage and loan investments consist of the following:

	September 30, 2017	December 31, 2016
	\$	\$
Mortgage loans, classified as loans and receivables	297,929	213,372
Mortgage loans, designated as FVTPL	31,501	41,858
	329,430	255,230

Mortgage and loan investments classified as loans and receivables are carried at outstanding principal balances adjusted for unamortized premiums or discounts and are net of specific provisions for credit losses, if any.

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Within mortgage and loan investments, the total of uninsured mortgages in arrears is approximately \$45,456 [December 31, 2016 – \$44,231]. Three of these mortgages are non-performing and have principal balances totaling \$43,703 as at September 30, 2017 [December 31, 2016 – three mortgages, totaling \$43,286]. The Company has stopped accruing interest on these mortgages, and has provided an allowance for potential credit loss of \$12,731 as at September 30, 2017 [December 31, 2016 – \$10,041]. The Company acknowledges that there is a higher risk of credit losses on this portfolio than the other mortgage portfolios on its interim condensed consolidated statements of financial position. The Company believes it has adequately provided for such losses in the allowance for potential credit loss disclosed above and considers there to be a lower risk of credit loss on performing mortgages, such that credit losses have been recorded only on account of non-performing mortgages.

7. Mortgages under administration

As at September 30, 2017, the Company had mortgages under administration of \$100,176,720 [December 31, 2016 – \$99,391,490], 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 September 30, 2017, the Company administered 301,051 mortgages [December 31, 2016 – 303,389] for 102 institutional investors [December 31, 2016 – 102], with an average remaining term to maturity of 41 months [December 31, 2016 – 41 months].

Mortgages under administration are serviced as follows:

	September 30, 2017	December 31, 2016
	\$	\$
Institutional investors	59,601,753	59,062,554
Mortgages accumulated for sale or securitization and mortgage and loan investments	2,565,423	2,099,598
Deferred placement investors	11,100,965	10,417,963
Mortgages pledged under securitization	26,033,152	25,946,355
CMBS conduits	875,427	1,865,020
	100,176,720	99,391,490

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 September 30, 2017, the Company has included in accounts receivable and sundry \$18,565 [December 31, 2016 – \$14,618] uninsured non-performing mortgages, net of provisions for credit losses and outstanding claims from mortgage default insurers. The Company incurred actual credit losses, net of recoveries, of \$200 [2016 – \$2] during the three months ended September 30, 2017.

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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 September 30, 2017 was \$692,423 [December 31, 2016 – \$798,876].

8. Bank indebtedness

Bank indebtedness includes a revolving credit facility of \$1,060,000 [December 31, 2016 – \$1,000,000] maturing in March 31, 2022, of which \$782,047 [December 31, 2016 – \$624,904] was drawn as at September 30, 2017 and 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 September 30, 2017, debt related to securitized mortgages was \$26,493,568 [December 31, 2016 – \$26,508,083], net of unamortized discounts of \$74,012 [December 31, 2016 – \$57,765]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

As at September 30, 2017, debt related to participation mortgages was \$331 [December 31, 2016 – \$6,098].

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 has 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

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[b] Capital stock activities

	Common shares		Preferred shares	
	#	\$	#	\$
Balance, December 31, 2016 and September 30, 2017	59,967,429	122,671	4,000,000	97,394

[c] Earnings per share

	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
	\$	\$	\$	\$
Net income and comprehensive income	58,809	51,440	163,704	130,032
Less: dividends declared on preferred shares	(685)	(687)	(2,046)	(2,529)
Less: earnings related to non- controlling interests	(334)	(479)	(1,299)	(1,612)
Net earnings attributable to common shareholders	57,790	50,274	160,359	125,891
Number of common shares outstanding	59,967,429	59,967,429	59,967,429	59,967,429
Basic earnings per common share	0.96	0.84	2.67	2.10

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

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analysis. The valuation methods and key assumptions used in determining fair values for the financial assets and financial liabilities are as follows:

[a] FVTPL mortgages in mortgages under securitization and certain mortgage and loan investments

The fair value of these mortgages 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. Refer to note 3 “Mortgages pledged under securitization” for the key assumptions used and sensitivity analysis.

[b] Deferred placement fees receivable

The fair value of deferred placement fees receivable is determined by internal valuation models using market data inputs, where possible. The fair value is determined by discounting the expected future cash flows related to the placed mortgages at market interest rates. The expected future cash flows are estimated based on certain assumptions which are not supported by observable market data. Refer to note 4 “Deferred placement fees receivable” for the key assumptions used and sensitivity analysis.

[c] Securities owned and sold short

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

[d] Servicing liabilities

The fair value of the servicing liabilities is determined by internal valuation models using market data inputs, where possible. The fair value is determined by discounting the expected future cost related to the servicing 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.

[e] Other financial assets and financial liabilities

The fair values of mortgage and loan investments classified as loans and receivables, 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 \$26,164,656 [December 31, 2016 – \$26,106,664] and a fair value of \$26,184,306 [December 31, 2016 – \$26,388,372], debt related to securitized and participation mortgages, which has a carrying value of \$26,493,899 [December 31, 2016 – \$26,514,181] and a fair value of \$26,408,560 [December 31, 2016 – \$26,681,028], and senior unsecured notes, which have a carrying value of \$174,659 [December 31, 2016 – \$174,556] and a fair value of \$174,650

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[December 31, 2016 – \$174,349]. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3].

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

	September 30, 2017			
	Level 1	Level 2	Level 3	Total
	\$	\$	\$	\$
Financial assets				
Mortgages accumulated for sale	—	10,814	—	10,814
FVTPL mortgages	—	—	2,665,255	2,665,255
Deferred placement fees receivable	—	—	42,198	42,198
Mortgage and loan investments	—	—	31,501	31,501
Interest rate swaps	—	56,030	—	56,030
Total financial assets	—	66,844	2,738,954	2,805,798
Financial liabilities				
Securities sold under repurchase agreements and sold short	—	1,930,083	—	1,930,083
Interest rate swaps	—	6,521	—	6,521
Total financial liabilities	—	1,936,604	—	1,936,604
	December 31, 2016			
	Level 1	Level 2	Level 3	Total
	\$	\$	\$	\$
Financial assets				
Mortgages accumulated for sale	—	40,595	—	40,595
FVTPL mortgages	—	—	2,663,756	2,663,756
Deferred placement fees receivable	—	—	43,933	43,933
Mortgage and loan investments	—	—	41,858	41,858
Interest rate swaps	—	22,227	—	22,227
Total financial assets	—	62,822	2,749,547	2,812,369
Financial liabilities				
Securities sold under repurchase agreements and sold short	—	1,308,483	—	1,308,483
Interest rate swaps	—	16,873	—	16,873
Total financial liabilities	—	1,325,356	—	1,325,356

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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 September 30, 2017 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 \$12,981 [2016 – gain of \$3,281]. 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 \$18,711 [2016 – losses of \$7,504] of the Company's financial assets and financial liabilities for the three and nine months ended September 30, 2017 and 2016, all of which have been classified as FVTPL:

	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
	\$	\$	\$	\$
FVTPL mortgages	(11,814)	3,291	(18,141)	10,302
Deferred placement fees receivable	(1,167)	(10)	(1,167)	201
Securities owned and sold short	17,916	(677)	34,085	(16,473)
Interest rate swaps	24,439	912	37,857	(4,148)
	29,374	3,516	52,634	(10,118)

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 September 30, 2017 and 2016. The Company classifies financial instruments as Level 3 when there is reliance on at least one significant unobservable input in the valuation models.

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	Fair value as at June 30, 2017 \$	Investments \$	Unrealized losses recorded in income \$	Payment and amortization \$	Fair value as at September 30, 2017 \$
Financial assets					
FVTPL mortgages	2,619,563	449,639	(11,814)	(392,133)	2,665,255
Deferred placement fees receivable	44,164	2,073	(1,167)	(2,872)	42,198
Mortgage and loan investments	36,710	2,105	—	(7,314)	31,501
	2,700,437	453,817	(12,981)	(402,319)	2,738,954

	Fair value as at June 30, 2016 \$	Investments \$	Unrealized gains (losses) recorded in income \$	Payment and amortization \$	Fair value as at September 30, 2016 \$
Financial assets					
FVTPL mortgages	3,240,816	1,322,942	3,291	(1,598,861)	2,968,188
Deferred placement fees receivable	41,359	4,153	(10)	(2,496)	43,006
Mortgage and loan investments	46,028	4,700	—	(10,549)	40,179
	3,328,203	1,331,795	3,281	(1,611,906)	3,051,373

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 September 30, 2017, the ratio was 1.49:1 [December 31, 2016 – 1.39:1]. The Company was in compliance with the bank covenant throughout the period.

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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 September 30, 2017			Nine months ended September 30, 2017		
	Residential \$	Commercial \$	Total \$	Residential \$	Commercial \$	Total \$
Revenue						
Interest revenue – securitized mortgages	123,863	40,433	164,296	367,748	116,136	483,884
Interest expense – securitized mortgages	(94,854)	(32,981)	(127,835)	(280,429)	(95,402)	(375,831)
Net interest – securitized mortgages	29,009	7,452	36,461	87,319	20,734	108,053
Placement and servicing	59,715	12,380	72,095	182,529	41,100	223,629
Mortgage investment income	14,143	4,407	18,550	34,427	14,179	48,606
Realized and unrealized gains on financial instruments	22,971	6,403	29,374	40,017	12,617	52,634
	125,838	30,642	156,480	344,292	88,630	432,922
Expenses						
Amortization	999	192	1,191	2,996	579	3,575
Interest	10,957	2,387	13,344	27,207	5,504	32,711
Other operating	51,187	10,749	61,936	144,095	30,297	174,392
	63,143	13,328	76,471	174,298	36,380	210,678
Income before income taxes	62,695	17,314	80,009	169,994	52,250	222,244
Identifiable assets	25,443,255	6,075,099	31,518,354	25,443,255	6,075,099	31,518,354
Goodwill	—	—	29,776	—	—	29,776
Total assets	25,443,255	6,075,099	31,548,130	25,443,255	6,075,099	31,548,130
Capital expenditures	260	111	371	2,437	1,044	3,481

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	Three months ended September 30, 2016			Nine months ended September 30, 2016		
	Residential	Commercial	Total	Residential	Commercial	Total
	\$	\$	\$	\$	\$	\$
Revenue						
Interest revenue – securitized mortgages	123,268	37,925	161,193	363,466	113,419	476,885
Interest expense – securitized mortgages	(96,364)	(30,714)	(127,078)	(278,172)	(91,622)	(369,794)
Net interest – securitized mortgages	26,904	7,211	34,115	85,294	21,797	107,091
Placement and servicing	75,153	17,004	92,157	204,341	45,924	250,265
Mortgage investment income	12,718	4,170	16,888	28,637	13,395	42,032
Realized and unrealized gains (losses) on financial instruments	4,555	(1,039)	3,516	(2,802)	(7,316)	(10,118)
	119,330	27,346	146,676	315,470	73,800	389,270
Expenses						
Amortization	968	177	1,145	4,393	1,532	5,925
Interest	9,161	1,762	10,923	22,580	5,588	28,168
Other operating	56,328	8,440	64,768	152,894	25,851	178,745
	66,457	10,379	76,836	179,867	32,971	212,838
Income before income taxes	52,873	16,967	69,840	135,603	40,829	176,432
Identifiable assets	24,682,599	5,814,986	30,497,585	24,682,599	5,814,986	30,497,585
Goodwill	—	—	29,776	—	—	29,776
Total assets	24,682,599	5,814,986	30,527,361	24,682,599	5,814,986	30,527,361
Capital expenditures	1,339	573	1,912	2,424	1,038	3,462

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14. Related party and other transactions

In the past ten years, the Company has originated and sold several commercial mezzanine mortgages to various entities controlled by a senior executive and shareholder of the Company. The Company has also taken on servicing contracts awarded by those same entities. The Company services these mortgages during their terms at market commercial servicing rates. During the quarter, the related entities funded several progress draws totaling \$815 on existing mortgages originated by the Company. One of the related entities assumed a \$2,023 mortgage which the Company had originated and serviced for one of its existing arm's-length institutional investors prior to the maturity of the mortgage in the quarter. The mortgages, which are administered by the Company, have a balance of \$64,885 as at September 30, 2017 [December 31, 2016 – \$69,115]. As at September 30, 2017, 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 Company did not pay any bulk insurance premium during the three months ended September 30, 2017 [2016 – \$357]. The insurance company has also engaged the Company to service a portfolio of mortgages at market servicing rates. As at September 30, 2017, the portfolio's balance was \$3,858 [December 31, 2016 – \$3,965].

First National Financial Corporation

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