

FIRST NATIONAL FINANCIAL INCOME FUND

ANNUAL REPORT 2009



FIRST NATIONAL

FINANCIAL INCOME FUND



SERVICE, INNOVATION, RESULTS

INVESTMENT HIGHLIGHTS

1

Canada's largest
non-bank
mortgage
originator

2

Leader in
high-growth
mortgage broker
distribution channel

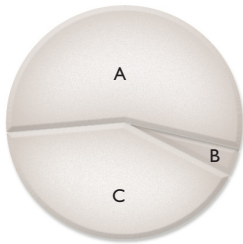
3

High-quality
mortgage
portfolio

4

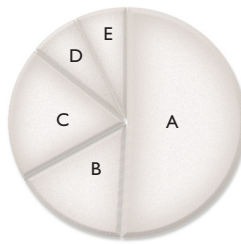
Diverse revenue
and
funding sources

FUNDING SOURCES
(Year ended December 31, 2009)



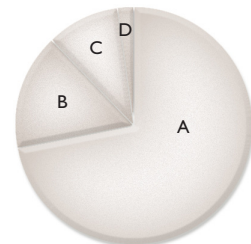
- A. **55%** Institutional placements
- B. **4%** Securitization and internal company resources
- C. **41%** NHA-MBS

REVENUE SOURCES*
(Year ended December 31, 2009)



- A. **51%** Institutional placements
- B. **16%** Gain on securitization
- C. **19%** Mortgage servicing
- D. **7%** Investment income
- E. **7%** Residual securitization

MORTGAGES UNDER ADMINISTRATION
(As at December 31, 2009)



- A. **72%** Insured
 - B. **16%** Multi-unit and commercial
 - C. **10%** Conventional single-family residential
 - D. **2%** Bridge loans/Alt-A
- 82% insured or conventional single-family residential**

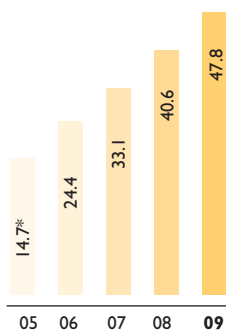
*Based on gross revenue, excluding revenue from realized and unrealized losses on financial instruments.

PROFILE

First National Financial Income Fund (TSX: FN.UN) owns a 21% interest in First National Financial LP, a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With nearly \$48 billion in mortgages under administration, First National is Canada's largest non-bank originator and underwriter of mortgages and is among the top three in market share in the growing mortgage broker distribution channel.

OUR 2009 PERFORMANCE AT A GLANCE

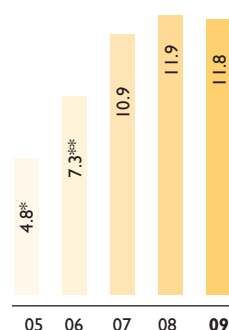
MORTGAGES UNDER ADMINISTRATION (In \$ Billions)



18%

Year-over-year growth
2008 to 2009

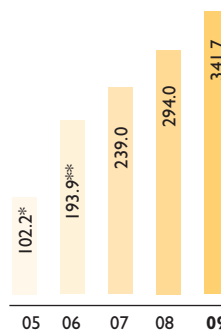
MORTGAGE ORIGINATIONS (In \$ Billions)



(1%)

Year-over-year growth
2008 to 2009

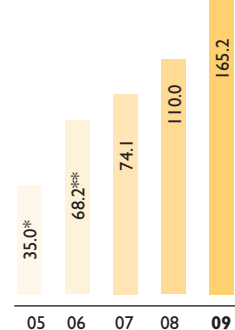
REVENUE (In \$ Millions)



16%

Year-over-year growth
2008 to 2009

EBITDA (In \$ Millions)



51%

Year-over-year growth
2008 to 2009

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*2005 figures are for the period ended March 31, the fiscal year-end for First National Financial Corporation, First National Financial LP's predecessor company.

**2006 figures reflect the operations of First National Financial Corporation from January 1, 2006 to June 14, 2006, combined with the operations of First National Financial LP from June 15, 2006 to December 31, 2006.

LETTER FROM THE PRESIDENT

FELLOW UNITHOLDERS,

First National Financial Income Fund had a record year, with significant increases in revenue, net income, mortgages under administration and EBITDA. Despite a severe downturn in world markets that persisted throughout most of the year, strict adherence to our strategic business plan, prudent risk management and an unwavering focus on delivering high-quality mortgage products to customers, produced unprecedented results for the Fund and confirmed our position as Canada's leading non-bank mortgage lender.

DELIVERING RECORD RESULTS

- Mortgages under administration stood at \$47.8 billion at year-end, growing by 18% from the \$40.6 billion established at the end of 2008.
- Revenue grew by 16% to \$341.7 million due to larger gains on securitization earned by the Company.
- Net income more than doubled from 2008, increasing by 51% to \$163.5 million.
- EBITDA increased by 51% to \$165.2 million due to steady volumes and higher margins experienced in both single-family and multi-unit residential markets.
- The Fund's performance led to First National's third distribution increase in three years and the declaration of a year-end special distribution.

The Fund's strong performance throughout the year was driven primarily by higher margins on its most creditworthy products, particularly in the multi-unit residential and single-family floating rate markets. Higher margins associated with mortgage placement and securitization combined with stable operating costs to produce a marked increase in profitability for the Fund in 2009.

As the year progressed, increased liquidity in capital markets, together with wide mortgage spreads, helped drive revenue to record highs, while single-family origination volumes and the level of mortgages under administration exceeded management's expectations for the year.

As testament to our confidence in the Fund's underlying strength and future growth prospects, the Board implemented an 11% increase in the cash distribution rate during the third quarter. This increase further underscores the strength and resiliency of the Fund's operating model and strategic plan going into the next year.

The proven success of our business model and our exceptional performance during an economically tumultuous 2009 affirms our leadership position within the non-bank mortgage lending market and sets the stage for success in the future.

INDUSTRY DEVELOPMENTS

A resilient Canadian housing market, historically low mortgage interest rates and the steady stabilization of credit markets in the second half of the year contributed to the Fund's strong performance in the midst of a recessionary economic environment.

The volatile economic conditions experienced by the industry in 2009 created additional opportunities for the Fund as key competitors exited the market and credit spreads widened. Our ability to grow origination volume throughout the year improved as a result of these developments, and we were able to achieve attractive pricing for our CMHC-insured multi-family mortgage product. Along with prime single-family residential, this product has always been a primary driver of our strong market position.

UNPRECEDENTED 2009 RESULTS SET THE STAGE FOR FUTURE SUCCESS

OUTLOOK

Our strategy of leveraging diverse funding sources has allowed the Fund to thrive, resulting in significant growth in profitability during 2009, and we anticipate continued strong demand for our mortgage products going forward. By focusing on the prime mortgage market, we believe that bids for mortgages will continue to grow as institutional customers seek government-insured assets for investment purposes. Our position of operational and financial strength allowed us to successfully manage the liquidity-related issues of the past few years and begin 2010 in a strong financial position.

Although the stabilization of credit markets has increased funding opportunities for First National, excess liquidity in capital markets means that mortgage spreads are being put under pressure as lenders begin to compete more aggressively for product. As a result, the Fund expects tighter mortgage spreads in both the prime single-family and multi-unit residential segments of its business in 2010; however, the Fund will profit from higher income and cash flow derived from our growing \$48 billion portfolio of mortgages under administration.

First National's solid balance sheet, increased profitability and higher returns to unitholders in 2009 demonstrate the sustainability of the Fund's business model and distribution policy through periods of economic weakness.

On January 1, 2011, the Fund will become subject to SIFT (Specified Investment Flow-Through) rules as a result of the upcoming change in Canadian federal taxation policy. After 2010, which will be the last year under the current income trust tax rules, the Fund will be liable to pay tax at rates comparable to most corporations in Canada. Accordingly, we do not see an advantage in remaining a trust and we are planning to convert to a corporation such that the income distributed to unitholders will be in the form of eligible dividends beginning in 2011.

LOOKING AHEAD

First National continues to remain focused on our four key priorities for long-term success. These are:

1. Minimizing funding costs by employing diverse and innovative funding sources;
2. Growing mortgages under administration;
3. Maintaining our steadfast commitment to excellence in service; and
4. Lowering operating costs through our systems and technology.

The Fund's continued success is a direct result of the dedication of our employees, the guidance of our Board, the loyalty of our customers and the trust of our committed unitholders. I would like to extend a special thank you to each of these groups for continuing to steadfastly support First National during the challenging market environment. It is because of this ongoing support that we remain in a position to deliver stable and reliable returns to our Unitholders. We look forward to proceeding into 2010 as a strong and profitable industry leader while continuing to deliver the same high level of service and innovation that we have prided ourselves on for over 20 years.

Sincerely,



Stephen Smith
Chairman and President

2009 DEMONSTRATED THE SUSTAINABILITY OF OUR BUSINESS MODEL

CORPORATE GOVERNANCE

FIRST NATIONAL'S

Board of Directors and management team fully acknowledge the importance of their duty to serve the long-term interests of unitholders.

Sound corporate governance is fundamental in maintaining the confidence of investors and increasing unitholder value. As such, First National is committed to the highest standards of integrity to ensure transparency, compliance and discipline. It defines the relationships among all of our stakeholders – Board, management and unitholders – and is the basis for building these values and nurturing a culture of accountability and responsibility across the organization.

POLICIES

The Board supervises and evaluates the management of the Fund, oversees matters related to our strategic direction and assesses results relative to our goals and objectives. As a result, the Board has adopted several policies that reflect best practices in governance and disclosure. These include a Disclosure Policy, a Code of Business Conduct, a Whistleblower Policy and an Insider Trading Policy. These policies are compliant with the corporate governance guidelines of the Canadian Securities Administrators. As a public company, First National's Board continues to update, develop and implement appropriate governance policies and practices as it sees fit.

COMMITTEES

The Board of Directors has established an Audit Committee and a Compensation, Governance and Nominating Committee to assist in the efficient functioning of the Fund's corporate governance strategy.

Audit Committee

The Audit Committee's responsibilities include:

- Management of the relationship with the external auditor including the oversight and supervision of the audit of the Fund's financial statements;
- Oversight and supervision of the quality and integrity of the Fund's financial statements; and

- Oversight and supervision of the adequacy of the Fund's internal accounting controls and procedures, as well as its financial reporting practices.

The Audit Committee consists of three independent directors, all of whom are considered financially literate for the purposes of the Canadian Securities Administrators' Multilateral Instrument 52-110 – Audit Committees.

Committee Members: John Brough (Chair), Peter Copestake and Robert Mitchell

Compensation, Governance and Nominating Committee

The Compensation, Governance and Nominating Committee's responsibilities include:

- Making recommendations concerning compensation of the Fund's senior executive officers and the remuneration of the Board of Directors;
- Developing the Fund's approach to corporate governance issues and compliance with applicable laws, regulations, rules, policies and orders with respect to such issues;
- Advising the Board of Directors on filling director vacancies;
- Periodically reviewing the composition and effectiveness of the directors and the contributions of individual directors; and
- Adopting and periodically reviewing and updating the Fund's written Disclosure Policy.

The Compensation, Governance and Nominating Committee consists of three independent directors for the purposes of the Canadian Securities Administrators' Multilateral Instrument 58-101 – Disclosure of Corporate Governance Practices.

Committee Members: Stanley Beck (Chair), Duncan Jackman and Peter Copestake

BOARD MEMBERS

INTRODUCTION

Collectively, the Board of Directors has extensive experience in mortgage lending, real estate, strategic planning, law and finance. The Board consists of seven members, five of whom are independent.

Stephen Smith (Chairman) is President and Co-founder of First National Financial. He has been an innovator in the development and utilization of various securitization techniques to finance mortgage assets throughout his career. He is the Vice Chairman of GO Transit, a member of the board of directors of The Dominion of Canada General Insurance Company and The Empire Life Insurance Company and a governor of The Dominion Institute. Mr. Smith has an M.Sc. (Economics) from the London School of Economics and Political Science and a B.Sc. (Honours) in electrical engineering from Queen's University.

Moray Tawse is Vice President, Mortgage Investments and Co-founder of First National Financial. In addition to directing the operations of all the company's commercial mortgage origination activities, he is one of Canada's leading experts on commercial real estate and is often called upon to deliver keynote addresses at national real estate symposiums. Prior to co-founding First National, Mr. Tawse was Manager of Mortgages for the Guaranty Trust Company of Canada from 1983 to 1988.

Stanley Beck, Q.C. is the President of Granville Arbitrations Limited. He was previously a Professor of Law and Dean at Osgoode Hall Law School. From 1985 to 1990, he served as Chairman of the Ontario Securities Commission. Mr. Beck is also the Chairman of 407 International Inc. and GMP Capital Trust and serves as a director on the boards of Scotia Utility Corp., Scotia NewGrowth Corp. and Hollinger Inc.

John Brough recently retired from his position as President of both Wittington Properties Limited and Torwest Inc., a role he held from 1998 to 2007. From 1996 to 1998, he was Executive Vice President and Chief Financial Officer of iStar Internet, Inc. From 1974 until 1996, he was with Markborough Properties, Inc., where for the last 10 years he served as Senior Vice President and Chief Financial Officer. He is a director of Kinross Gold Corporation, Silver Wheaton Corp., Canadian REIT,

Livingston International Inc. and Quadra Mining Ltd. He has a Bachelor of Arts (Economics) degree from the University of Toronto and is a Chartered Accountant.

Peter Copestake serves as a corporate director and consultant to business, academic and government organizations globally, and most recently served in the role of Senior Vice President and Treasurer of Manulife Financial. He is currently Chairman Emeritus of the Association for Financial Professionals of Canada, Chair Emeritus of the Society of Canadian Treasurers, Chairman of the Independent Review Committee for the Board of First Trust Portfolios and a member of the board of directors of Manulife Bank and Canadian Derivatives Clearing Corporation. Mr. Copestake has a Master of Business Administration in Finance from Dalhousie University and a Bachelor of Arts from Queen's University.

Duncan Jackman is the Chairman, President and Chief Executive Officer of E-L Financial Corporation Ltd., and the Chairman and President of Economic Investment Trust Ltd. and United Corporations Ltd. Prior to this, he was a portfolio manager at Cassels Blaikie and an investment analyst at RBC Dominion Securities Inc. Mr. Jackman has a Bachelor of Arts in Literature from McGill University.

Robert Mitchell has been the President of Dixon Mitchell Investment Counsel Inc. since 2000. Prior to that, he was Vice President, Investments at Seaboard Life Insurance Company. He is currently a director and audit committee chair for Discovery Parks Holdings Ltd. and a trustee for Discovery Parks Trust. Mr. Mitchell has a Master of Business Administration degree from the University of Western Ontario, a Bachelor of Commerce (Finance) from the University of Calgary and is a CFA charterholder.

Management's Discussion and Analysis

The following management's discussion and analysis of financial condition and results of operations is prepared as of March 9, 2010. This discussion should be read in conjunction with the audited consolidated financial statements of First National Financial Income Fund (the "Fund") and First National Financial LP ("FNFLP") as at and for the year (the "period") ended December 31, 2009 (as applicable) and the notes thereto. This discussion should also be read in conjunction with the audited consolidated financial statements and notes thereto of the Fund and FNFLP for the year ended December 31, 2008. The audited consolidated financial statements of the Fund and FNFLP have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

The Fund earns income from its 21.15% interest in FNFLP. The Fund accounts for its investment in FNFLP using the equity method and therefore does not consolidate the results of operations of FNFLP. As a result, financial statements with accompanying notes thereon have been presented for both the Fund and FNFLP. In addition, the following management's discussion and analysis ("MD&A") presents a discussion of the financial condition and results of operations for both the Fund and FNFLP.

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 "non-GAAP measures" such as "EBITDA", "Distributable Cash" and "Distributable Cash per Unit" should not be construed as alternatives to net income or loss or other comparable measures determined in accordance with GAAP as an indicator of performance or as a measure of liquidity and cash flow. Non-GAAP measures do not have standard meanings prescribed by GAAP and therefore may not be comparable to similar measures presented by other issuers.

The Fund is entirely dependent upon the operations and financial condition of FNFLP. The earnings and cash flows of FNFLP are affected by certain risks. For a description of those risks, please refer to the "Risk and Uncertainties Affecting the Business" section.

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

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

GENERAL DESCRIPTION OF THE FUND AND FIRST NATIONAL FINANCIAL LP

Pursuant to an underwriting agreement dated June 6, 2006 and initial public offering ("IPO"), the Fund sold 10,600,000 units of the Fund ("Fund Units", "Units" or "Unit"), at a price of \$10.00 per Unit for proceeds totalling \$106,000,000. The proceeds of the offering were used to partially fund the indirect acquisition (through the Fund's wholly-owned subsidiary, First National Financial Operating Trust) by the Fund of a 17.94% interest in FNFLP. In turn, FNFLP purchased the net business assets of First National Financial Corporation ("FNFC") as predecessor to FNFLP. Subsequently, with the issue of Units pursuant to an over-allotment option and its Distribution Reinvestment Plan ("DRIP"), the Fund now indirectly holds a 21.15% interest in FNFLP and FNFC holds a 78.85% controlling interest in FNFLP.

First National Financial Income Fund

The Fund is an unincorporated, open-ended trust established under the laws of the Province of Ontario on April 19, 2006, pursuant to a Declaration of Trust. The Fund was established to acquire and hold, through a newly constituted wholly-owned trust, First National Financial Operating Trust (the "Trust"), investments in the outstanding limited partnership units of FNFLP. Each unitholder participates pro rata in any distribution from the Fund. Income tax obligations related to the distributions of the Fund are the obligations of the unitholders. The Fund effectively commenced operations through its indirect investment in FNFLP on June 15, 2006 and the income reported by the Fund commenced on that date.

SELECTED QUARTERLY INFORMATION

Quarterly Results of First National Financial Income Fund (in \$000s, except for per Unit amounts)

	Revenue	Net Income for the period	Net Income per Unit	Total Assets
2009				
Fourth Quarter	\$ 7,100	\$ 6,950	\$ 0.55	\$ 119,296
Third Quarter	\$ 7,092	\$ 5,192	\$ 0.41	\$ 116,961
Second Quarter	\$ 6,413	\$ 5,463	\$ 0.43	\$ 114,138
First Quarter	\$ 4,498	\$ 4,048	\$ 0.32	\$ 112,005
2008				
Fourth Quarter	\$ 1,560	\$ 1,210	\$ 0.09	\$ 112,675
Third Quarter	\$ 4,617	\$ 4,117	\$ 0.33	\$ 115,716
Second Quarter	\$ 3,946	\$ 3,696	\$ 0.30	\$ 113,286
First Quarter	\$ 3,299	\$ 2,799	\$ 0.24	\$ 102,592

INVESTMENTS

At December 31, 2009, the Fund had an investment in 12,681,113 units (21.15%) of First National Financial LP at a cost of \$122,670,434. Under Canadian GAAP, the Fund is required to account for this investment using the equity method. During the year ended December 31, 2009, the Fund's earnings from FNFLP were \$34.6 million, amortization of identifiable assets inherent in the investment was \$9.5 million and the carrying value of this investment at December 31, 2009 was \$117.1 million.

STATEMENT OF DISTRIBUTABLE CASH

(in \$000s, except where noted)

	For the quarter ended		For the year ended	
	December 31 2009	December 31 2008	December 31 2009	December 31 2008
First National Financial LP				
Distributable Cash from First National Financial LP ⁽¹⁾	\$ 30,252	\$ 18,795	\$ 76,907	\$ 81,818
First National Financial Income Fund				
Weighted Average Share of Distributable				
Cash from First National Financial LP ⁽¹⁾	6,399	3,975	16,266	16,991
Distributable Cash per Unit (\$/Unit) ⁽¹⁾	0.50	0.31	1.28	1.37
Distributions Declared	5,390	5,168	18,388	16,844
Distributions Declared per Unit (\$/Unit)	0.42	0.41	1.45	1.36
Payout Ratio	84%	132%	113%	99%

(1) Distributable cash and distributable cash per Unit are non-GAAP measures generally used by Canadian open-ended trusts as an indicator of financial performance. They are considered key measures as they demonstrate the cash available for distributions to unitholders. See FNFLP section in this MD&A for their determination.

DISTRIBUTIONS

The initial public offering described above closed on June 15, 2006, and beginning on this date the Fund began making monthly distributions at the rate of \$0.07917 per Unit on or around the 15th of each month. Subsequently, the Fund increased the monthly distribution each year: to \$0.10417 per Unit in 2007, \$0.1125 per Unit in 2008 and \$0.125 per Unit beginning with the distribution paid on October 15, 2009. The Fund also announced special distributions in December of the last three years. In 2009 the amount was \$0.05, in 2008 the amount was \$0.07 per Unit and in 2007 the amount was \$0.06 per Unit. For the year, the Fund's distributions of approximately \$18.4 million were equivalent to the distributions that the Fund received from FNFLP. The current monthly distribution rate represents an annualized distribution rate of \$1.50 per Unit, a 58% increase from the distribution rate contemplated at the time of the IPO. The following table shows the payout ratio based on the Fund's pro rata share of distributable cash earned by FNFLP.

For the year ended December 31, 2009, the payout ratio was 113%. Despite strong earnings, distributable cash was adversely affected by working capital requirements, particularly increased liquidity required to support the Alt-A program. The requirements totalled approximately \$1.9 million at the Fund level at year end, accounting for a use of \$0.15/Unit of distributable cash. The Alt-A support requirements peaked in the third quarter of 2009. In the fourth quarter, the Fund received more cash than it invested in working capital, such that the payout ratio was 84% for the quarter. These ratios were also affected by the large portion of the Company's income related to gains on securitization revenue. These gains provide only insignificant amounts of cash in the period of recognition; however, the Company is still liable for the full cost of origination, which is entirely cash based. The ratio of distributions to net income at the FNFLP level, which management believes is an important ratio, was 53% for the year.

INCOME TAXES

The Fund is a mutual fund trust for income tax purposes. As such, the Fund is only taxed on any amount of taxable income not distributed to unitholders. The Fund intends to distribute substantially all of its taxable income to its unitholders and also intends to comply with the provisions of the Income Tax Act (Canada) that permit, among other items, the deduction of distributions to unitholders from the Fund's income for tax purposes.

As described in the Fund's financial statements and the "Income Tax Matters" section later in this analysis, on June 22, 2007, the government enacted previously announced legislation that will have the effect of imposing additional income taxes on the Fund commencing January 1, 2011. Accordingly, the Fund's financial statements have been affected in two ways: (1) a future tax liability has been accrued based upon the net book value of the intangible assets inherent in the carrying value of the Fund's investment in FNFLP; and (2) a future tax liability has been accrued related to differences between the net book value of assets and liabilities in FNFLP and their tax cost base.

ACCRUED FUTURE TAX LIABILITY ON INTANGIBLE ASSETS

The first issue relates to the intangible assets described in Note 2 to the financial statements. Due to a difference between the accounting carrying value of these assets and their underlying tax carrying value, GAAP requires that a future tax liability be accrued. This was effectively accrued at the time of the IPO based on the then current effective tax rate for income trusts, which was a rate of Nil. Under the new laws enacted on June 22, 2007, together with the general tax changes announced subsequently, the effective tax rate for the Fund as at January 1, 2011 was changed to approximately 29%. Based on this new rate, the Fund accrued a future tax liability related to these assets of \$8.5 million in June 2007. Commencing in the second quarter of 2008, the difference between the accounting carrying value of these assets and their underlying tax carrying value increased pursuant to increased investment in FNFLP made through the DRIP. As such, the Fund has accrued an additional future tax liability of \$1.05 million. In 2009 the Fund recorded a credit to the provision for future taxes as enacted changes in federal and provincial tax rates reduced this tax liability by \$0.6 million. The combined liability of \$8.6 million is expected to be drawn down beginning on January 1, 2011, as the Fund continues to amortize the related intangible assets until 2016. This future tax liability is an accounting convention and has no effect on the distributable cash of the Fund.

ACCRUED FUTURE TAX LIABILITY ON INVESTMENT IN FNFLP

Similar to the discussion above, there can also be differences in accounting and tax carrying values of certain assets and liabilities in FNFLP. Because there is no tax levied at the partnership level, these differences are temporary and require tax allocation accounting at the Fund level. In the reporting periods ended prior to June 22, 2007, these differences had been accounted for using a tax rate of Nil. As the new rules have been enacted, the Fund has accounted for these differences with the applicable higher tax rates. As at December 31, 2009, these differences were such that the Fund recorded a future tax liability of \$5.15 million. This tax liability represents the Fund's estimated pro rata share of tax liabilities that FNFLP will incur in the periods subsequent to December 31, 2010 and is based on timing differences related to the period from June 15, 2006 (the IPO date) to December 31, 2009. Up until June 22, 2007, the Fund had been applying tax rates to temporary differences in FNFLP at a Nil tax rate. This was based on the assumption that the Fund would make sufficient tax-deductible cash distributions to unitholders such that the Fund's taxable income would be Nil for the foreseeable future. The new legislation enacted on June 22, 2007 imposes a tax on certain income distributed to unitholders such that income taxes may become payable in the future. For the year ended December 31, 2009, the Fund recorded a provision for future taxes on these differences of \$4.4 million.

The Fund has estimated both of these future income tax accruals based on its best estimates of the results of operations, current tax legislation and future cash distributions, assuming no material change to the Fund's current organizational structure. The Fund's estimate of future income taxes will vary as the Fund's assumptions vary in accordance with the factors above, and such variations may be material. Until 2011, the new legislation does not directly affect the Fund's distributable cash and, as such, does not affect the Fund's financial condition.

OUTSTANDING SECURITIES OF THE FUND

At December 31, 2009 and March 9, 2010, the Fund had 12,681,113 Units outstanding.

FNFC holds 47,286,316 exchangeable Class B LP units of FNFLP, each of which is exchangeable into one Fund Unit at no cost at any time at the option of FNFC, and each of which carries a Special Voting Right that entitles the holder to receive notice of, attend and vote at all meetings of unitholders of the Fund.

CRITICAL ACCOUNTING ESTIMATES

Management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements, and revenues and expenses during the reporting period. Management reviews these estimates on an ongoing basis, including those related to securitization accounting and future income taxes. Changes in facts and circumstances may result in revised estimates and actual results may differ from these estimates.

BUSINESS RISKS

The Fund is entirely dependent upon the operations and financial condition of FNFLP. The earnings and cash flows of FNFLP are affected by certain risks. For a description of those risks, please refer to the "Risk and Uncertainties Affecting the Business" section in the First National Financial LP portion of this analysis.

GUARANTEE

The Fund's wholly-owned subsidiary, First National Financial Operating Trust, has provided guarantees to and subordinated their rights to receive payments from FNFLP in respect of FNFLP's \$378 million bank credit facility.

First National Financial LP

BASIS OF PRESENTATION

The financial statements of First National Financial LP ("FNFLP" or the "Company") are prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). FNFLP is considered to be a continuation of FNFC's business following the continuity of interest method of accounting. Under this method of accounting, FNFLP's acquisition of the FNFC business is recorded at the net book value of FNFC's business assets and liabilities on June 14, 2006 and the equity of FNFLP represents the equity of the FNFC business at that date.

EXECUTIVE SUMMARY

In 2009, the Company achieved record profitability: capitalizing on strong mortgage origination while optimizing the use of its diverse funding sources. More specifically, the year featured sustained growth in mortgages under administration, revenue and net income. The demand for prime insured mortgages was strong and wide spreads were earned on much of the Company's origination. This allowed the Company to earn higher profits on its most creditworthy products and increase origination volumes of multi-unit residential mortgages. Single-family residential origination volumes rebounded from a slow start in the first quarter of the year such that year-over-year volumes were similar to those experienced in 2008.

2009 RESULTS SUMMARY

- During the year, the Company increased the annual distribution rate by 11% from \$1.35 per Unit to \$1.50 per Unit based on growing profits and increasing cash flow from operations.
- Mortgages under administration grew to \$47.8 billion at December 31, 2009 from \$40.6 billion at December 31, 2008, an increase of 18%; the growth from September 30, 2009, when mortgages under administration were \$45.9 billion, was 17% on an annualized basis.
- After a slow start to 2009, the Canadian single-family real estate market showed its strength with three strong quarters to end the year. Total mortgage originations for the Company declined by 1% from \$11.9 billion in 2008 to \$11.8 billion for 2009. Excluding \$225 million of Alt-A originations in 2008, mortgage origination increased by 1% from 2008 to 2009.
- Revenue for the year ended December 31, 2009 increased by 16% year-over-year as larger gains on securitization were earned by the Company, driven by wide mortgage spreads and more liquidity in the credit markets.
- Net income increased by 51% for the year ended December 31, 2009 compared to 2008. This increase resulted from higher volumes and margins experienced in both the single-family and multi-unit residential origination departments, particularly from gains on securitization related to the Company's single-family NHA-MBS program.
- EBITDA increased by 51% for the year ended December 31, 2009 compared to last year. This increase was due to the same factors cited above for net income.

Subsequent to year end the Company's business model was validated as DBRS assigned an issuer rating of BBB with a Stable trend. DBRS indicated that this rating reflects the Company's status as Canada's largest non-bank mortgage originator and servicer; its strong asset quality, as well as its servicing capabilities.

SELECTED QUARTERLY INFORMATION FOR RESULTS OF FNFLP

	Revenue	Net Income for the period	Net Income (\$/unit)	Total Assets
2009				
Fourth Quarter	\$ 88,280	\$ 44,768	\$ 0.75	\$ 1,067,690
Third Quarter	\$ 96,161	\$ 44,730	\$ 0.75	\$ 1,122,651
Second Quarter	\$ 91,570	\$ 41,519	\$ 0.69	\$ 919,300
First Quarter	\$ 65,705	\$ 32,466	\$ 0.54	\$ 905,774
2008				
Fourth Quarter	\$ 59,488	\$ 17,743	\$ 0.29	\$ 737,065
Third Quarter	\$ 91,266	\$ 33,649	\$ 0.56	\$ 857,273
Second Quarter	\$ 76,893	\$ 30,098	\$ 0.51	\$ 1,001,600
First Quarter	\$ 66,312	\$ 26,531	\$ 0.45	\$ 663,594

MANAGEMENT'S DISCUSSION AND ANALYSIS

First National's quarterly revenue can be divided into two categories, (1) seasonally affected revenues and (2) those which are steadily earned throughout its fiscal year. Mortgage servicing income, mortgage investment income interest and, generally, residual securitization income accrue to the Company each quarter and will reflect the trend of the changing portfolio of mortgages under administration. Alternatively, origination (including placement and securitization) activities are more seasonal in nature. This is particularly true for single-family residential origination, for which volumes follow the purchasing patterns of single-family home buyers: origination activity is generally slower in the first quarter of each year; increases in the second quarter; peaks in the third quarter and gradually retreats in the last quarter of the year. Single-family origination has the effect of "smoothing out" net income fluctuations because the large amount of revenue generated from this category does not generally result in significant income due to the high percentage of related brokerage fees.

Both the seasonal and income smoothing trends are apparent in the information presented above except the fourth quarter of 2008. In this quarter, the Company took charges against revenue related to unrealized fair value adjustments on the Company's securitization assets. If these adjustments are added back, revenue and net income for these quarters would have been in line with seasonal expectations and a growing business. In 2009, a steady mortgage origination market benefited from more reliable capital markets, as First National was able to earn higher margins on both single-family and multi-unit residential origination, creating record net income.

Total assets fluctuated between \$663 million and \$1.1 billion over the past eight quarters due primarily to movements between the periods in the amount of securities purchased under resale agreements which are used for hedging purposes.

SELECTED ANNUAL FINANCIAL INFORMATION FOR THE COMPANY'S FISCAL YEAR ENDED

(\$000s, except per unit amounts)

	December 31 2009	December 31 2008	December 31 2007
For the Period			
Income Statement Highlights			
Revenue	\$ 341,716	\$ 293,959	\$ 238,971
Brokerage fees	(98,677)	(105,757)	(102,886)
Other operating expenses	(77,807)	(78,526)	(61,999)
EBITDA ⁽¹⁾	165,232	109,675	74,086
Amortization of capital assets	(1,749)	(1,654)	(1,242)
Provision for income taxes	-	-	-
Net income	163,483	108,021	72,844
Distributions declared	86,953	81,233	71,497
Per Unit Highlights			
Net income per Unit	2.73	1.81	1.23
Distributions declared per Unit	1.45	1.36	1.21
At Period End			
Balance Sheet Highlights			
Total assets	1,067,690	737,065	460,336
Total long-term financial liabilities	\$ -	\$ -	\$ -

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

VISION AND STRATEGY

The Company provides mortgage financing solutions to virtually the entire mortgage market in Canada. By offering a full range of mortgage products, with a focus on customer service and superior technology, the Company believes that it is the leading non-bank mortgage lender in the industry. Growth has been achieved while maintaining a relatively conservative risk profile. The Company intends to continue leveraging these strengths to lead the "non-bank" mortgage lending industry in Canada, while appropriately managing risk.

The Company's strategy is built on four cornerstones: Providing a full range of mortgage solutions; growing assets under administration; employing leading-edge technology to lower costs and rationalize business processes; and maintaining a conservative risk profile. An important consequence of the Company's strategy is its direct relationship with the mortgage borrower. Although the Company places most of its originations with third parties, FNFLP is perceived by all 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 higher margin mortgages;
- Lowering the costs of operations through the innovation of systems and technology; and
- Employing innovative securitization transactions to minimize funding costs.

GROWTH IN PORTFOLIO OF MORTGAGES UNDER ADMINISTRATION

Management considers the growth in mortgages under administration ("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 mortgage servicing portfolios purchased from third parties. Mortgage originations not only drive placement and securitization revenues but, perhaps more importantly, longer term values such as servicing fees, mortgage administration fees, renewal opportunities and growth in customer base for marketing initiatives. As at December 31, 2009, mortgages under administration totalled \$47.8 billion, up from \$40.6 billion at December 31, 2008, a rate of increase of 18%. This compares to \$45.9 billion at September 30, 2009, representing a quarter-over-quarter increase of 4% and an annualized increase of 17%.

GROWTH IN ORIGINATION OF HIGHER MARGIN MORTGAGES

The Company's main focus has always been on the prime single-family mortgage market. Prior to the credit issues which have affected the market in the last three years, these mortgages had tight spreads such that the Company's strategy was to sell these mortgages on commitment to institutional investors and retain the servicing. This strategy changed with the challenges in the credit environment and the Company was able to take a larger portion of the spread for itself. Liquidity and credit concerns increased the cost of funding for most, if not all, of the Company's competitors, particularly the five large Canadian banks. Given the increased costs, mortgage rates did not fall in step with Government of Canada bond yields, such that spreads on prime single-family mortgages have been at historically wide margins since mid-2007. In the spring of 2007, such spreads for discounted five-year mortgage rates were approximately 1.25 percentage points. For 2009, comparable spreads began the year as high as 3.00 percentage points; however, in the first quarter of 2009 mortgage spreads began narrowing as competition among lenders began to lower mortgage rates. Each quarter throughout the year brought more tightening, such that by year end spreads were back to pre-crisis historical norms. The Company also took advantage of wider spreads on floating rate single-family mortgages in 2009. Historically such mortgages were priced at a discount to prime (a discount that reached a high of 0.90 percentage points in 2007). In 2009, these mortgages began the year priced at prime plus 0.80 percentage points as liquidity issues affected the large banks' funding costs. As the liquidity issues were resolved, pricing gradually narrowed during the year such that by year end these mortgages were being originated at slight discounts to prime. Although these spreads have tightened during the year, the bid from the NHA-MBS market for this product tightened as well. The Company chose to securitize much of this origination as it was able to earn a higher return than on an institutional placement. In 2009, the Company originated for securitization approximately \$2 billion of floating rate single-family mortgages to take advantage of these wider spreads.

LOWERING COSTS OF OPERATIONS THROUGH INNOVATION OF SYSTEMS AND TECHNOLOGY

The Company has always used technology to provide for efficient and effective operations. This is particularly true for its MERLIN underwriting system, Canada's only web-based real-time broker information system. By creating a paperless, 24/7 available commitment management platform for mortgage brokers, the Company is now ranked among the top three lenders by market share in the broker channel. This has translated into increased single-family origination volumes and higher closing ratios (the percentage of mortgage commitments the Company issues that actually become closed mortgages). Despite a sometimes volatile year, the Company was able to maintain its single-family origination volumes, which were \$8.5 billion for the year ended December 31, 2009. This represents a decrease of 3% from \$8.8 billion originated in 2008, which included \$225 million of Alt-A product.

EMPLOYING INNOVATIVE SECURITIZATION TRANSACTIONS TO MINIMIZE FUNDING COSTS

Uncertainty in the Asset-Backed Commercial Paper ("ABCP") Market

As described in the MD&A in prior periods, ABCP funded by third-party sponsored ABCP conduits became frozen in August 2007 due to liquidity and credit concerns. Similar issues have affected bank-sponsored ABCP conduits. The Company has continued to fund a portion of its assets (approximately \$1.5 billion of the \$47.8 billion of MUA as at December 31, 2009) with bank-sponsored ABCP. Although bank-sponsored ABCP has continued to trade in the marketplace, its cost has varied greatly in the past two years due to uncertainty surrounding both the quality of the underlying assets and the bank's ability to support the paper's continued liquidity. During 2008, ABCP spreads were volatile, trading at spreads ranging between 0.10 percentage points and 1.10 percentage points in excess of historical levels. The Company considers historical levels to be when ABCP traded at the same rates as bankers' acceptances rates ("BA"). In the fourth quarter of 2008, the global credit crisis worsened: the Bank of Canada dropped overnight lending rates dramatically; the cost of funds for the large Canadian banks increased significantly and fears of recession grew. Together, these events negatively affected potential ABCP investors, resulting in spreads that increased to approximately 1.10 percentage points in excess of BA as at December 31, 2008. In the first half of 2009, spreads began tightening as the credit markets stabilized such that by December 31, 2009, 30-day AAA-rated ABCP traded at rates comparable to BA.

The Company is required to mark-to-market its securitization receivables at the end of each reporting period. A significant portion of those receivables are calculated using assumptions about the cost of funding arranged through the ABCP market. At the end of 2008, the Company had approximately \$1.7 billion of mortgages under administration funded with ABCP, including all of its Alt-A mortgages. The Company's exposure to ABCP at December 31, 2009 has decreased to \$1.4 billion. As described above, advertised ABCP spreads narrowed during the course of the year. Although the banks' trading desks indicate that the spot rate for AAA-rated ABCP was the same as BA rates at the end of the year, the costs passed through to the Company from the bank-sponsored conduits have averaged approximately 0.25 percentage points for the six-month period ended December 31, 2009. Management believes that there is still some uncertainty in this market, which may lead to further fluctuations in pricing, and considers its best estimate of fair value to be represented by its actual ABCP costs. The Company has changed its assumption such that its models assume that ABCP will trade at 0.25 percentage points over BA. Accordingly, in the year the Company has recorded an unrealized gain of \$16.4 million with respect to the changing fair value of the Company's securitization receivables involving ABCP.

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

The Company has been involved in the issuance of National Housing Act – Mortgage Backed Securities ("NHA-MBS") since 1995. This program has been very successful, with over \$4 billion of NHA-MBS issued. In December 2007, the Company was approved by Canada Mortgage and Housing Corporation ("CMHC") as an issuer of NHA-MBS and as a seller into the Canada Mortgage Bond ("CMB") program, one of the first non-OSFI regulated companies in Canada to be so approved. Issuer status will provide the Company with another funding source that it will be able to access independently. Perhaps more importantly, seller status for the CMB will give the Company direct access to the CMB. This status has also allowed the Company to participate in the federal government's NHA-MBS reverse auction and has provided the Company with an additional, albeit temporary, source of liquidity. In addition, the demand for high-quality fixed income and floating rate investments increased significantly in the year. This demand allowed the Company to issue \$1.7 billion of NHA-MBS pools consisting of single-family floating rate mortgages directly through the NHA-MBS market during the year.

Canada Mortgage Bond (CMB) Program

The CMB program is an initiative introduced by CMHC whereby the Canada Housing Trust ("CHT") issues securities to investors in the form of semi-annual interest-yielding five-year bonds. The proceeds of these bonds are used to buy NHA-MBS. In previous years, the Company entered into an agreement with a Canadian bank which allowed the Company to indirectly sell a portion of the Company's residential mortgage origination into several CMB issuances. Subsequently, pursuant to the Company's approval as a seller into the CMB, the Company was able to make direct sales into the program. Because of the similarities to a traditional Government of Canada bond (both have five-year unamortizing terms with a government guarantee), the CMB trades in the capital markets at a modest premium to the yields on Government of Canada bonds. The Company's 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 these funding structures do not amortize, the Company can fund future mortgages through this channel as the original mortgages amortize or pay out. The Company also enjoys significant demand for mortgages from investment dealers who sell directly into the CMB. Because of the effectiveness of the CMB, there have been requests from approved

CMB sellers for larger issuances. CHT has indicated that it will not unduly increase the size of its issuances, and has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is also subject to these limitations.

KEY PERFORMANCE INDICATORS

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

- Earnings before income taxes, depreciation and amortization ("EBITDA"); and
- Distributable cash.

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

(\$000s)	Quarter ended		Year ended	
	December 31 2009	December 31 2008	December 31 2009	December 31 2008
For the Period				
Revenue	\$ 88,280	\$ 59,488	\$ 341,716	\$ 293,959
Net income	44,768	17,743	163,483	108,021
EBITDA ⁽¹⁾	45,247	18,201	165,232	109,675
At Period End				
Total assets	1,067,690	737,065	1,067,690	737,065
Mortgages under administration	47,793,045	40,596,013	47,793,045	40,596,013

(1) This non-GAAP measure adjusts income before income taxes by adding back expenses for amortization of capital assets.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Distributable cash is not a defined term under GAAP. Management believes that net cash generated by FNFLP prior to distribution is an important measure for investors to monitor. Management cautions investors that due to the Company's nature as a mortgage seller and securitizer, there will be significant variations in this measure from quarter to quarter as the Company collects and invests cash from mortgage transactions. Distributable cash is determined by the Company as cash provided from operating activities increased/decreased by the change in mortgages accumulated for sale in the period and reduced by capital expenditures. Mortgages accumulated for sale consist primarily of mortgage loans that the Company

funds on behalf of institutional investors. Normally a few days after funding, the Company aggregates all mortgages "warehoused" to date for each investor and receives a cash settlement. As the majority of mortgages are advanced in the last few days of a month, there are large amounts of cash invested at quarter ends by the Company that are typically received in the first week of the subsequent quarter. The Company's credit facility provides full financing for the majority of these mortgage loans. Accordingly, management believes the measure of distributable cash is only meaningful if the change in mortgages accumulated for sale between reporting periods is accounted for.

DETERMINATION OF DISTRIBUTABLE CASH

(\$000s)	Quarter ended		Year ended	
	December 31 2009	December 31 2008	December 31 2009	December 31 2008
For the Period				
Cash provided by (used in) operating activities	\$ (91,838)	\$ (35,263)	\$ (83,549)	\$ (79,797)
Add (deduct):				
Cash change in mortgages accumulated for sale between periods	122,302	54,292	161,966	162,526
Less:				
Capital expenditures	(212)	(234)	(1,510)	(911)
Distributable cash ⁽¹⁾	\$ 30,252	\$ 18,795	\$ 76,907	\$ 81,818

(1) This non-GAAP measure adjusts cash provided by (used in) operating activities by accounting for changes between periods in mortgages accumulated for sale and deducting maintenance capital expenditures.

REVENUES AND FUNDING SOURCES

Mortgage Origination

The Company derives a significant amount of its revenue from mortgage origination activities. The majority of mortgages originated are funded by either placement with institutional investors or sale to 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 provides the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2009, origination volume decreased from \$11.9 billion to \$11.8 billion or 1% from the prior year.

Placement Fees, Gain on Securitization and Gain on Deferred Placement Fees

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor or sold to a securitization conduit. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as "Placement fees". Prior to 2009, the present value of additional amounts (excess spread) expected to be received over the remaining life of the mortgages sold (net of servicing and other costs) was included with "Gain on securitization". The excess spread on a mortgage is the difference between the interest rate on the mortgage and the yield earned by the investor after accounting for all anticipated prepayment provisions, servicing obligations and other costs. For Alt-A and small conventional multi-unit residential and commercial mortgages, the excess spread also includes assumptions for credit losses.

Beginning in the first quarter of 2009, the Company changed the presentation of such gains, dividing the revenue into two components. Going forward the Company separates this revenue into "Gain on deferred placement fees" and "Gain on securitization".

This distinction acknowledges the nature of the future payments being received. At the time of the IPO, these future payments represented primarily the present value of future payments from direct securitization by the Company, where the Company was the principal risk taker. This included securitizations through ABCP, NHA-MBS and the CMB program. At that time, the Company also entered into transactions with institutional investors in which placement fees were received over time instead of just at the time of the mortgage sale. In these cases the Company applied the same accounting methodology as it had with the direct securitization transactions; future expected cash flows were discounted to present and a gain on securitization was recorded. While arguably a different type of revenue, the Company determined it was insignificant to disclose separately from regular "Gain on securitization" revenue. As described in previous discussions, the Company began to enter into more placement transactions that attracted larger deferred placement fees starting in the third quarter of 2007. During 2008, a significant portion of the Company's direct securitization business ceased, particularly with the discontinuance of the uninsured Alt-A program. Accordingly, deferred gains related to placement activity became a larger and larger component of the "Gain on securitization" revenue line. The Company believes that such revenue is better described as "Gain on deferred placement fees" as the Company is not directly securitizing these mortgages but placing them with institutional investors. It has used this new presentation for its revenue beginning in the first quarter of 2009, reclassifying comparative figures on the same basis.

Upon the recognition of a "Gain on securitization", the Company establishes a "Securitization receivable", which is amortized as spread income is received by the Company. In addition, the Company is also required to establish a "Servicing liability", which represents the future cost of servicing the securitized mortgages. As spread income is received by the Company, both the securitization receivable and the servicing liability are amortized accordingly. Residual securitization income consists of two components: (a) the difference between the spread income received over time and the spread income assumed in the Company's derivation of securitization receivable at the time of sale; and b) the amortization of the servicing liability. The excess is attributable to better than expected cash flows being earned by the securitization compared to those anticipated when gain on sale assumptions regarding prepayments, cost of funds and credit losses were originally forecasted. All mortgages securitized through the Company's ABCP programs or directly sold as NHA-MBS or CMB produce "Gain on securitization" revenue. Of the Company's \$11.8 billion of originations for the year ended December 31, 2009, \$451 million was originated for ABCP conduits and other securitization vehicles, and \$2.1 billion for direct sale to the NHA-MBS market, both generating "Gain on securitization" revenue.

For all institutional placements and most mortgages securitized through the NHA-MBS program, 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. Of the Company's \$11.8 billion of originations for the year ended December 31, 2009, \$6.5 billion was placed with institutional investors and \$2.8 billion was originated for institutional investors involved in the issuance of NHA-MBS. 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. Upon the recognition of a "Gain on deferred placement fee", the Company establishes a "Deferred placement fee receivable", which is amortized as income is received by the Company with similar accounting as described in the previous paragraph for a "Securitization receivable".

In the past several years, the Company has experienced significant growth in mortgages funded through its securitization programs and deferred placement fee activities. As a result, revenues from "Gain on securitization" and "Gain on deferred placement fees" have increased accordingly. Since cash flows received from these assets are received over the life of the mortgages involved and the revenue is recognized upon securitization, there will be a timing difference between the recognition of revenue and the receipt of cash. The financial effect of the timing difference between the recognition of revenue and the receipt of cash is effectively equal to the sum of "Gains on securitization" and "Gains on deferred placement fees" less the "Amortization of securitization and deferred placement fees receivable" (net of "Amortization of servicing liability") for any given period. For the year ended December 31, 2009, the volume of mortgages funded through NHA-MBS and institutional placements that earn either "Gain on securitization" or "Gain on deferred placement fees" revenue increased. This timing difference required working capital funding of approximately \$79.3 million for the year ended December 31, 2009 (\$36.6 million for the year ended December 31, 2008). To the extent that gains on securitization and deferred placement fees do not increase for a number of years, the effects of the timing difference would be neutralized, as new securitization and deferred placement receivables would be offset by collections of existing receivables.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

are earned by the Company throughout the mortgage term. Another aspect of servicing is the administration of funds held in trust, including borrower's property tax escrow, 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 bank that maintains the deposit account, which has resulted in significant interest revenue.

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

RESULTS OF OPERATIONS

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

(\$ millions)	Quarter ended		Year ended	
	December 31 2009	December 31 2008	December 31 2009	December 31 2008
Mortgage Originations by Asset Class				
Single-family residential	\$ 2,018	\$ 1,910	\$ 8,468	\$ 8,757
Multi-unit residential and commercial	841	869	3,319	3,129
Total originations	2,859	2,779	11,787	11,886
Funding of Mortgage Originations by Source				
Institutional investors	1,101	1,935	6,519	8,875
NHA-MBS	1,799	570	4,817	1,739
Securitization and internal resources ⁽¹⁾	(41)	274	451	1,272
Total	2,859	2,779	11,787	11,886
Mortgages Under Administration				
Single-family residential	31,880	26,333	31,880	26,333
Multi-unit residential and commercial	15,913	14,263	15,913	14,263
Total	47,793	40,596	47,793	40,596

(1) The negative amount of \$41 million in the fourth quarter of 2009 results from \$103 million of mortgages securitized in the first and second quarters of 2009 with an institutional investor. In the fourth quarter of 2009 this transaction was repackaged in the form of a First National issued MBS.

The Company experienced strong origination volumes, given the economic environment. Total mortgage origination volumes decreased in 2009 by just 1% to \$11.8 billion from \$11.9 billion in 2008. This decrease reflects a 3% decrease in single-family origination figures between the periods and a 6% increase in the multi-unit residential and commercial segment. Although single-family volumes are lower than the levels experienced in 2008, these volumes are above those expected by management coming in to the year. Management believes the single-family origination has remained strong as a result of three factors: historically low mortgage interest rates, the return of consumer confidence in the economy and the Company's strong position in the mortgage broker market.

For the commercial segment, the Company continued its strong performance in the multi-unit business as its pricing remained the most competitive in the market. Origination for the NHA-MBS program increased from \$1.7 billion in 2008 to \$2.8 billion in 2009. Institutional placements, however, decreased from 2008 as the demand for uninsured commercial product fell off.

Canadian capital markets that began the year in turmoil improved steadily throughout the year as economic indicators turned more positive. Despite the improvement, the Bank of Canada's monetary policy remained accommodative. For the Company, these conditions had primarily favourable outcomes. As an originator of primarily prime CMHC-insured mortgages, the Company

continued to see demand for mortgages and funding costs for 30-day paper were reduced significantly. However, mortgage spreads that began narrowing in the first quarter of 2009 continued to do so as mortgage rates fell despite rising bond yields. The large spreads that existed at the end of 2008 have gradually tightened such that by the end of 2009 prime mortgage spreads were close to the levels seen prior to the credit crisis which began in 2007. The tightening is a result of increased liquidity in the economy that saw the five big Canadian banks start to compete for mortgage products by reducing their offered mortgage rates. Increased bond yields have also meant some adverse changes in the value of the Company's securitization receivable, deferred placement fees receivable and mortgage and loan investments, as the time value of money has increased somewhat. The commercial segment of the Company continued to benefit from wider spreads on its prime origination due to lessened competition.

At the same time, the Company profited from a stabilizing ABCP market. At December 31, 2008, the Company had adjusted the fair value of its retained interests in ABCP conduits to assume the highest grade of ABCP would trade at a spread of 1.10 percentage points in excess of BA. However, by the beginning of March 2009, posted ABCP rates began coming down such that by December 31, 2009 quoted ABCP spreads were comparable to BA rates. While the Company welcomed the decrease, management is concerned that as fast as these spreads have come in, they could widen suddenly in the future. Additionally, the cost of funds currently being experienced by the Company is approximately 0.25 percentage points in excess of BA. Accordingly, the Company revised its assumption for ABCP costs such that its models assume 30-day ABCP will trade at 0.25 percentage points higher than BA in its calculation of the fair value of its securitization receivable. This has resulted in an unrealized fair value gain of \$16.4 million recorded in 2009. Many of First National's securitization programs use BAs to fund Prime-indexed mortgages. Similar to the ABCP issue, the Company has a risk that the spread between these rates changes adversely for the Company. The Company updated its securitization models to assume this spread would revert to historical norms in the first quarter of 2009. The result was an unrealized loss of \$10.9 million recorded in 2009.

Total revenues for the year ended December 31, 2009 compared to 2008 increased by 16% from \$294 million to \$342 million. This increase resulted primarily from higher amounts of mortgages originated for the Company's securitization programs, which generated higher revenue on wider margins.

Placement Fees

Comparing the year ended December 31, 2009 to the year ended December 31, 2008, placement fee revenue decreased by 15% to \$123.9 million from \$145.9 million. This was largely due to the change in the Company's strategy with respect to single-family floating rate mortgages. In 2008, these mortgages were originated for institutional placement. For much of 2009, the Company chose to fund these mortgages through securitization transactions. As a result, the volume of residential origination for institutional placement decreased by 22%. The Company also saw increased origination through its multi-unit residential NHA-MBS program, which had volumes of \$2.8 billion for the year due to its continued competitive position. This compares to \$1.7 billion in 2008. Together with mortgages for institutional investors, origination volumes, which drive placement fees, decreased by 15% from 2008 to 2009.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue increased 28% to \$51.8 million from \$40.4 million. The increase was due primarily to increased volumes of multi-unit residential mortgages originated for the Company's MBS program. These volumes grew by 58% and the wide margins realized in 2008 continued to be earned by the Company. From the program, the Company recognized both a placement fee (described above) and ongoing interest-only strips on these mortgages. The Company has valued these strips at \$35.3 million, which is reflected in gains on deferred placement fees revenue. In 2008, the Company recorded \$19.2 million in revenue from this program. These gains were offset with lower gains on deferred placement fees from mortgages sold to institutional investors for the CMB program. As previously described, the Company sells a portion of its residential origination volume to institutional investors. In some cases, the Company earns additional revenue over the term of the sold mortgages based on those investors' current funding rates. The Company benefited from the increased mortgage spreads resulting from the turmoil in the credit markets beginning in August 2007. Although spreads in 2009 were greater than historical levels, such spreads decreased throughout the year as markets normalized. As such, the Company recorded reduced gains on deferred placement fees of \$3.7 million for 2009 compared to 2008.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Gains on Securitization

Gains on securitization revenue increased 106% to \$55.4 million from \$26.9 million. The increase was due to the Company's decision to sell pools of insured floating rate mortgages to the NHA-MBS market. With the CMB and the federal government auction providing significant liquidity to the market, combined with the very low interest rates on 30-day money market securities, institutional investors came to the market looking for alternative investment opportunities. During the year, the Company originated \$2.1 billion (and pooled \$1.7 billion) of single-family mortgages for inclusion in NHA-MBS pools. Due to historically high spreads currently being offered on these mortgages relative to funding costs, the Company was able to execute securitizations at very favourable terms. For all of 2009, the Company recognized \$57.0 million in gains on securitization for such transactions. In 2008, the Company recorded only \$11 million related to the securitization of such floating rate mortgages, primarily for replacement assets in the Company's existing CMB programs. ABCP was used mainly in 2008 to support the Alt-A and small commercial loan programs. These securitizations, which produced no revenue in 2009, earned the Company about \$11 million of gains on securitization in 2008. Offsetting the 2009 gains was a downward adjustment of \$4.3 million related to gains on securitization on the Alt-A program recorded in previous periods. Although the program is slowly winding down, the Company began experiencing higher rates of loss severity than estimated on defaults in the program. In the third quarter of 2009, the Company increased its assumption for credit losses for the Alt-A program from 0.35% annually to 0.70% in its models.

Mortgage Servicing Income

Mortgage servicing income increased 3% to \$64.4 million from \$62.3 million. This was primarily due to the growth in the portfolio of mortgages under administration offset by smaller returns on monies held in trust. The mortgage administration portfolio grew by 18% year-over-year. The residential component grew by 21% and should have a larger impact on servicing revenue than the commercial component (the price per unit is much higher on residential than that on the commercial portfolio). In aggregate, revenue associated with mortgage administration activities increased by 20%. This growth was offset by a decrease in the interest earned on funds held in trust. These funds are administered by the Company and include borrowers' property tax escrow. In the year, this income did not grow at the same rate as the mortgage portfolio, decreasing to \$1.3 million for 2009 from \$9.6 million in 2008. The reduction was the result of the significant decrease in short-term interest rates offset by the normal growth of the amount of funds held in trust. At December 31, 2009, the amount of funds held in trust was \$435 million compared to \$334 million at December 31, 2008, and the average 30-day CDOR, which is a benchmark for short-term interest rates, decreased from 3.19% in 2008 to 0.56% for 2009.

Mortgage Investment Income

Mortgage investment income increased 6% to \$23.4 million from \$22.1 million. The change is a combination of offsetting factors, including an increase in the amount of securitization and deferred placement fees receivables, higher bond yields than in the comparative year (which affect the interest earned on these receivables), falling prime lending rates (which affect gross revenues on mortgage and loan investments), and increased amounts of mortgages accumulated for sale and mortgage and loan investments held during the year.

Residual Securitization Income

Residual securitization income increased 154% to \$22.9 million from \$9.0 million. The recurring source of this revenue is the amortization of the servicing liability, which represents the servicing portion of the spread received from past securitization transactions. The other source is any excess of cash flows received above the expected cash flows assumed in the Company's calculation of the securitization and deferred placement fee receivables. The increase in 2009 is a result of the conservatism inherent in the Company's securitization models. The Company has tried to use realistic values for spread, prepayment and credit losses assumptions in these models. Faced with a choice, the Company tends to use conservative assumptions to record its gain on securitization revenue. If actual receipts in a period exceed the Company's assumed cash flows for that same period, the amount is recognized as residual securitization income in the period. This conservatism is demonstrated by the Company's assumption on the spread between prime and 30-day BA rates. This spread has remained historically wide since the fourth quarter of 2008; however, as disclosed previously in this MD&A, the Company assumed that this spread would narrow by 0.25 percentage points as at April 1, 2009. Because this spread did not narrow as predicted, the Company received approximately \$6 million of spread in excess of what it had assumed in the models which determine the value of the Company's securitization receivables.

Realized and Unrealized Gains (Losses) on Financial Instruments

For First National, this line item typically consists of two components: (1) gains and losses related to holding term assets derived using discounted cash flow methodology, and (2) those related to the Company's economic hedging activities. The term assets are affected by changes in credit markets and Government of Canada bond yields (which form the risk-free benchmarks used to price the Company's assets, including the Company's investment in securitization and deferred placement fees receivable, cash collateral and subordinate notes held by securitization trusts, as well as swap derivatives). The Company does not attempt to hedge these assets and, accordingly, will experience potentially significant unrealized gains and losses as credit spreads change and bond yields fluctuate.

Bond yields began the year at comparatively low absolute levels due to the financial crisis experienced at the end of 2008. During 2009, yields rose rapidly in the second quarter as recessionary pressures subsided, then remained choppy for the remainder of the year. Generally, five-year Government of Canada bond yields increased from approximately 2% at the beginning of the year to 2.6% by year-end. The impact of these changing bond yields on the fair market values of the Company's assets held during 2009 was a loss of \$5.7 million recorded in unrealized losses on financial instruments. The Company will now earn a higher implicit rate of return on these assets going forward such that this loss is essentially a deferral of accounting earnings to future periods.

The decreased assumption for ABCP from 1.10 percentage points over BAs to 0.25 percentage points over BAs, as described earlier in this MD&A, has created an unrealized gain of \$16.4 million for the year. Offsetting this gain was an unrealized loss of \$10.9 million, which the Company recorded in the first quarter of 2009 to account for the expected normalization of Prime/BA spreads over the next five-year time horizon. The changes in fair value related to the Company's interest rate swaps, securities sold short, mortgages accumulated for sale and mortgage commitments had offsetting effects such that the Company recorded only a small net gain on these during 2009.

Brokerage Fees Expense

Brokerage fees expense decreased 4% to \$98.7 million from \$102.9 million. The decrease is partially the result of single-family residential origination, which decreased 1% year-over-year. The Company also realized a decrease in this expense due to the timing of mortgage securitizations. As the Company originates mortgages to be securitized, it capitalizes the related broker fee to the mortgage. When the mortgage is subsequently securitized, the fee is expensed. Comparing the end of 2009 to the end of 2008, this accounting treatment has reduced the amount of brokerage fees by approximately \$3.4 million, resulting in a 3% decrease in the overall expense.

Salaries and Benefits Expense

Salaries and benefits expense increased 19% to \$48.2 million from \$40.4 million. The increase is due primarily to the employee costs associated with commercial mortgage origination. The Company compensates its sales staff with a significant portion of the fees earned by the Company. Because of the increased revenue in the year, particularly with respect to placement fees, this compensation increased by \$6.5 million year-over-year. Excluding these amounts, the core salaries and benefits expense remained consistent year-over-year; in line with the small increase in headcount and reduction in average salaries as attrition has occurred at more senior levels and new staff added at entry level positions. As at December 31,

2009, the Company had 519 employees compared to 506 as at December 31, 2008. Management salaries were paid to the two senior executives who indirectly own the Class B LP units. The current year's expense is as a result of the compensation arrangement executed on the closing of the initial public offering.

Interest Expense

Interest expense decreased 15% to \$13.4 million from \$15.7 million. This expense has decreased from the prior year due to the changing interest rate environment during the year. The Company's interest expense is indexed primarily off of BA rates and prime lending rates. Both rates fell dramatically between the years; average prime from 4.81% down to 2.43% and average BA's from 3.19% to 0.56%. This represents decreases of 49% and 82%, respectively. The decrease has been offset with the Company's increased usage of the credit facility and higher interest rate spreads payable to the syndicate of bank lenders. As discussed in the "Liquidity and cash resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the ultimate investor or securitization. The Company uses a credit facility with a syndicate of banks to fund the mortgages in this period. The Company renewed this agreement in June 2009, keeping the total commitment at \$378 million.

Other Operating Expense

Other operating expense decreased 27% to \$16.4 million from \$22.6 million. In 2008, the Company recorded \$6.9 million for provisions related to losses on mortgage and loan investments held on its balance sheet. These provisions were recorded to meet specific mortgage exposures within the commercial real estate market in Canada. The Company has assessed the mortgages held on balance sheet and has recorded a provision for credit losses of \$1.3 million in 2009. Without these provisions, these expenses would have decreased by 4% due primarily to discretionary spending cuts pursuant to the expected slow down of single-family residential origination.

Net Income and EBITDA

Net income increased 51% to \$163.5 million from \$108.0 million. The growth in earnings was derived from the combination of the higher margins associated with mortgage placement and securitization, coupled with stable operating costs. In particular, profitability has increased through higher margins on multi-unit residential mortgage origination and single-family floating rate mortgages as demand for these high credit quality assets increased with the uncertain credit environment which prevailed for much of 2009. EBITDA increased 51% to \$165.2 million from \$109.7 million. The increase was due to the same factors described for net income.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

Year ended	Residential		Commercial	
	December 31 2009	December 31 2008	December 31 2009	December 31 2008
(\$000s except percent amounts)				
Originations	\$ 8,468,000	\$ 8,757,000	\$ 3,319,000	\$ 3,129,000
Percentage change	(3.3%)		6.1%	
Revenue	\$ 240,263	\$ 229,371	\$ 101,453	\$ 64,588
Percentage change	4.7%		57.1%	
Income before income taxes and corporate non-allocated expenses	\$ 93,863	\$ 75,925	\$ 71,120	\$ 33,596
Percentage change	23.6%		116.9%	
Period ended	December 31 2009	December 31 2008	December 31 2009	December 31 2008
Identifiable assets	\$ 530,903	\$ 399,185	\$ 536,787	\$ 337,880
Mortgages under administration	\$ 31,879,946	\$ 26,333,014	\$ 15,913,099	\$ 14,263,000

RESIDENTIAL SEGMENT

Residential revenues increased by 4.7%, although origination decreased 3.3% between 2009 and 2008. The increased revenue is attributed to higher margins earned on prime single-family mortgage origination, primarily with respect to gains on securitization on floating rate mortgages. Income before income taxes increased by 23.6%, reflecting the higher gross margins earned in revenue and a low-cost operating environment.

Identifiable assets have increased from those at December 31, 2008 due to higher mortgages accumulated for sale held at the end of the December 2009.

COMMERCIAL SEGMENT

Commercial revenues increased by 57% from the prior year due to greater margins on higher volumes of multi-unit residential product. Although overall origination grew by just 6.1%, this was the result of increased volumes of high-margin insured origination net of decreased volumes for lower-margin uninsured commercial mortgage product. The increased revenue flowed through to the bottom line and, together with lower loan loss expenses of \$5.5 million, net income doubled from that recorded in 2008.

Identifiable assets for the commercial sector increased primarily due to increased hedging requirements of \$318 million for funded and committed multi-unit residential mortgages to be securitized after year end.

LIQUIDITY AND CAPITAL RESOURCES

The Company's liquidity strategy has been to use bank credit to fund working capital requirements and to use cash flow from operations to fund longer-term assets, providing a relatively low leveraged balance sheet. The Company's credit facilities are typically drawn to fund: (1) mortgages accumulated for sale, (2) deferred placement fees receivable, (3) securitization receivables and (4) mortgage and loan investments. The Company has a credit facility with a syndicate of five banks for a total credit of \$378.3 million (2008 – \$378.3 million). This Facility was renewed in June 2009 for a 364-day term on substantially the same terms as the previous banking agreement except for higher interest rates commensurate with the then current credit environment. Subsequent to year end, the Company elected to reduce the commitment under the credit facility to \$300.3 million as less expensive funding sources became available. Bank indebtedness also includes borrowings obtained through securitization transactions, outstanding cheques and overdraft facilities. At December 31, 2009, the Company has also entered into repurchase transactions with financial institutions to borrow \$221.9 million related to \$223.5 million of mortgages and NHA-MBS securities held in mortgages accumulated for sale on the balance sheet.

At December 31, 2009, outstanding bank indebtedness was \$249.3 million (December 31, 2008 – \$331.0 million), of which \$159.8 million (December 31, 2008 – \$224.6 million) was drawn to fund mortgages accumulated for sale. At December 31, 2009, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$98.1 million (December 31, 2008 – \$64.0 million), (2) securitization receivables of \$104.0 million (December 31, 2008 – \$51.1 million) and (3) mortgage and loan investments of \$54.7 million (December 31, 2008 – \$75.4 million). The difference between bank indebtedness and mortgages accumulated for sale, which the Company considers a proxy for true leverage, has decreased between December 2008 and December 2009 and now stands at \$89.5 million. This represents a debt-to-equity ratio of approximately 0.42 to 1, which the Company believes is at a conservative level. This ratio has decreased from 0.74 to 1 as at December 31, 2008 as the Company has increased its equity through retained earnings.

The Company funds a portion of its mortgage originations with institutional placements and sales to securitization vehicles on the same day as the advance of the related mortgage. The remaining originations, primarily residential, are funded by the Company on behalf of institutional investors or securitization vehicles on the day of the advance of the mortgage. On specified days, typically weekly, the Company aggregates all mortgages "warehoused" to date for an institutional investor and transacts a settlement with that institutional investor. A similar process occurs for sales to securitization vehicles, although the Company can dictate the date of sale into the vehicle at its discretion. 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 eighteen 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 and securitization receivables and other miscellaneous longer-term financing needs.

A portion of the Company's capital has been employed to support its ABCP programs, primarily to provide credit enhancements as required by rating agencies. The largest part of this investment was made on behalf of the Alt-A program. As at December 31,

2009, this investment was \$26.1 million. Now that this program has been discontinued, this investment will be repaid to the Company (less any losses in excess of the Company's credit loss assumptions) over the term of the related mortgages. Since June 30, 2008, when First National stopped offering the Alt-A product, the Company has received repayment of approximately \$16.6 million of this collateral. The cash flow associated with this return of collateral will provide more liquidity to the Company in future periods. This positive cash flow has been offset with the need for additional liquidity to manage the administration of defaulted mortgages in the Alt-A program. As this program has paid down with no addition of new assets, the ratio of defaulted mortgages to the total mortgages in the program has become skewed. In order to keep these ratios at an acceptable level for the Trust, the Company repurchased approximately \$40.9 million of defaulted mortgages in 2009. Most of these mortgages were in the midst of the foreclosure process such that the Company liquidated \$29.5 million of these mortgages during the year, experiencing credit losses at expected rates. At December 31, 2009, the Company employs an assumption for credit losses in the Alt-A program of 0.70% per annum. To date, this assumption has been more than enough to absorb all actual losses experienced in the program. The Company believes that prudent management of this program will continue to require some level of liquidity from the Company throughout its term.

As demonstrated previously, the Company continues to see strong demand for its mortgage product from institutional investors and liquidity from bank-sponsored commercial paper conduits. The Company's strategy of using diverse funding sources has allowed the Company to thrive, significantly increasing its profitability in 2009. By focusing on the prime mortgage market, the Company believes it will continue to attract bids for mortgages as its institutional customers seek government-insured assets for investment purposes. The Company also believes it can manage any liquidity issues that would arise from a year-long slowdown in origination volumes. Based on cash flow received in the fourth quarter of 2009, the Company estimates that it will receive approximately \$53 million of cash annually from its servicing operations and \$52 million of cash flow from previously recorded securitization and deferred placement fees receivables. Together, this \$105 million of annual cash flow would be sufficient to support the almost \$90 million of distributions which the current distribution rate would require. Although a simplified analysis, it does highlight the sustainability of the Company's business model and distribution policy through periods of economic weakness.

FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

With the adoption of the accounting standards surrounding financial instruments, the Company's income is subject to more volatility. This is particularly true for the deferred placement fees and securitization receivables, together with the cash collateral and subordinate short-term notes held by securitization trusts. The Company had a choice between categorizing these assets as held-for-trading or available-for-sale. The accounting standard does not allow these assets to be treated as held-to-maturity, although this has always been the Company's intention. Each alternative available to the Company requires these assets to be recorded at their fair market value. The Company has elected to treat these assets as held-for-trading such that changes in market value are recorded in the statement of income. By electing to classify these assets as available-for-sale, the Company would have been required to allocate mark-to-market amounts between "normal" income and comprehensive income. Management believes this would needlessly increase the complexity of the financial statements. Effectively, these assets will now be treated much like bonds earning the Company a coupon at the different 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 securitization's residual cash flows. As such, as rates in the bond market change, so will the recorded value of the Company's securitization-related assets. These changes may be significant (favourable and unfavourable) from quarter to quarter. The Company has no intention of attempting to hedge this exposure due to the cost and complexity required to do so. Further, the Company does not intend to sell these assets before maturity. The accounting standard has had no impact on distributable cash.

The Company believes its hedging policies are suitably disciplined such that the related mark-to-market adjustments will be insignificant; however, in the event that effective economic hedging does not occur, the resulting gains and losses will be included in the current period's income. The Company uses 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 sold to securitization trusts and the underlying cost of funding is fixed. As interest rates change, the value of these interest rate hedges varies inversely with the value of the mortgage contract. As interest rates increase, a gain will be recorded on the hedge, which should be offset by a loss on the sale of the mortgage to the purchaser, as the mortgage rate committed to the borrower is fixed at the point of commitment. For residential mortgages, primarily mortgages for the Company's own inventory, only a portion of the mortgage commitments issued by the Company

eventually fund. The Company must assign a probability of funding to each mortgage in the pipeline and estimate how that probability changes as mortgages move through the various stages of the pipeline. The amount that is actually hedged is the expected value of mortgages funding within the next 120 days (120 days being the standard maximum rate hold period available for the mortgages). As at December 31, 2009, the Company does not have any forward bond positions related to its residential 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 sale to the Company's own securitization vehicles. As at December 31, 2009, the Company had entered into \$41 million in notional value forward bond sales. The change in mark-to-market value of the hedges from January 1, 2009 to December 31, 2009 has been expensed through the statement of income.

The Company is party to an amortizing fix for float rate swap to economically hedge the interest rate exposure related to certain mortgages held on balance sheet which the Company considers as replacement assets for its CMB activities. As at December 31, 2009, the notional value of this swap is \$33.0 million. Market swap rates increased slightly in the period since the end of December 2008; as such, the net mark-to-market adjustment for the year was a gain of \$528 for the Company. The amortizing swap matures in September 2013.

As described above, the Company uses various strategies to reduce interest rate risk. The financial statements also disclose the sensitivity which the deferred placement fees and securitization receivable have to changing discount rates. In the normal course of business, the Company also takes 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 moved wider. 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 loss or

gains related to credit spread movement. Despite the fact that the Company had entered into effective economic interest rate hedges, the exposure to credit spreads remained. This risk is inherent in the Company's business model and cannot be hedged economically. Although the Company has recorded these losses in its past financial results, the mortgages themselves are all in good standing and continue to pay monthly principal and interest payments at the contracted terms of the mortgages. If scheduled repayment continues for the full term of the mortgages, the Company will earn higher mortgage investment income equivalent to the amount of the cumulative losses recorded.

The same exposure to risk has also been described in the valuation of the Company's securitization receivable through ABCP conduits. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Initially it 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. As described earlier in this discussion, 30-day ABCP traded at approximately 1.10 percentage points over BAs as at December 31, 2008 but by the end of December 2009 were priced flat to BAs. At the same time the Company has leveraged on changing credit spreads. This has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages.

As at December 31, 2009, the Company has various exposures to changing credit spreads. The Company has \$68 million of exposure related to commercial mortgages originated originally for the CMBS market. As described earlier, there are \$1.4 billion of mortgages in securitization conduits that are exposed to BA – ABCP spread risk. In mortgages accumulated for sale, there are \$375 million of mortgages that are susceptible to some degree of changing credit spreads.

Payments Due By Period (in \$000s)

	<i>Total</i>	<i>0-1 Years</i>	<i>1-3 Years</i>	<i>4-5 Years</i>	<i>After 5 Years</i>
Lease Obligations	\$ 6,992	\$ 3,037	\$ 3,471	\$ 484	\$ –
Servicing Liability	\$ 21,022	\$ 7,647	\$ 8,734	\$ 3,134	\$ 1,507
Total Contractual Obligations	\$ 28,014	\$ 10,684	\$ 12,205	\$ 3,618	\$ 1,507

NORMAL COURSE ISSUER BID AND DISTRIBUTION RE-INVESTMENT PROGRAM (“DRIP”)

To assist the Company in managing its liquidity, both of these programs were introduced in 2008. In August 2008, the Company was approved by the Toronto Stock Exchange to make a normal course issuer bid to purchase for cancellation up to 632,817 Units, representing approximately 5% of the Units issued and outstanding. Purchases under the bid were permitted to begin on August 8, 2008 and end no later than August 7, 2009. No Units were purchased under provisions of the bid and management did not renew the bid at maturity. Upon approval by the board of directors in March 2008, the DRIP program was made available to unitholders in April 2008; the Company suspended the DRIP after the July 2008 distribution paid on August 15, 2008.

CAPITAL EXPENDITURES

First National's business is not a capital-intensive business. Historically, capital expenditures have included technology software and hardware, facility improvements and office furniture. During the year ended December 31, 2009, the Company purchased new computers and office and communication equipment to support primarily its single-family residential business.

Going forward, the Company expects capital expenditures will be approximately \$1.5 million annually and primarily relate to technology (software and hardware). Capital expenditures are expected to be funded from operating cash flow.

SUMMARY OF CONTRACTUAL OBLIGATIONS

The Company's long-term obligations include five- to ten-year premises leases for its four 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 and purchases servicing rights 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS

GUARANTEES

First National Financial Operating Trust (the "Trust") and First National Financial GP Corporation (FNFLP's general partner, the "GP") have entered into postponement of claim and guarantees with respect to FNFLP's borrowings under its credit facility. The guarantee is supported by first ranking security over all the present and future assets of the Trust, including a first ranking pledge of all securities held by the Trust in FNFLP and the GP.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

FNFLP prepares its financial statements in accordance with GAAP, 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, which 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 audited financial statements prepared as at December 31, 2009. 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 securitization and 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 to special purpose entities ("Trusts") through securitizations as well as its gains or losses on those mortgages placed with institutions earning a deferred fee. Under GAAP, valuing a gain on sale requires the use of estimates to determine the fair value of the retained interest (derived from the present value of expected future net cash flows) in the mortgages. These retained interests are reflected on the Company's balance sheet as securitization receivables and deferred placement fees receivable. The key assumptions used in the valuation of gains on securitization and deferred placement fees are spread, prepayment rates, the annual expected credit losses and the discount rate used to present value future expected residual 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 that average approximately 18% for residential mortgages and 33% for commercial floating rate mortgages. The Company assumes there is virtually no prepayment on commercial fixed rate mortgages. Credit losses are also reviewed

on a monthly basis in the context of the type of mortgages securitized. For the largest portion of the Company's securitizations, the mortgages are either insured or low ratio mortgages for which the Company does not provide for the event of a credit loss.

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 life of the mortgages. The assumptions underlying the estimates used for the year ended December 31, 2009 continue to be consistent with those used for the year ended December 31, 2008 and the quarters ended March 31, June 30 and September 30, 2009, with the exception of some assumptions for prepayment and credit losses. For adjustable rate insured single-family residential mortgages, the Company increased the assumption for annual prepayment from 16% to 20.6% in the third quarter of 2009 and from 20.6% to 25.6% in the fourth quarter of 2009. This change was the result an anticipated trend of higher rates of conversion to fixed rate mortgages identified during each quarter. For the securitization of Alt-A mortgages, the Company currently assumes a credit loss rate of 0.70% per annum. The Company increased this assumption in 2009 from 0.35% used prior to December 31, 2008 as the loss rates on this portfolio increased. For the securitization of small multi-unit residential and commercial mortgages, the Company used a credit loss rate of 0.25% per annum. Both these rates are greater than the actual rates experienced by the Company to date, but which management feels are appropriate estimates of losses that will average over the life of the mortgages being securitized.

Inherent in the determination of the Company's securitization receivable is also an assumption about the relationship of short-term interest rates, specifically the spread between one-month BA and one-month high quality ABCP. Historically, the Company built its financial models with the assumption that the spread between these two rates would always be quite narrow. As described previously in this discussion, this relationship deviated from historical norms beginning in the third quarter of 2007 and then moved even wider in the fourth quarter of 2008, before narrowing during the course of 2009 such that the spread between these instruments is very tight as at December 31, 2009. As described previously, the Company has adjusted its securitization receivable to account for this change in circumstances. Currently the Company has assumed that ABCP spreads are 0.25 percentage points over one-month BA.

The Company has elected to treat its financial assets and liabilities, including deferred placement fees receivable, securitization receivables, mortgages accumulated for sale, cash collateral and short-term subordinated loans, and bonds sold short as held-for-trading. 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.

FUTURE ACCOUNTING CHANGES

International Financial Reporting Standards ("IFRS")

In January 2006, the Canadian Accounting Standards Board announced its decision requiring all publicly accountable entities to report under International Financial Reporting Standards ("IFRS"). This decision establishes standards for financial reporting with increased clarity and consistency in the global marketplace. These standards are effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011 and will be applicable for the Company's first quarter of 2011. One issue that has become evident is the difference in accounting for securitization transactions. Under current GAAP, the Company's securitizations are all considered "true sales" for accounting purposes such that the Company has recorded gains on securitization when these mortgages were sold to various securitization conduits. Under current IFRS standards, these securitizations will likely not meet the definition of a "true sale" and instead will be accounted for as a secured financing. Accordingly, the Company believes that all of its securitizations (through ABCP conduits, NHA-MBS and direct CMB issuance) will not qualify for sale accounting; however, it believes that its deferred placement transactions will continue to meet the criteria for off-balance sheet treatment. Because the ABCP programs are generally amortizing down while deferred placement transactions continue to grow, it is difficult at this time to evaluate the extent of the impact of these changes as at January 1, 2011.

As described in the "Revenue and Funding Sources" of this MD&A, the Company decided to differentiate revenue earned from transactions that provide the Company future cash flow streams. In the past, the Company treated all such transactions as "gains on securitization"; now "gains on deferred placement fees" will be disclosed separately. This change in presentation will assist stakeholders with the transition to IFRS, as the Company believes that the mortgages related to "deferred placement fees receivable" will be more likely to receive off-balance sheet treatment and the current accounting treatment will continue to be appropriate under IFRS. The "securitization receivable" consists primarily of direct securitizations through ABCP, NHA-MBS and the CMB. In these cases, the Company believes that for most, if not all, of these transactions, off-balance sheet treatment will not be permitted under current IFRS and these receivables will be effectively reversed against opening equity as at January 1, 2011. In March 2009 the International Accounting Standards Board published an exposure draft ("ED")

on "Derecognition". This ED describes new criteria for obtaining off-balance sheet accounting when financial assets are sold/transferred. This proposed standard focuses on the effective control of the related assets as opposed to the risk/reward framework that was the foundation of the existing standard. Should this standard be adopted in its current form, the Company may have to treat other mortgage assets as on-balance sheet assets, including those currently accounted for as "deferred placement fees", due to new tests of "control" being defined in the accounting standards. This exposure draft has attracted much opinion and criticism from the accounting community and has yet to be finalized at this time.

The Company's project team has completed its initial impact assessment and commenced system changes to gather financial information that will be required for the conversion. Detailed diagnostic work shops have taken place and the Company has been working with its external auditors to assess the impact. The Company is now in the process of producing the requisite documentation to support its position in adopting the new international accounting standards under IFRS and is preparing a pro forma balance sheet as at December 31, 2009 based on the new standards. The Company will continue to evaluate the impact of these new standards and will report accordingly in future MD&A.

Controls over Financial Reporting

No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

RISK 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, including 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, cash collateral and retained interest, reliance on multi-unit residential and commercial mortgages, general economic conditions, government regulation, competition, reliance on mortgage insurers, reliance on key personnel, 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, environmental liability and risk related to Alt-A mortgages, which experience higher arrears rates and credit

MANAGEMENT'S DISCUSSION AND ANALYSIS

losses than prime mortgages. In addition, risks associated with the structure of the Fund include those related to the dependence on FNFLP, leverage and restrictive covenants, cash distributions which are not guaranteed and will fluctuate with FNFLP's performance, the nature of Units, distribution of securities on redemption or termination of the Fund, restrictions on potential growth, unitholder liability, undiversified and illiquid holding in the Trust, the market price of Units, dilution of existing unitholders and FNFLP unitholders, statutory remedies, control of the Company, and contractual restrictions and income tax matters. 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 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 Fund's business, reference should be made to the Annual Information Form of the Fund.

Income Tax Matters and Conversion to a Corporation

Amendments to the Tax Act enacted June 22, 2007 affect the taxation of certain publicly traded trusts and their beneficiaries (the "SIFT Rules"). The Fund will benefit from a transitional period, and will not be subject to the SIFT Rules until January 2011 provided the Fund experiences only normal growth and no undue expansion, as described below, before then. When the SIFT Rules are applicable to the Fund, it will be liable for tax at a rate comparable to the combined federal and provincial corporate tax rate on all or a significant portion of its income distributed to unitholders, and unitholders will receive Fund income distributions as eligible dividends. The application of the SIFT Rules to the Fund is expected to result in adverse tax consequences to the Fund and certain unitholders (in particular, unitholders that are tax exempt or non-residents of Canada) and may impact the future level of distributions made by the Fund. The enactment of the SIFT Rules and their ultimate application to the Fund may reduce the value of Fund Units and hence increase the cost to the Fund of raising capital in the public capital markets.

The Department of Finance (Canada) has indicated that, while there is no intention to prevent normal growth of existing trusts during the transition period, any undue expansion of a particular trust could result in loss of the benefit of the transitional period. On December 15, 2006, the Department of Finance (Canada) issued guidelines with respect to what will be considered normal growth in this context. While the Fund does not intend to raise capital in excess of the safe harbour limits outlined in these guidelines, there is a risk that the adverse tax consequences resulting from the SIFT Rules could be realized sooner than 2011.

As a result of the enactment of the SIFT Rules, the Fund has been required to account for future income taxes under the asset and liability method, whereby future income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Future income tax assets are recorded in the consolidated financial statements to the extent that realization of such benefits is more likely than not. See the description above under "Accrued Future Tax Liability on Intangible Assets" and "Accrued Future Tax Liability on Investment in FNFLP".

Currently, a trust will not be considered to be a mutual fund trust if it is established or maintained primarily for the benefit of non-residents unless all or substantially all of its property is property other than taxable Canadian property as defined in the Tax Act. On September 16, 2004, the Minister of Finance (Canada) released draft amendments to the Tax Act. Under the draft amendments, a trust would lose its status as a mutual fund trust if the aggregate fair market value of all units issued by the trust held by one or more non-resident persons or partnerships that are not Canadian partnerships is more than 50% of the aggregate fair market value of all the units issued by the trust, where more than 10% (based on fair market value) of the trust's property is taxable Canadian property or certain other types of property. To date, the Department of Finance has not tabled a Notice of Ways and Means Motion which includes these proposed changes, and the Department of Finance has indicated that the implementation of the proposed changes has been suspended pending further consultation with interested parties. Depending upon the final form of these proposed changes, if enacted, it may be necessary to amend the Fund's declaration of trust to take into account any new restrictions. This amendment may be made without unitholder approval.

The Company believes that to remain a trust after the SIFT rules come into effect in 2011 would not be in the best interest of unitholders. Although the rates of taxation applicable to the Company's earnings would be similar, these taxes would be marginally higher if the Fund were to remain as a mutual fund trust. Additionally, any earnings not distributed by the Fund would be taxed at the highest marginal personal tax rates. In order to provide the Company with the most flexibility, management believes a conversion to a corporation is the most prudent course of action. Management has begun discussions with its tax advisors and plans to use tax-free roll-over provisions to reorganize the current trust structure. Generally speaking, the reorganization plan will be brought before all unitholders for approval and will be timed to take full advantage of the current beneficial tax rules until they expire on December 31, 2010.

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 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 March 9, 2010, and is subject to change after such date. However, management and the Fund 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

Despite the challenging economic environment, the Company achieved record results in 2009. These results were the product of several favourable market conditions and the execution of the Company's strategy. Single-family origination volumes remained at levels similar to those experienced in 2008, prime mortgage spreads provided the Company with additional margin for gains on securitization, multi-unit residential origination spreads remained wide as competitors stayed on the sidelines and ABCP spreads moved in to more rational levels. The mortgage broker distribution channel continued to grow relative to other distribution channels, as did the Company's leadership position within it.

As the Company has shown in its results, the credit tightening that began in August 2007 has created opportunities due to the departure of several competitors from the market and the widening out of credit spreads. These departures improved the Company's ability to gain origination volume and assisted it in achieving attractive pricing for its CMHC-insured multi-family mortgage product. This product, like prime single-family residential, has always been one of the reasons for the Company's strong market position. First National has taken advantage of these market conditions and produced the record quarter described throughout this MD&A.

Current economic statistics suggest some lingering uncertainty about the length of the current recession. For the Company, management believes this will mean that overall single-family origination levels in 2010 will be comparable to those experienced in 2009. The stabilization of credit markets which began in the second quarter continues and the excess liquidity in the capital markets has increased funding opportunities for the Company. However, this increased liquidity has also put pressure on mortgage spreads as the Company's competitors have re-entered the market. Increased competition will reduce the margins the Company enjoyed in 2009. The Company expects tighter mortgage spreads in both the prime single-family and the multi-family residential segments of its business. Offsetting these reductions will be higher income and cash flow derived from the growing \$47 billion portfolio of mortgages under administration and a reduced cost of funding.

As described earlier, the tax treatment of income trusts is changing and the Company is planning to restructure and become a corporation on or about January 1, 2011. Beginning in 2011, the Company plans to replace its distributions with dividend payments. The results of both 2010 and 2011 will have a bearing on the Company's new dividend policy, as will the tax rates imposed by Canadian tax authorities. Accordingly, it is difficult to give definitive direction at this time; however, at a minimum the Company expects to set its initial annual dividend at \$1.50 per share, less the applicable liability for current income taxes.

Management's Responsibility for Financial Reporting

The accompanying consolidated financial statements of First National Financial Income Fund for the period from January 1, 2009 to December 31, 2009 and the financial statements of First National Financial LP for the period January 1, 2009 to December 31, 2009 and all information in this annual report are the responsibility of management.

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect certain reported amounts which management believes are reasonable.

The Audit Committee of the Board of Directors has reviewed in detail the financial statements with management and the independent auditor. The Board of Directors has approved the financial statements on the recommendation of the Audit Committee.

Ernst & Young LLP, an independent auditing firm, has audited First National Financial Income Fund's 2009 consolidated financial statements and First National Financial LP's 2009 financial statements in accordance with Canadian generally accepted auditing standards and has provided independent audit opinions. The auditors have full and unrestricted access to the Audit Committee to discuss the results of their audits.



Stephen J. R. Smith
Chairman and President



Robert A. Inglis
Chief Financial Officer

Auditors' Report

To the Unitholders of First National Financial Income Fund

We have audited the consolidated balance sheets of First National Financial Income Fund as at December 31, 2009 and 2008 and the consolidated statements of income and unitholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants
Licensed Public Accountants

Toronto, Canada,
March 9, 2010

FIRST NATIONAL FINANCIAL INCOME FUND
CONSOLIDATED BALANCE SHEETS
(in \$000s)

As at December 31

	2009	2008
ASSETS		
Distributions receivable	\$ 2,219	\$ 2,314
Investment in First National Financial LP (note 4)	117,077	110,361
	119,296	112,675
LIABILITIES AND EQUITY		
Liabilities		
Distributions payable	2,219	2,314
Accounts payable and accrued liabilities	37	37
Future income taxes (note 6)	13,750	10,300
Total liabilities	16,006	12,651
Equity		
Unitholders' equity	103,290	100,024
	\$ 119,296	\$ 112,675

See accompanying notes

Approved by the Trustees:



Trustee
John Brough



Trustee
Robert Mitchell

FIRST NATIONAL FINANCIAL INCOME FUND
CONSOLIDATED STATEMENTS OF INCOME AND UNITHOLDERS' EQUITY
(in \$000s, except per Unit amounts and number of Units)

<i>Years ended December 31</i>	<i>2009</i>	<i>2008</i>
REVENUE		
Equity income from investment in First National Financial LP	\$ 25,103	\$ 13,422
EXPENSES		
Provision for future income taxes <i>(note 6)</i>	3,450	1,600
Net income for the year	\$ 21,653	\$ 11,822
Unitholders' equity, beginning of year	100,024	94,015
Issued pursuant to Distribution Reinvestment Plan <i>(note 3)</i>	–	11,031
Distributions <i>(note 5)</i>	(18,387)	(16,844)
Unitholders' equity, end of year	\$ 103,290	\$ 100,024
Average number of Units outstanding during the year	12,681,113	12,307,954
Earnings per Unit <i>(note 8)</i>		
Basic	\$ 1.71	\$ 0.96

See accompanying notes

FIRST NATIONAL FINANCIAL INCOME FUND
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in \$000s)

<i>Years ended December 31</i>	<i>2009</i>	<i>2008</i>
OPERATING ACTIVITIES		
Net income for the year	\$ 21,653	\$ 11,822
Add (deduct) items not involving cash		
Provision for future income taxes	3,450	1,600
Equity income from investment in First National Financial LP	(25,103)	(13,422)
Distributions received from First National Financial LP	18,482	16,467
Cash provided by operating activities	18,482	16,467
INVESTING ACTIVITIES		
Investment in First National Financial LP	\$ -	\$ (11,031)
Cash used in investing activities	-	(11,031)
FINANCING ACTIVITIES		
Issuance of Fund Units	-	11,031
Distributions paid	\$ (18,482)	\$ (16,467)
Cash used in financing activities	(18,482)	(5,436)
Net change in cash during the year and cash equivalents, end of year	\$ -	\$ -

See accompanying notes

FIRST NATIONAL FINANCIAL INCOME FUND
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009 and 2008

(in \$000s, except per Unit amounts)

NOTE 1

ORGANIZATION AND BUSINESS OF THE FUND

First National Financial Income Fund [the "Fund"] is an unincorporated, open-ended trust established under the laws of the Province of Ontario on April 19, 2006, pursuant to a Declaration of Trust. The Fund was established to acquire and hold, through a newly constituted wholly-owned trust, First National Financial Operating Trust [the "Trust"], investments in the outstanding limited partnership units of First National Financial LP ["FNFLP"]. Pursuant to an underwriting agreement dated June 6, 2006 and initial public offering and over-allotment option in June 2006, the Fund sold 11,800,000 units of the Fund ["Fund Units", "Units" or "Unit"], at a price of \$10.00 per Unit for proceeds totalling \$118,000. The proceeds of the offering, net of underwriters' fees of \$7,080, were used to partially fund the indirect acquisition [through the Trust] by the Fund of a 19.97% interest in FNFLP, through the issuance of 11,800,000 Class A LP units by FNFLP.

Concurrent with the initial public offering and as part of the acquisition agreement between the Fund, FNFLP and First National Financial Corporation ["FNFC" or the "predecessor"], on June 15, 2006 FNFLP purchased all of FNFC's assets and assumed its liabilities, except for future income tax liabilities. Part of the consideration for this purchase was the issuance of 48,486,316 exchangeable Class B LP units. The exchangeable Class B LP units retained by FNFC are exchangeable on a one-for-one basis for Units of the Fund at any time at the option of FNFC. FNFLP is managed by First National Financial GP Corporation, the general partner, which holds a 0.01% interest in FNFLP. The Fund initially owned 19.97% of the shares of First National Financial GP Corporation and FNFC wholly owned the remaining 80.03%. The ownership of the general partner will change pro rata as the exchangeable Class B LP units are exchanged for units in the Fund. Pursuant to the Distribution Reinvestment Plan ["DRIP"] initiated in April 2008, another 881,113 Class A LP Units were issued. Accordingly, as at December 31, 2009, the Fund indirectly holds a 21.15% [2008 – 21.15%] interest in FNFLP and FNFC holds a 78.85% [2008 – 78.85%] controlling interest in FNFLP.

The Class A LP unitholders and the exchangeable Class B LP unitholders of FNFLP are entitled to one vote for each unit held at all meetings of holders of the LP units and have economic rights that are equivalent in all material respects, except that exchangeable Class B LP units are exchangeable, directly or indirectly, on a

one-for-one basis [subject to customary anti-dilution provisions] for Fund Units at the option of the holder at any time. Additionally, exchangeable Class B LP units have special voting rights that entitle the holder to receive notice of, attend and vote at all meetings of Unitholders of the Fund.

The Fund effectively commenced operations through its indirect investment in FNFLP on June 15, 2006. The excess of the Fund's cost of its investments in units of FNFLP over the carrying value of the underlying net assets has been assigned to goodwill and finite life intangible assets. Income reported by the Fund commenced on the acquisition date.

NOTE 2

BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

Income taxes

Accounting for income taxes is reflected in these consolidated financial statements on the assumption that the Fund will qualify as a "mutual fund trust" as defined in the Income Tax Act (Canada) [the "Tax Act"], including its establishment and maintenance as a trust for the benefit of Canadian residents. Consequently, these consolidated financial statements do not reflect any provision for current income taxes, as the Fund intends to distribute to its Unitholders substantially all of its taxable income and the Fund intends to comply with the provisions of the Tax Act that permit, amongst other items, the deduction of distributions to Unitholders from the Fund's taxable income.

The Fund accounts for income taxes in accordance with the liability method. Under this method, future income tax assets and liabilities are determined based on temporary differences between the carrying amounts and tax bases of assets and liabilities, and measured using the substantively enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. The effect on future income taxes of a change in tax rates is recognized in income in the period that includes the date of substantive enactment. A valuation allowance is established, if necessary, to reduce future income tax assets to the amount that is more likely than not to be realized.

Investments in FNFLP and First National Financial GP Corporation

The Fund accounts for its investments in FNFLP and First National Financial GP Corporation using the equity method. Under this method, the cost of the investment is increased by the Fund's proportionate share of FNFLP's earnings and reduced by any distribution paid to the Fund by FNFLP and amortization of the portion of the purchase price discrepancy, consisting of intangible assets.

The excess of the Fund's cost of its investment in Units over the carrying value of the underlying net assets has been allocated notionally to FNFLP's servicing rights, broker and borrower relationships and goodwill. The excess related to servicing rights is being amortized over the average term of the related mortgages and the excess related to broker and borrower relationships over the estimated useful term of 5 and 10 years of the relationships. The goodwill component of the purchase price discrepancy is not amortized. The value of the investments is tested annually for impairment.

NOTE 3

FUND UNITS

The Fund may issue an unlimited number of Units for consideration and on the terms and conditions as determined by the Fund's trustees. Each Fund Unit is transferable and represents an equal undivided beneficial interest in any distribution from the Fund. All Fund Units are of the same class and have equal rights and privileges.

Under the terms of the Exchange, Voting and Registration Rights Agreement dated June 15, 2006, the exchangeable Class B LP units held by FNFC are exchangeable for Fund Units on a one-for-one basis. After exercise of the over-allotment options, the Fund has reserved 47,286,316 Units for the exchange of the exchangeable Class B LP units.

The following Units are issued and outstanding:

	2009		2008	
	Number of Units	Amount	Number of Units	Amount
Balance of Units outstanding, January 1	12,681,113	\$ 120,171	11,800,000	\$ 109,140
Units issued pursuant to the DRIP	—	—	881,113	11,031
Balance of Units outstanding, December 31	12,681,113	\$ 120,171	12,681,113	\$ 120,171

Fund Units are redeemable at any time on demand by the Unit-holder. The redemption price per Unit is equal to the lesser of:

- 90% of the weighted average trading price per Unit during the last 10 days on the principal exchange on which the Units are listed; or
- An amount equal to:
 - the closing price of the Units on the date on which the Units were tendered for redemption on the principal stock exchange on which the Units are listed, if there was a trade on the specified date and the applicable market or exchange provides a closing price; or
 - the average of the highest and lowest prices of the Units on the date on which the Units were tendered for redemption on the principal stock exchange on which the Units are listed, if there was trading on the date on which the Units were tendered for redemption and the exchange or other market provides only the highest and lowest trade prices of the Units traded on a particular day; or
 - the average of the last bid and ask prices quoted in respect of the Units on the principal stock exchange on which the Units are listed if there was no trading on the date on which the Units were tendered for redemption.

The Fund's optional DRIP allowed eligible Canadian Unitholders to elect to have their cash distributions from the Fund automatically reinvested in additional Units. Unitholders who participated in the DRIP received a further bonus distribution of Units equal in value to 5% of each distribution that was reinvested. During 2008, the Company issued 881,113 Units pursuant to this plan and invested the proceeds of \$11,031 in increased investment in FNFLP. No Units under the DRIP were issued in 2009.

FIRST NATIONAL FINANCIAL INCOME FUND
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4

INVESTMENT IN FIRST NATIONAL FINANCIAL LP

Investment in First National Financial LP consists of the following:

	2009	2008
Units outstanding	\$ 123,671	\$ 111,640
Investment pursuant to DRIP	–	12,031
Equity accounting adjustments		
Made prior to beginning of year	(13,310)	(9,888)
Equity earnings of First National Financial LP for the year	34,571	22,333
Amortization of purchase price discrepancy	(9,468)	(8,911)
Distributions received in the year	(18,387)	(16,844)
	\$ 117,077	\$ 110,361

NOTE 5

DISTRIBUTIONS TO UNITHOLDERS

The Fund is entirely dependent on distributions from FNFLP to make its own distributions. The Fund pays monthly distributions to its Unitholders of record on the last business day of each month approximately 15 days after the end of each month. The table below outlines the cumulative distributions to the Unitholders:

	Per Unit	Amount
Distributions paid		
2008 regular distribution	\$ 0.11250	\$ 1,427
2008 special distribution	0.07000	887
January 2009	0.11250	1,427
February 2009	0.11250	1,427
March 2009	0.11250	1,426
April 2009	0.11250	1,427
May 2009	0.11250	1,427
June 2009	0.11250	1,426
July 2009	0.11250	1,427
August 2009	0.11250	1,426
September 2009	0.12500	1,585
October 2009	0.12500	1,585
November 2009	0.12500	1,585
		1,8482
Distributions payable		
December 2009		
regular distribution	0.12500	1,585
2009 special distribution	0.05000	634
		\$ 20,701

NOTE 6

INCOMETAXES

In June 2007, the Government of Canada enacted new legislation imposing additional income taxes upon publicly traded income trusts, including the Fund, effective January 1, 2011. Prior to June 2007, the Trust estimated the future income taxes on certain temporary differences between amounts recorded on its consolidated balance sheets for book and tax purposes at a nil effective tax rate. Under the legislation and general federal and provincial corporate rate reductions, the Trust now estimates the effective tax rate on the post-2010 reversal of these temporary differences to be 28.25% for 2011, 26.25% for 2012, 25.50% for 2013 and 25.0% for 2014. Temporary differences reversing before 2011 will still give rise to nil future income taxes.

The change in future tax rates has had two consequences for the Fund's consolidated financial statements: [i] the Fund has provided for a future income tax liability on the anticipated net book value and tax carrying cost difference as at January 1, 2011 related to the servicing rights and broker and borrower relationships listed in note 2, and [ii] the Fund has accounted for temporary tax differences implicit in its investment in FNFLP.

On the first issue, because there is a difference between the accounting carrying value of these intangible assets and their underlying tax carrying value, Canadian generally accepted accounting principles require a future income tax liability to be accrued. This was accrued on the initial public offering based on tax rates for income trusts, which at that time was a rate of nil. With new rates being enacted in 2009, the effective tax rate was changed to 28.25% for 2011, 26.25% for 2012, 25.50% for 2013 and 25.0% for 2014. Based on these new tax rates, the Fund accrued a future income tax liability of \$8,600 as at December 31, 2009 [2008 – \$9,200]. This liability will, in all likelihood, remain at this amount until January 1, 2011, when it will be drawn down every quarter as the Fund continues to amortize the related intangible assets until 2016.

In June 2007, based on the assets and liabilities of FNFLP, the Fund began estimating its portion of the amount of the temporary differences which were previously not subject to tax and has estimated the periods in which these differences will reverse. The Fund estimates that as at December 31, 2009, FNFLP has a net taxable temporary difference pertaining to the Fund which will

reverse after January 1, 2011 such that an accrual of \$5,150 of future income taxes is required at year end. The temporary differences relate principally to the difference of net tax carrying values of the securitization receivable, servicing liability, purchased mortgage servicing rights and intangible assets recorded in the financial statements of FNFLP over the net book value of those assets.

While the Fund believes it will be subject to additional tax under the new legislation, the estimated effective tax rate on temporary difference reversals after 2011 may change in future periods. As the legislation is new, future technical interpretations of the legislation could occur and could materially affect management's estimate of the future income tax liability.

The amount and timing of reversals of temporary differences will also depend on the Fund's future operating results, acquisitions and dispositions of assets and liabilities, and distribution policy. A significant change in any of the preceding assumptions could materially affect the Fund's estimate of the net future income tax liability.

The calculation of taxable income of the Fund is based on estimates and the interpretations of tax legislation. In the event that the tax authorities take a different view, the balances of future income taxes could change and the change could be significant.

NOTE 7

GUARANTEE

The Fund's wholly-owned subsidiary, First National Financial Operating Trust, has provided guarantees to and subordinated its rights to receive payments from FNFLP in respect of FNFLP's bank credit facility that had an outstanding amount at December 31, 2009 of \$240,704 [2008 – \$320,100] and an authorized limit of \$378,330 [2008 – \$378,330]. No fee is charged for this guarantee.

On February 12, 2010, FNFLP elected to cancel \$78,000 of its line of credit commitment, reducing the revolving line of credit to \$300,330.

NOTE 8

EARNINGS PER UNIT

Earnings per Unit are calculated using net income for the year divided by the equivalent number of Fund Units outstanding during the year:

Auditors' Report

To the Partners of First National Financial LP

We have audited the balance sheets of First National Financial LP as at December 31, 2009 and 2008 and the statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst + Young LLP

Chartered Accountants
Licensed Public Accountants

Toronto, Canada,
March 9, 2010

FIRST NATIONAL FINANCIAL LP

BALANCE SHEETS

(in \$000s)

<i>As at December 31</i>	<i>2009</i>	<i>2008</i>
ASSETS		
Accounts receivable and sundry	\$ 37,161	\$ 26,566
Mortgages accumulated for sale	383,257	224,570
Securitization receivable (note 3)	103,964	51,104
Deferred placement fees receivable (note 3)	98,121	63,977
Cash collateral and short-term notes held by securitization trusts (note 3)	45,112	54,198
Mortgage and loan investments (note 4)	54,737	75,450
Purchased mortgage servicing rights (note 5)	6,607	8,631
Securities purchased under resale agreements and owned (note 10)	333,705	227,304
Property, plant and equipment, net (note 6)	5,026	5,265
Total assets	1,067,690	737,065
LIABILITIES AND EQUITY		
Liabilities		
Bank indebtedness (note 7)	\$ 249,336	\$ 331,003
Obligations related to securities and mortgages sold under repurchase agreements (note 11)	221,937	–
Accounts payable and accrued liabilities	18,097	16,692
Distributions payable	10,494	10,944
Servicing liability (note 3)	21,022	15,697
Securities sold under repurchase agreements and sold short (note 10)	332,427	224,882
Total liabilities	853,313	599,218
Commitments and guarantees (note 9)		
Equity		
GP units (notes 1 and 18)	59	59
Class A LP units (notes 1 and 18)	120,171	120,171
Exchangeable Class B LP units (notes 1 and 18)	(22,940)	(22,940)
Retained earnings	117,087	40,557
Total equity	214,377	137,847
Total liabilities and equity	\$ 1,067,690	\$ 737,065

See accompanying notes

On behalf of the Board:



Director
Stephen Smith



Director
Moray Tawse

FIRST NATIONAL FINANCIAL LP
STATEMENTS OF INCOME AND RETAINED EARNINGS

(in \$000s, except earnings per unit)

<i>Years ended December 31</i>	<i>2009</i>	<i>2008</i>
REVENUE		
Placement fees	\$ 123,882	\$ 145,930
Gains on deferred placement fees <i>(note 3)</i>	51,805	40,760
Gains on securitization <i>(note 3)</i>	55,417	26,524
Mortgage investment income <i>(note 4)</i>	23,428	22,148
Mortgage servicing income	64,440	62,258
Residual securitization income <i>(note 3)</i>	22,853	9,005
Realized and unrealized losses on financial instruments <i>(notes 2 and 13)</i>	(109)	(12,666)
	341,716	293,959
EXPENSES		
Brokerage fees	\$ 98,677	\$ 105,757
Salaries and benefits	48,204	40,376
Interest	13,439	15,663
Management salaries	1,500	1,500
Other operating	16,413	22,642
	178,233	185,938
Net income for the year	\$ 163,483	\$ 108,021
Retained earnings, beginning of year	40,557	13,769
Less distributions declared	(86,953)	(81,233)
Retained earnings, end of year	\$ 117,087	\$ 40,557
Earnings per unit <i>(note 16)</i>		
Basic	\$ 2.73	\$ 1.81

See accompanying notes

FIRST NATIONAL FINANCIAL LP
STATEMENTS OF CASH FLOWS
(in \$000s)

<i>Years ended December 31</i>	<i>2009</i>	<i>2008</i>
OPERATING ACTIVITIES		
Net income for the year	\$ 163,483	\$ 108,021
Add (deduct) items not affecting cash		
Gains on securitization and gains on deferred placement fees	(121,565)	(75,506)
Amortization of securitization receivable and deferred placement fees receivable	48,019	45,283
Amortization of purchased mortgage servicing rights	2,024	1,123
Amortization of property, plant and equipment	1,749	1,655
Unrealized losses on financial instruments	32	6,809
Amortization of servicing liability	(5,743)	(6,399)
	87,999	80,986
Net change in non-cash working capital balances related to operations <i>(note 12)</i>	(171,548)	(160,783)
Cash used in operating activities	(83,549)	(79,797)
INVESTING ACTIVITIES		
Additions to property, plant and equipment	\$ (1,510)	\$ (1,992)
Repayment of cash collateral and short-term notes, net	8,614	1,210
Investment in mortgage and loan investments	(82,924)	(60,887)
Repayment of mortgage and loan investments	101,063	81,436
Cash provided by (used in) investing activities	25,243	19,767
FINANCING ACTIVITIES		
Issuance of Class A LP units <i>(note 1)</i>	\$ –	\$ 11,031
Distributions paid	(87,403)	(70,989)
Obligations related to securities and mortgages sold under repurchase agreements	221,937	–
Securities purchased under resale agreements and owned, net	(106,401)	(104,440)
Securities sold under repurchase agreements and sold short, net	111,840	100,925
Cash provided by financing activities	139,973	(72,473)
Net decrease (increase) in bank indebtedness during the year	81,667	(132,503)
Bank indebtedness, beginning of year	(331,003)	(198,500)
Bank indebtedness, end of year	\$ (249,336)	\$ (331,003)
Supplemental cash flow information		
Interest paid	\$ 13,330	\$ 15,951

See accompanying notes

FIRST NATIONAL FINANCIAL LP
NOTES TO FINANCIAL STATEMENTS

December 31, 2009 and 2008

(in \$000s, except per unit amounts or unless otherwise noted)

NOTE 1

**GENERAL ORGANIZATION AND BUSINESS
OF FIRST NATIONAL FINANCIAL LP**

First National Financial LP [the "Company" or "FNFLP"], a limited partnership established under the laws of Ontario, is a Canadian-based originator, underwriter and servicer of predominantly prime single-family residential and multi-unit residential and commercial mortgages.

As a Canada Mortgage and Housing Corporation approved lender, the Company is active in the single-family residential and commercial mortgage markets. As at December 31, 2009, the Company had mortgages under administration of \$47,793,045 [2008 – \$40,596,013] and cash held in trust of \$435,358 [2008 – \$334,451]. Mortgages under administration are serviced for financial institutions such as insurance companies, pension funds, mutual funds, trust companies, credit unions and special purpose entities [including trusts], also referred to as securitization vehicles. As at December 31, 2009, the Company administered 155,401 mortgages [2008 – 133,177] for 98 institutional investors [2008 – 109] with an average remaining term to maturity of 47 months [2008 – 51 months].

Pursuant to the Limited Partnership Agreement between FNFLP, First National Financial Operating Trust [the "Trust"] and First National Financial Corporation ["FNFC"] dated June 15, 2006, First National Financial GP Corporation, as general partner, has full power and exclusive authority to employ all persons necessary for the conduct of the partnership, to enter into an agreement and to incur any obligation related to the affairs of the partnership and is entitled to full reimbursement of all costs and expenses incurred on behalf of the partnership. As general and administrative costs incurred by First National Financial GP Corporation are on behalf of the partnership, these costs have been reflected in the financial statements of FNFLP.

NOTE 2

SIGNIFICANT ACCOUNTING POLICIES

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including contingencies, at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates. Major areas requiring use of estimates by management are the securitization receivable and the fair values of financial assets and liabilities.

Adoption of new accounting standards

***Credit risk and the fair value of financial assets
and financial liabilities***

In January 2009, the Emerging Issues Committee of the Canadian Institute of Chartered Accountants ["CICA"] issued Abstract EIC-173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities", which establishes guidance requiring an entity to consider its own credit and the credit risk of the counterparty when determining the fair value of financial assets and financial liabilities, including derivative instruments. EIC-173 should be applied retroactively, without restatement of prior periods. The adoption of this abstract did not have a significant impact on the Company's financial statements.

Financial instruments – disclosures

In June 2009, the CICA amended Handbook Section 3862, "Financial Instruments – Disclosures", to enhance disclosures about fair value measurements and the liquidity risk of financial instruments. All financial instruments recognized at fair value on the balance sheets must be classified into three fair value hierarchy levels, which are as follows:

Level 1 – valuation based on quoted prices [unadjusted] observed in active markets for identical assets or liabilities;

Level 2 – valuation techniques based on inputs that are quoted prices of similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; inputs other than quoted prices used in a valuation model that are observable for that instrument; and inputs that are derived principally from or corroborated by observable market data by correlation or other means; and

Level 3 – valuation techniques with significant unobservable market inputs.

The amendments have no impact on how the Company determines the fair value of financial instruments; however, they require additional disclosures, which details are provided in note 13.

Impairment of financial assets

In August 2009, the CICA amended Handbook Section 3855, "Financial Instruments – Recognition and Measurement". The amendments apply to annual financial statements relating to fiscal years beginning on or after November 1, 2008, with retroactive application to the beginning of the fiscal year. The amendments allow certain debt securities not quoted in an active market to be classified as loans and receivables and measured at amortized cost, with impairment being measured using the incurred credit loss model of Section 3025, "Impaired Loans". Loans and receivables that an entity intends to sell immediately or in the near term must be classified as held-for-trading, and loans and receivables for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, must be classified as available-for-sale. Impairment losses recognized in income relating to an available-for-sale debt security must be reversed in income when, in a subsequent period, the fair value of the security increases and the increase can be objectively related to an event occurring after the loss was recognized. The initial application of these amendments had no significant impact on the Company's financial statements, primarily because the Company has not classified any assets as available-for-sale.

Revenue recognition

The Company earns revenue from placement, securitization and servicing activities related to its mortgage business. The majority of originated mortgages are funded either by placement of mortgages with institutional investors or the sale of mortgages to securitization conduits. The Company retains servicing rights on substantially all of the mortgages it originates, providing the Company with servicing fees.

The Company complies with CICA Accounting Guideline 12, "Transfers of Receivables". Accordingly, gains on securitization are recognized in income at such time as the Company transfers mortgages to securitization vehicles and surrenders control, whereby the transferred assets have been isolated presumptively beyond the reach of the Company and its creditors, even in bankruptcy or other receivership. When the Company securitizes mortgages, it generally retains a residual interest, presented in the balance sheets as securitization receivable, and the rights and obligations associated with servicing the mortgages. The measurement of gains or losses recognized on the sale of mortgages depends in part on the previous carrying amount of the transferred mortgages, as allocated between the assets sold and the interests that are retained by the Company as the seller, based on the relative fair value of the assets and the retained interest at the date of transfer. To obtain fair values, quoted market prices are used where available. Since quoted

prices are generally not available for retained interests, the Company estimates fair value based on the net present value of future expected cash flows, calculated using management's best estimates of key assumptions related to expected credit loss experience, prepayment rates and discount rates commensurate with the risks involved.

Placement fees are earned by the Company for its origination and underwriting activities on a completed transaction basis when the mortgage is funded. Amounts collected or collectible in excess of the mortgage principal are recognized as placement fees. When placement fees are earned over the term of the related mortgages, the Company determines the present value of the ongoing placement fees. This amount is recorded in income as gains on deferred placement fees. The same accounting methodology is applied as described above for gains on securitization.

Residual securitization income represents primarily the difference between the actual cash flows received on securitized mortgages and the assumed cash flows, and is recognized in income as received. It also includes the difference between the actual cash flows received on mortgages sold under deferred placement arrangements and the assumed cash flows. Further, subsequent to securitization/placement, the fair value of retained interests is measured quarterly and compared to the receivables at the balance sheet dates. Should the carrying value of the receivables differ from the fair value of the retained interests determined by reference to the underlying remaining expected cash flows, unrealized gains or losses on financial instruments are recorded in the statements of income and retained earnings to adjust the carrying value of the receivables.

The Company services substantially all of the mortgages that it originates whether the mortgage is placed with institutional investors or transferred to a securitization vehicle. In addition, mortgages are serviced on behalf of third-party institutional investors and securitization structures. Servicing revenue is recognized in income on an accrual basis and is collected on a monthly basis from institutional investors. For securitized mortgages, the Company retains the rights and obligations to service the mortgages and records a liability for future servicing and a reduction to gains on securitization revenue at the time of transfer. Servicing income related to securitized mortgages is accreted to income over the life of the servicing obligation and included in residual securitization income. Interest income earned by the Company related to servicing activities is classified as mortgage servicing income.

In addition to the foregoing sources of revenue, the Company earns interest income, which is recorded on an accrual basis from its interest bearing assets including securitization receivable, deferred placement fees receivable, mortgage and loan investments and mortgages accumulated for sale. Prior to placement or transfer, funded mortgages are presented in the balance sheets as mortgages accumulated for sale, which are typically held for a period of less than 90 days and are carried at fair value.

Brokerage fees

Brokerage fees relating to the mortgages recorded at fair value are expensed as incurred and brokerage fees relating to mortgages recorded at amortized cost are deferred and amortized over the term of the mortgages.

Cash collateral and short-term notes

Cash collateral and short-term notes held by securitization trusts are classified as held-for-trading under the Fair Value Option ["FVO"] and recorded at fair value.

Mortgage and loan investments

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

Mortgage and loan investments are recognized as being impaired when the Company is no longer reasonably assured of the timely collection of the full amount of principal and interest. An allowance for loan losses is established for mortgages and loans that are known to be uncollectible. When management considers there to be no probability of collection, the investments are written off.

Mortgages accumulated for sale

Mortgages accumulated for sale are mortgages funded on behalf of the Company's investors. These mortgages are held for terms usually not exceeding 90 days. These mortgages are classified as held-for-trading under the FVO and recorded at fair value.

Purchased mortgage servicing rights

The Company purchases the rights to service mortgages from third parties. Purchased mortgage servicing rights are initially recorded at cost and charged to income over the life of the underlying mortgage servicing obligation. The fair value of such rights is determined on a periodic basis to assess the continued recoverability of the unamortized cost in relation to estimated future cash flows associated with the underlying serviced assets. Any loss arising from an excess of the unamortized cost over the fair value is immediately recorded as a charge to income.

Property, plant and equipment

Property, plant and equipment are recorded at cost, less accumulated amortization, at the following annual rates and bases:

Computer equipment	30% declining balance
Office equipment	20% declining balance
Leasehold improvements	straight-line over the term of the lease
Computer software	30% declining balance except for computer license, which is straight-line over 10 years

Securities sold short and securities purchased under resale agreements

Securities sold short consist of the short sale of a bond. Bonds purchased under resale agreements consist of the purchase of a bond with the commitment by the Company to resell the bond to the original seller at a specified price. The Company uses combinations of bonds sold short and bonds purchased under resale agreements to economically hedge its mortgage commitments and the portion of mortgages accumulated for sale that it intends to sell.

Bonds sold short are classified as held-for-trading under the FVO and recorded at fair value. The accrued coupon on bonds sold short is recorded as interest expense. Bonds purchased under resale agreements are carried at cost plus accrued interest, which approximates market value. The difference between the cost of the purchase and the predetermined proceeds to be received on a resale agreement is recorded over the term of the hedged mortgages as an offset to interest expense. Transactions are recorded on a settlement date basis.

Securities sold under repurchase agreements

The Company purchases bonds and enters into bond repurchase agreements to close out economic hedging positions when mortgages are sold to institutional investors or securitization vehicles.

These transactions are accounted for in a similar manner as the transactions described for securities sold short and securities purchased under resale agreements.

Income taxes

These financial statements are those of the Company and do not reflect the assets, liabilities, revenues and expenses of its partners. FNFLP is a partnership carrying on business in Canada, and consequently is not directly subject to federal or provincial income taxes. The income or loss for income tax purposes of the Company is required to be allocated to FNFLP's partners.

The calculation of taxable income of the Company is based on estimates and the interpretations of tax legislation. In the event that the tax authorities take a different view, income for tax purposes of the Company as allocated to FNFLP partners could change and the change could be significant.

Cash and cash equivalents

Cash and cash equivalents consist of cash balances with banks and bank indebtedness.

Derivative instruments

Derivative instruments are marked to market and recorded at fair value with the changes in fair value recognized in income as they occur. Positive values are recorded as assets and negative values are recorded as liabilities.

Financial Instruments – Disclosures and Presentation

Effective January 1, 2008, the Company adopted CICA Handbook Section 3862, "Financial Instruments – Disclosures", and 3863, "Financial Instruments – Presentation". These sections require the disclosure of information with regard to the significance of financial instruments for the Company's financial position and performance and the nature and extent of risks arising from financial instruments

to which the Company is exposed during the period and at the balance sheet dates, and how the Company manages those risks. In 2009, Section 3862 was amended to enhance the disclosure requirements regarding the liquidity risk of financial instruments. As these are disclosure items, they had no measurement effect on the Company's financial statements.

Financial instrument classification is as follows:

Accounts receivable and sundry	Loans and receivables
Securities purchased under resale agreement	Loans and receivables
Securitization receivable	Held-for-trading
Deferred placement fees receivable	Held-for-trading
Mortgages accumulated for sale	Held-for-trading
Cash collateral and short-term notes held by securitization trusts	Held-for-trading
Mortgage commitments	Held-for-trading
Securities owned and sold short	Held-for-trading
Obligation related to securities and mortgages sold under repurchase agreements	Other liabilities
Mortgage and loan investments, except for long-term commercial mortgages	Loans and receivables
Accounts payable and bank indebtedness	Other liabilities
Long-term commercial mortgages included in mortgage and loan investments	Held-for-trading

Variable interest entities

The Company applies the guidance in CICA Accounting Guideline 15, "Consolidation of Variable Interest Entities" ["AcG-15"], when preparing its financial statements. AcG-15 provides a framework for identifying a variable interest entity ["VIE"] and requires a primary beneficiary to consolidate a VIE. A primary beneficiary is the enterprise that absorbs the majority of the VIE's expected losses or receives a majority of the VIE's residual returns, or both. The Company has interests in VIEs that are not consolidated because the Company is not considered the primary beneficiary.

Paper ["ABCP"], NHA-MBS and the Canada Mortgage Bonds ["CMB"] program. At that time, the Company also entered into transactions with institutional investors in which placement fees were received over time instead of just at the time of the mortgage sale. In these cases, the Company applied the same accounting methodology as it had with the direct securitization transactions; future expected cash flows were discounted to present value and a gain on securitization was recorded. Because of the growth of transactions that attract deferred placement fees, the Company considers this change appropriate. It has used this new presentation for its revenue beginning in the first quarter of 2009 and presented reclassified comparative figures on the same basis.

NOTE 3

SECURITIZATION AND DEFERRED PLACEMENT FEES RECEIVABLE

Beginning in the first quarter of 2009, the Company changed the presentation of its activities that were previously disclosed generally as securitizations. Going forward, the Company separates this revenue into "Gains on deferred placement fees" and "Gains on securitization", and the resultant assets between "Securitization receivable" and "Deferred placement fees receivable". This distinction acknowledges the nature of the future payments being received. Originally, these future payments represented primarily the present value of future payments from direct securitization by the Company, where the Company was the principal risk taker. This included securitizations through Asset-Backed Commercial

The Company securitizes residential and commercial mortgage loans. In all of these securitizations, the Company retains servicing responsibilities and subordinate interests. Most of these securitizations consist of sales of fixed and floating rate mortgages to special purpose entities [including direct sales into the CMB program]. In these cases, the Company does not receive an explicit servicing fee; instead, the Company receives subordinated interests consisting of rights to future cash flows arising after the investors in the special purpose entities have received the return for which they contracted, and provides credit enhancement to the special purpose entity in the form of cash collateral accounts and short-term notes. The special purpose entities and other securitization vehicles have no recourse to the Company's other assets for failure of debtors to pay when due. The Company's retained interests are subject to

FIRST NATIONAL FINANCIAL LP
NOTES TO FINANCIAL STATEMENTS

credit, prepayment and interest rate risks on the transferred receivables. The Company also places residential and commercial mortgages with institutions and earns fees which are collected over future periods. These placement fees consist of sales of fixed and floating rate mortgages to institutional investors. The investors have no recourse to the Company's other assets for failure of debtors to pay when due. The Company's deferred placement fees receivable are subject primarily to prepayment risk on the mortgages sold.

During the year ended December 31, 2009, the Company securitized \$2,543,505 [2008 – \$671,987] of mortgage loans to special purpose entities and other securitization vehicles, recognizing gains on securitization of \$55,417 [2008 – \$26,524]. Gains on securitization are net of losses from interest rate hedging of \$9,638 [2008 – \$8,241]. During the year ended December 31, 2009, the Company sold \$4,606,051 [2008 – \$4,776,930] of mortgage loans to institutional investors which created placement fees receivable in future periods, recognizing gains on deferred placement fees of \$51,805 [2008 – \$40,760]. These gains are net of losses from interest rate hedging of \$4,705 [2008 – gains of \$19].

The liability for implicit servicing on securitization was \$21,022 as at December 31, 2009 [2008 – \$15,697]. In the absence of quoted market rates for servicing securitized assets, management has estimated, based on industry expertise, that the fair market value of this liability approximates its carrying value. Amortization of the servicing liability during the year ended December 31, 2009 amounted to \$5,743 [2008 – \$6,399] and is included in residual securitization income.

As part of its securitization activities, the Company provides cash collateral and invests in short-term notes for credit enhancement purposes as required by the rating agency. Credit exposure to securitized mortgages is limited to the securitization receivable, cash collateral and amounts invested in the notes. The securitization receivable is paid to the Company by the special purpose entity over the term of the mortgages, as monthly net spread income. The full amount of the cash collateral and the notes held by the securitization trusts, and accrued interest thereon, is also recorded as a receivable, and the Company anticipates full recovery

of these amounts. As at December 31, 2009, the cash collateral was \$32,178 [2008 – \$40,264] and the short-term notes were \$12,934 [2008 – \$13,934].

The key weighted average assumptions used in determining gains on deferred placement fees and securitization were as follows:

	2009	2008
Prepayment rate	13.5%	11.1%
Discount rate	5.4%	4.6%

There was no credit loss assumption used for insured mortgages as no loss is expected. For uninsured mortgages, the expected weighted average credit loss assumption used was 0.51% [2008 – 0.33%]. In 2009 the Company increased its assumption in its securitization models for credit losses from 0.35% annually to 0.70%. The result of this change was to decrease the securitization receivable and income by \$4.3 million.

Cash flows received from securitization vehicles for the years ended December 31 are as follows:

	2009	2008
Proceeds from new securitizations and deferred placements	\$ 7,149,556	\$ 5,494,918
Receipts on securitization and deferred placement fees receivable	\$ 71,126	\$ 53,088

The Company uses various assumptions to value the securitization receivable and deferred placement fee receivable [excluding cash collateral and short-term notes held by the securitization trusts], which are set out below in the table, including the rate of unscheduled prepayments. Accordingly, the securitization receivable is subject to measurement uncertainty. The effect of variations between actual experience and assumptions will be recorded in future

statements of income and retained earnings. 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 as follows:

	Commercial mortgage loans		Residential mortgage loans	
	Fixed rate	Adjustable	Fixed rate	Adjustable
2009				
Fair value of securitization receivable and deferred placement fees receivable (FVO)	\$ 78,012	\$ 958	\$ 48,399	\$ 74,716
Average life (in months) ⁽¹⁾	56	11	39	43
Prepayment speed assumption (annual rate)	0.6%	33.7%	15.2%	25.5%
Impact on fair value of 10% adverse change	\$ 88	\$ 28	\$ 1,091	\$ 2,854
Impact on fair value of 20% adverse change	\$ 173	\$ 54	\$ 2,144	\$ 5,537
Residual cash flows discount rate (annual)	5.6%	3.7%	5.1%	5.3%
Impact on fair value of 10% adverse change	\$ 1,029	\$ 3	\$ 378	\$ 607
Impact on fair value of 20% adverse change	\$ 2,033	\$ 6	\$ 751	\$ 1,205
Expected credit losses	0.0%	0.1%	0.0%	0.0%
Impact on fair value of 10% adverse change	\$ 65	\$ 3	\$ 423	\$ 177
Impact on fair value of 20% adverse change	\$ 129	\$ 7	\$ 847	\$ 353
Spread assumption	0.5%	0.7%	0.6%	1.0%
Impact on fair value of 10% adverse change	\$ 7,847	\$ 96	\$ 5,161	\$ 7,435
Impact on fair value of 20% adverse change	\$ 15,693	\$ 191	\$ 10,323	\$ 14,869
	Commercial mortgage loans		Residential mortgage loans	
	Fixed rate	Adjustable	Fixed rate	Adjustable
2008				
Fair value of securitization receivable and deferred placement fees receivable (FVO)	\$ 37,620	\$ 1,796	\$ 38,263	\$ 37,402
Average life (in months) ⁽¹⁾	61	22	45	37
Prepayment speed assumption (annual rate)	0.0%	32.2%	15.7%	16.3%
Impact on fair value of 10% adverse change	\$ 19	\$ 55	\$ 1,081	\$ 792
Impact on fair value of 20% adverse change	\$ 38	\$ 105	\$ 2,117	\$ 1,557
Residual cash flows discount rate (annual)	4.8%	4.1%	4.5%	4.4%
Impact on fair value of 10% adverse change	\$ 449	\$ 8	\$ 304	\$ 240
Impact on fair value of 20% adverse change	\$ 889	\$ 15	\$ 604	\$ 476
Expected credit losses	0.0%	0.1%	0.0%	0.0%
Impact on fair value of 10% adverse change	\$ 107	\$ 11	\$ 410	\$ 140
Impact on fair value of 20% adverse change	\$ 214	\$ 22	\$ 821	\$ 280
Spread assumption	0.3%	0.7%	0.5%	0.9%
Impact on fair value of 10% adverse change	\$ 3,942	\$ 180	\$ 4,100	\$ 9,080
Impact on fair value of 20% adverse change	\$ 7,884	\$ 359	\$ 8,201	\$ 16,959

(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.

FIRST NATIONAL FINANCIAL LP
NOTES TO FINANCIAL STATEMENTS

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 of the retained interest 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 and increased credit losses], which might magnify or counteract the sensitivities.

The sensitivity for spread assumptions disclosed above includes the sensitivity of securitization receivables to changes in ABCP spreads. The securitization receivable assumes ABCP will trade at 0.25 percentage points in excess of Bankers' Acceptances rates. If this spread increased by 0.10 percentage points, the related fair value of the securitization receivable would be decreased by approximately \$1,912.

The Company estimates that the expected cash flows of the securitization receivable and the deferred placement fees receivable will be as follows:

2010	\$	73,090
2011		53,122
2012		37,964
2013		22,704
2014 and thereafter		15,205
	\$	202,085

Mortgages under administration are serviced as follows:

	2009	2008
Institutional investors	\$ 33,316,698	\$ 28,723,298
Securitization vehicles	9,445,142	6,503,294
CMBS conduits	5,031,205	5,369,421
	\$ 47,793,045	\$ 40,596,013

The Company's exposure to credit loss is limited to mortgages under administration totalling \$858,023 [2008 – \$1,114,466], of which \$60,928 of mortgages have principal and interest payments outstanding as at December 31, 2009 [2008 – \$20,259]. The Company incurred actual credit losses, net of recoveries, of \$3,736 during the year ended December 31, 2009 [2008 – \$8,250]. As at December 31, 2009, the Company has \$9,296 [2008 – \$322] of uninsured non-performing mortgages [net of provisions for credit losses] included in accounts receivable and sundry related to defaulted mortgages purchased from securitization trusts.

NOTE 4

MORTGAGE AND LOAN INVESTMENTS

As at December 31, 2009, mortgage and loan investments consist primarily of commercial first and second mortgages held for various terms up to nine years.

Mortgage and loan investments consist of the following:

	2009	2008
Mortgage loans, classified as loans and receivable	\$ 44,133	\$ 55,191
Mortgage loans, designated as held-for-trading	9,604	12,389
Mortgage-backed securities, designated as held-for-trading	–	5,370
Subordinated note	1,000	2,500
	\$ 54,737	\$ 75,450

Mortgage loan and 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.

The following table discloses the composition of the Company's portfolio of mortgage and loan investments by geographic region as at December 31, 2009:

Province	Portfolio balance	Percentage of portfolio
Alberta	\$ 5,217	9.53
British Columbia	901	1.65
Manitoba	11,758	21.48
New Brunswick	545	1.00
Newfoundland	105	0.19
Nunavut	400	0.73
Nova Scotia	31	0.06
Ontario	19,242	35.15
Quebec	15,768	28.80
Saskatchewan	223	0.41
Yukon	547	1.00
	\$ 54,737	100.00

These balances are net of discounts of \$674 [2008 – \$1,286] and provisions for credit losses of \$4,306 [2008 – \$3,437]. The portfolio contains \$869 [2008 – \$5,938] of insured mortgages and \$53,868 [2008 – \$69,512] of uninsured mortgage and loan investments as at December 31, 2009.

The following table discloses the mortgages that are past due as at December 31:

Days	2009	2008
31 to 60	\$ 400	\$ –
61 to 90	–	6,771
Greater than 90	5,956	2,739
	\$ 6,356	\$ 9,510

Of the above total amount, the Company considers \$5,956 [2008 – \$5,433] as impaired, for which it has provided an allowance for potential loss of \$4,306 [2008 – \$3,437] as at December 31, 2009.

Allowance for loan losses

The following table discloses credit losses which the Company has provided for impaired mortgage and loan investments:

	2009	2008
Balance, beginning of year	\$ 3,437	\$ 55
Provisions for credit losses	1,313	6,795
Write-offs	(444)	(3,413)
Balance, end of year	\$ 4,306	\$ 3,437

Due to loan specific issues, the Company has experienced credit losses of \$1,313 for the year ended December 31, 2009 [2008 – \$6,795]. These losses are included in other operating expenses in the statements of income and retained earnings.

The contractual repricing on the table below is based on the earlier of contractual repricing or maturity dates.

	2009					2008
	Within 1 year	Over 1 to 3 years	Over 3 to 5 years	Over 5 years	Book value	Book value
Residential	\$ 5,492	\$ –	\$ 32	\$ –	\$ 5,524	\$ 11,379
Commercial	29,050	4,585	1,267	14,311	49,213	64,071
					\$ 54,737	\$ 75,450

The maturity profile of mortgage and loan investments is as follows:

2010	\$ 34,542
2011	2,886
2012	1,699
2013	1,128
2014 and thereafter	14,482
	\$ 54,737

The subordinated note was issued by a securitization trust not related to the Company. The Company's exposure is limited to \$1,000 [2008 – \$2,500].

Interest income for the year was \$9,626 [2008 – \$8,711] and is included in mortgage investment income on the statements of income and retained earnings.

FIRST NATIONAL FINANCIAL LP
NOTES TO FINANCIAL STATEMENTS

NOTE 5

PURCHASED MORTGAGE SERVICING RIGHTS

Purchased mortgage servicing rights consist of the following components:

	2009			2008		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Third-party commercial mortgage servicing rights	\$ 3,614	\$ 2,462	\$ 1,152	\$ 3,614	\$ 2,283	\$ 1,331
Commercial mortgage-backed securities primary and master servicing rights	8,705	3,250	5,455	8,705	1,405	7,300
	\$ 12,319	\$ 5,712	\$ 6,607	\$ 12,319	\$ 3,688	\$ 8,631

The Company did not purchase any new servicing rights during the years ended December 31, 2009 and 2008. Amortization, including impairment, charged to income for the year ended December 31, 2009 was \$2,024 [2008 – \$1,123].

During the year ended December 31, 2009, management performed an impairment test on these assets and concluded that the Company's unamortized cost exceed the fair market value and, as a result, the Company recorded an impairment charge of \$1,194.

NOTE 6

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

	2009			2008		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Computer equipment	\$ 6,327	\$ 3,662	\$ 2,665	\$ 5,065	\$ 2,790	\$ 2,275
Office equipment	3,006	2,016	990	2,945	1,776	1,169
Computer software	1,869	1,259	610	1,682	984	698
Leasehold improvements	2,429	1,668	761	2,429	1,306	1,123
	\$ 13,631	\$ 8,605	\$ 5,026	\$ 12,121	\$ 6,856	\$ 5,265

NOTE 7

BANK INDEBTEDNESS

Bank indebtedness includes a one-year revolving line of credit of \$378,330 [2008 – \$378,330] maturing in June 2010, of which \$240,704 [2008 – \$320,100] was drawn at December 31, 2009 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 revolving line of credit bears a variable rate of interest based on prime or bankers' acceptance rates.

On February 12, 2010, the Company elected to cancel \$78,000 of its line of credit commitment, reducing the revolving line of credit to \$300,330.

NOTE 8

SWAP CONTRACTS

Swaps are over-the-counter contracts in which two counterparties exchange a series of cash flows based on agreed upon rates to a notional amount. The Company used an interest rate swap to manage interest rate exposure relating to variability of interest earned on a portion of mortgages accumulated for sale held on

the balance sheets. The swap agreement that the Company entered into was an interest rate swap where two counterparties exchange a series of payments based on different interest rates applied to a notional amount in a single currency.

The following table presents the notional amounts and fair value of the swap contract as at December 31, 2009 and 2008 by remaining term to maturity:

	2009			
	3 to 5 years	> 5 years	Total notional amount	Fair value
Interest rate swap contract	\$ 33,000	\$ —	\$ 33,000	\$ (209)

	2008			
	3 to 5 years	> 5 years	Total notional amount	Fair value
Interest rate swap contract	\$ 33,000	\$ —	\$ 33,000	\$ (737)

Positive fair values of the interest rate swap contracts are included in accounts receivable and sundry and negative fair values are included in accounts payable and accrued liabilities on the balance sheets.

NOTE 9

COMMITMENTS AND GUARANTEES

As at December 31, 2009, the Company has the following operating lease commitments for its office premises:

2010	\$ 3,037
2011	2,752
2012	719
2013	329
2014	155
	\$ 6,992

Outstanding commitments for future advances on mortgages with terms of one to 10 years amounted to \$1,835,674 as at December 31, 2009 [2008 – \$1,277,364]. The commitments generally remain open for a period of up to 90 days. These commitments have credit and interest rate risk profiles similar to those mortgages which are currently under administration. Certain of these commitments have been sold to institutional investors while others will expire before being drawn down. Accordingly, these amounts do not necessarily represent future cash requirements of the Company.

In the normal course of business, the Company enters into a variety of guarantees. Guarantees include contracts where the Company may be required to make payments to a third party, based on changes in the value of an asset or liability that the third party holds. In addition, contracts under which the Company may be required to make payments if a third party fails to perform under the terms of the contract [such as mortgage servicing contracts] are considered guarantees. The Company has determined that the estimated potential loss from these guarantees is insignificant.

NOTE 10

SECURITIES TRANSACTIONS UNDER REPURCHASE AND RESALE TRANSACTIONS

The Company's outstanding securities purchased under resale agreements and securities sold under repurchase agreements have a remaining term to maturity of less than one month.

NOTE 11

**OBLIGATIONS RELATED TO SECURITIES
AND MORTGAGES SOLD UNDER
REPURCHASE AGREEMENTS**

The Company uses repurchase agreements to fund specific mortgages included in mortgages accumulated for sale. The current contracts are with financial institutions and have a weighted-average interest rate of 1.0% and mature on or before February 10, 2010. This liability includes \$62.5 million for repo transactions related to mortgages carried by the Company in the form of NHA-MBS and \$159.5 million related to the sale of whole loan mortgages. The sale is entered into concurrently with a total return swap, which with the mortgage sale is the economic equivalent of a repurchase agreement.

NOTE 12

STATEMENTS OF CASH FLOWS

The net change in non-cash working capital balances related to operations consists of the following:

	2009	2008
Accounts receivable and sundry	\$ (10,068)	\$ (7,396)
Mortgages accumulated for sale	(161,966)	(158,123)
Accounts payable and accrued liabilities	936	3,492
Distributions payable	(450)	1,244
	\$ (171,548)	\$ (160,783)

NOTE 13

**FINANCIAL INSTRUMENTS
AND RISK MANAGEMENT**

Risk management

The various risks to which the Company is exposed and the Company's policies and processes to measure and manage them individually are set out below:

Interest rate risk

Interest rate risk arises when changes in interest rates will affect the fair value of financial instruments.

The Company uses various strategies to reduce interest rate risk. The Company's risk management objective is to maintain interest rate spreads from the point that a mortgage commitment is issued to the sale of the mortgage to the related securitization vehicle or institutional investor. Primary among these strategies is the Company's decision to sell mortgages at the time of commitment, passing on interest rate risk that exists prior to funding to institutional investors. The Company uses 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 borrowers and the time the mortgage is sold to a securitization vehicle and the underlying cost of funding is fixed. As interest rates change, the values of these interest rate-dependent financial instruments vary inversely with the values of the mortgage contracts. As interest rates increase, a gain will be recorded on the economic hedge, which will be offset by the loss on the sale of the mortgage to the securitization vehicle or institutional investor, as the mortgage rate committed to the borrower is fixed at the point of commitment. For single-family mortgages, only a portion of the 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 economically hedged is the expected value of the mortgage funding within the future commitment period. The Company also hedges against interest rate fluctuations by offsetting the exposure of the Company's bank indebtedness and funds held in trust. The bank indebtedness consists entirely of floating rate bank debt; the funds held in trust earn the Company interest based on the same floating rate basis [essentially the prime lending rate]. Because both are very similar in terms of amount [bank indebtedness and obligations related to securities and mortgages sold under repurchase agreements is \$471,273 [2008 – \$331,003] at December 31, 2009; funds held in trust are \$435,358 [2008 – \$334,451] on the same date], the Company considers the arrangement to be a natural hedge against short-term interest rate fluctuations. Accordingly, as short-term interest rates change, the Company is not exposed to large fluctuations in net income.

The table below provides the financial impact that an immediate and sustained 100 basis point and 200 basis point increase and decrease in short-term interest rates would have had on the net income of the Company in 2009 and 2008.

	<i>Increase in interest rate</i>		<i>Decrease in interest rate</i>	
	<i>2009</i>	<i>2008</i>	<i>2009</i>	<i>2008</i>
100 basis points shift				
Impact on net income and unitholders' equity	\$ 1,024	\$ 377	\$ 1,802	\$ (377)
200 basis point shift				
Impact on net income and unitholders' equity	\$ 2,049	\$ 755	\$ 4,417	\$ (755)

Interest revenue earned on funds held in trust is included in mortgage servicing income on the statements of income and retained earnings. These funds are administered by the Company and include borrowers' property tax escrow. For the year ended December 31, 2009, this revenue was \$1,260 [2008 – \$9,577].

As at December 31, 2009, the Company administered \$68,025 of fixed rate commercial mortgages, of which it has a direct face value interest of \$13,719 included in mortgage and loan investments. The other interests in these mortgages are owned by an arm's-length investor and are subject to participation agreements such that this investor receives a floating rate of return on their portion of these mortgages. The Company has exposure to the risk that short-term interest rates increase, which represents a first loss position. Accordingly, these mortgages are much more sensitive to changes in interest rates and credit loss than the Company's typical mortgage and loan investments.

The Company's accounts receivable and sundry, accounts payable and accrued liabilities, distributions payable, purchased mortgage servicing rights and servicing liability are not exposed to interest rate risk. The Company's floating rate interest bearing assets and liabilities, such as mortgage and loan investments and bank indebtedness, are subject to liquidity risk.

Credit risk

Credit risk is the risk of loss associated with a counterparty's inability or unwillingness to fulfill its payment obligations. The Company's credit risk is mainly lending-related in the form of mortgage default. The Company uses stringent underwriting criteria and experienced adjudicators to mitigate this risk. The Company's approach to managing credit risk is based on the consistent application of a detailed set of credit policies and prudent arrears management. The Company's exposure is also mitigated by the short period over which a mortgage is held by the Company prior to securitization.

The maximum credit exposures of the financial assets are their carrying values, as reflected on the balance sheets. The Company does not have significant concentration of credit risk within any particular geographic region or group of customers.

Mortgages accumulated for sale consist primarily of \$383,257 prime mortgages, of which 90% are insured, 1% are uninsured but sold on commitment to institutional investors and the remainder is low loan-to-value conventional. Securitization receivables, cash collateral and short-term notes held by securitization trusts represent the Company's retained interest in various securitizations, as described in note 3. Mortgage and loan investments are primarily first and second mortgage charges on commercial properties with an average loan to value of 56% and average yield of 6.6%, as described in detail in note 4. These mortgages are primarily bridge financing for the Company's borrowers and have a higher exposure to credit risk than the Company's primary commercial mortgage products. The majority of purchased mortgage servicing rights are investments in the servicing component of CMBS securitizations. The Company is at risk that the underlying mortgages default and the servicing cash flows cease. The large portfolio of individual mortgages that underlies these assets is diverse in terms of geographical locations, borrower exposure and underlying type of real estate. This and the priority ranking of the Company's rights mitigate the potential size of any credit losses. Securities purchased under resale agreements are transacted with large regulated Canadian institutions such that the risk of credit loss is very remote. Securities owned are all government of Canada bonds and, as such, have virtually no risk of credit loss.

Liquidity risk and capital resources

Liquidity risk is the risk that the Company will be unable to meet its financial obligations as they come due.

The Company's liquidity strategy has been to use bank credit to fund working capital requirements and to use cash flow from operations to fund longer-term assets, providing relatively low leveraged balance sheets. The Company's credit facilities are typically drawn to fund: [i] mortgages accumulated for sale, [ii] securitization receivable, [iii] deferred placement fees receivable and [iv] mortgage and loan investments. The Company has a credit facility with a syndicate of five banks which provides for a total of \$378,330 in financing. Bank indebtedness also includes borrowings obtained through securitization transactions, outstanding cheques and overdraft facilities.

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Market risk

Market risk is the risk of loss that may arise from changes in market factors such as interest rates and credit spreads. The level of market risk to which the Company is exposed varies depending on market conditions, expectations of future interest rates and credit spreads.

Fair value measurement

The Company uses the following hierarchy for determining and disclosing fair value of financial instruments recorded at fair value in the balance sheets:

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.

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

	<i>December 31, 2009</i>			
	<i>Level 1</i>	<i>Level 2</i>	<i>Level 3</i>	<i>Total</i>
Financial assets				
Mortgages accumulated for sale	\$ –	\$ 383,257	\$ –	\$ 383,257
Securitization receivable	–	–	103,964	103,964
Deferred placement fees receivable	–	–	98,121	98,121
Cash collateral and short-term notes held by securitization trusts	–	–	45,112	45,112
Mortgage and loan investments	–	–	9,604	9,604
Total financial assets	\$ –	\$ 383,257	\$ 256,801	\$ 640,058
Financial liabilities				
Securities sold under repurchase agreements and sold short	\$ 332,427	\$ –	\$ –	\$ 332,427
Mortgage commitments	–	(29)	–	(29)
Interest rate swaps	–	209	–	209
Total financial liabilities	\$ 332,427	\$ 180	\$ –	\$ 332,607

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 year ended December 31, 2009 that was estimated using a valuation

technique based on assumptions that are not fully supported by observable market prices or rates was approximately \$(733) [2008 – \$(9,670)]. Although the Company's management believes that the estimated fair values are appropriate at the balance sheet dates, those fair values may differ if other reasonably possible alternative assumptions are used.

The following table presents changes in the fair values [including realized losses of \$77 [2008 – \$5,857]] of the Company's financial assets and financial liabilities for the years ended December 31, 2009 and 2008, all of which have been designated as held-for-trading under the FVO except for the interest rate swaps, which are required to be classified as held-for-trading:

	2009		2008
Mortgages accumulated for sale	\$ (3,279)	\$	3,528
Securitization receivable	4,048		(11,872)
Deferred placement fees receivable	(1,658)		1,840
Cash collateral and short-term notes held by securitization trusts	(472)		(165)
Mortgage and loan investments	(2,651)		527
Securities owned and sold short	4,294		(7,798)
Mortgage commitments	(919)		940
Interest rate swaps	528		334
	\$ (109)	\$	(12,666)

Valuation methods and assumptions

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

[a] Mortgages accumulated for sale and mortgage and loan investments

The fair value of these mortgages is determined by discounting projected cash flows using market industry pricing practices for discount rates at which similar loans made to borrowers with similar credit profiles and maturities would be discounted and, therefore, reflects changes in interest rates which have occurred since the mortgages were originated. Impaired mortgages are recorded at net realizable value.

[b] Securitization receivable and deferred placement fees receivable

The fair values of securitization receivable and deferred placement fees receivable are determined by internal valuation models consistent with industry practice, using market data inputs where possible. The fair value is determined by discounting the expected future cash flows related to the mortgages securitized and placed 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 3, "Securitization and deferred placement fees receivable", for the key assumptions used and sensitivity analysis.

[c] Cash collateral and short-term notes held by securitization trusts

The fair value is determined by discounting the expected cash flows related to these assets at estimated market interest rates. These rates are determined based on the amount of variability, mitigated by the assumptions inherent in the calculation of the securitization receivable.

[d] Securities owned and sold short

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

[e] Mortgage commitments

The fair value reflects changes in interest rates which have occurred since the mortgage commitments were issued and is determined using standard industry pricing practices.

[f] Other financial assets and liabilities

The fair value of mortgage and loan investments classified as loans and receivables and bank indebtedness corresponds to the respective outstanding amounts due to their short-term maturity profiles.

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Movement in Level 3 financial instruments measured at fair value

The following table shows the movement in Level 3 financial instruments in the fair value hierarchy for the year ended December 31, 2009. The Company classifies financial instruments to Level 3 when there is reliance on at least one significant unobservable input in the valuation models.

	<i>Fair value as at January 1 2009</i>	<i>Investments and repayments</i>	<i>Realized and unrealized gain (loss) recorded in income</i>	<i>Amortization</i>	<i>Fair value as at December 31 2009</i>
Financial assets					
Securitization receivable	\$ 51,104	\$ 73,424	\$ 4,048	\$ (24,612)	\$ 103,964
Deferred placement fees receivable	63,977	59,209	(1,658)	(23,407)	98,121
Cash collateral and short-term notes held by securitization trusts	54,198	(8,614)	(472)	–	45,112
Mortgage and loan investments	12,389	–	(2,651)	(134)	9,604
Total financial assets	181,668	124,019	(733)	(48,153)	256,801

Note 3 provides detailed sensitivity analysis of the securitization receivable and deferred placement fees receivable, using various assumptions. The following table shows the potential impact on fair values of the remaining Level 3 financial instruments by changing key assumptions. The sensitivity analysis is calculated based on a 10% change in discount rates and spread over risk-free rates for cash collateral and short-term notes held by securitization trusts and mortgage and loan investments.

	<i>Increase in fair value</i>	<i>Decrease in fair value</i>
Financial assets		
Cash collateral and short-term notes held by securitization trusts	\$ 545	\$ (545)
Mortgage and loan investments	1,218	(1,218)
Total	\$ 1,763	\$ (1,763)

NOTE 14

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 and retained earnings. The Company does not have any long-term debt and therefore the net income generated from operations is available for reinvestment in the Company or distribution to the unitholders. The Board of Directors does not establish quantitative return on capital criteria for management, but rather promotes year-over-year sustainable profit growth. The Board of Directors also reviews on a quarterly basis the level of

distributions paid to the unitholders. There were no changes in the Company's approach to capital management during the year ended December 31, 2009. The Company has a minimum capital requirement as stipulated by its bank credit facility. The agreement requires a debt to equity ratio of 4:1. As at December 31, 2009, the ratio was 2.20:1 [2008 – 2.32:1]. The Company was in compliance with the bank agreement throughout the year.

NOTE 15

INFORMATION ABOUT MAJOR CUSTOMERS

Placement fees, mortgage servicing income and gains on deferred placement fees revenue from three Canadian financial institutions represent approximately 41% [2008 – 51%] of the Company's total revenue. During the year ended December 31, 2009, the Company placed 51% [2008 – 87%] of all mortgages it originated with the same three institutional investors.

NOTE 16

EARNINGS PER UNIT

Earnings per unit are calculated as follows:

	<i>2009</i>	<i>2008</i>
Net income for the year available to unitholders	\$ 163,483	\$ 108,021
Number of equivalent unitholders [Class A and B (000s)]	59,967	59,595
Basic earnings per unit	2.73	1.81

NOTE 17

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. Expenses not allocated to segments relate to compensation paid to senior management. Identifiable assets are those used in the operations of the segments.

	2009		
	<i>Residential</i>	<i>Commercial</i>	<i>Total</i>
REVENUE			
Placement, securitization and servicing	\$ 229,096	\$ 89,192	\$ 318,288
Mortgage investment income	11,167	12,261	23,428
	<u>240,263</u>	<u>101,453</u>	<u>341,716</u>
EXPENSES			
Amortization	1,353	396	1,749
Interest	10,333	3,106	13,439
Other operating	134,714	26,831	161,545
Corporate non-allocated expenses	-	-	1,500
	<u>146,400</u>	<u>30,333</u>	<u>178,233</u>
Net income for the year	93,863	71,120	163,483
Identifiable assets	530,908	536,782	1,067,690
Capital expenditures	\$ 1,056	\$ 454	\$ 1,510
2008			
	<i>Residential</i>	<i>Commercial</i>	<i>Total</i>
REVENUE			
Placement, securitization and servicing	\$ 218,934	\$ 52,877	\$ 271,811
Mortgage investment income	10,437	11,711	22,148
	<u>229,371</u>	<u>64,588</u>	<u>293,959</u>
EXPENSES			
Amortization	1,310	345	1,655
Interest	10,568	5,095	15,663
Other operating	141,568	25,552	167,120
Corporate non-allocated expenses	-	-	1,500
	<u>153,446</u>	<u>30,992</u>	<u>185,938</u>
Net income for the year	75,925	33,596	108,021
Identifiable assets	399,185	337,880	737,065
Capital expenditures	\$ 1,393	\$ 599	\$ 1,992

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NOTE 18

UNITHOLDERS' EQUITY

Pursuant to the Fund Distribution Reinvestment Plan ["DRIP"] initiated in April 2008, eligible Canadian unitholders are allowed to elect to have their cash distributions from the Fund automatically reinvested in additional Units. Unitholders who participate in the DRIP will receive a further bonus distribution of Units equal in value to 5% of each distribution that was reinvested. The DRIP was suspended in 2008 and no DRIP Units were issued in fiscal 2009.

The following Units are issued and outstanding:

	<i>Number of units</i>	<i>Amount</i>
GP units		
Units outstanding, January 1, 2009 and 2008	1	\$ 59
Units outstanding, December 31, 2009	1	\$ 59
Class A LP units		
Units outstanding, January 1, 2008	11,800,000	\$ 109,140
Issued pursuant to the DRIP in 2008	881,113	11,031
Units outstanding, December 31, 2008 and 2009	12,681,113	\$ 120,171
Class B LP units		
Units outstanding, January 1, 2009 and 2008	47,286,316	\$ (22,940)
Units outstanding, December 31, 2009	47,286,316	\$ (22,940)

The Company is authorized to issue an unlimited number of GP units, Class A LP units and Class B LP units. The Class B LP units are exchangeable for units of the Fund at the option of the holder subject to certain conditions.

NOTE 19

RELATED PARTY TRANSACTIONS

During the past two years, several of the Company's borrowers tendered opportunities to invest in large commercial mezzanine mortgages. The amounts of the mortgages were in excess of the

Company's internal investment policies for investments of that nature; however, a business controlled by a senior executive of the Company entered into agreements with the borrowers to fund the mortgages. The Company serviced these mortgages during their terms at normal commercial servicing rates. The mortgages are administered by the Company at market rates and have a balance of \$5,483 as at December 31, 2009 [2008 – nil].

NOTE 20

FUTURE ACCOUNTING CHANGES

International Financial Reporting Standards ["IFRS"]

In February 2008, the Canadian Accounting Standards Board confirmed that all publicly accountable enterprises would be required to report under IFRS for fiscal years beginning on or after January 1, 2011. These standards are effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011 and will be applicable for the Company's first quarter of 2011.

In preparation for the changeover to IFRS, the Company has developed an IFRS transition plan consisting of three phases:

1. Scoping and Diagnostic Phase,
2. Impact Analysis and Design Phase, and
3. Implementation and Review Phase

Pursuant to the plan, an initial diagnostic impact assessment has been completed to identify the IFRS standards that represent key accounting differences from Canadian GAAP for the Company. A number of differences have been identified with respect to the recognition and measurement of certain balance sheet items. While the Company's key analyses are progressing well, preliminary conclusions have not yet been reached and, as such, they have not been reported at this time.

The evolving nature of IFRS will likely result in additional accounting changes and, as a result, the final impact on the Company's financial statements of applying IFRS in full will only be entirely measurable once all applicable IFRS requirements are known. While the Company continues to execute the IFRS transition plan, the Company will monitor changes in the standards and report on the status of the plan, significant findings, and provide more detailed information on preliminary conclusions reached.

NOTE 21

COMPARATIVE FINANCIAL STATEMENTS

The comparative financial statements have been reclassified from statements previously presented to conform to the presentation of the 2009 financial statements.

INVESTOR INFORMATION

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TSX Broadcast & Conference Centre
The Gallery
The Exchange Tower
130 King Street West
Toronto, Ontario

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