

FIRST NATIONAL

FINANCIAL CORPORATION



ANNUAL REPORT 2010

Service. Innovation. Results.

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PROFILE

First National Financial Corporation (TSX:FN) is the successor to First National Financial Income Fund, and its wholly-owned subsidiary, First National Financial LP, is a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over \$53 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.

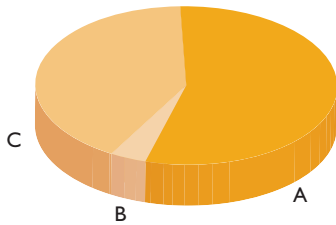
- **Canada's largest non-bank mortgage originator**
- **Leader in mortgage broker distribution channel**
- **High-quality mortgage portfolio**
- **Diverse revenue and funding sources**



INVESTMENT HIGHLIGHTS

FUNDING SOURCES

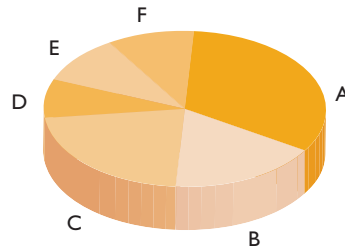
(Year ended December 31, 2010)



- A. 59% Institutional placements
- B. 4% Securitization and internal company sources
- C. 37% NHA-MBS

REVENUE SOURCES*

(Year ended December 31, 2010)

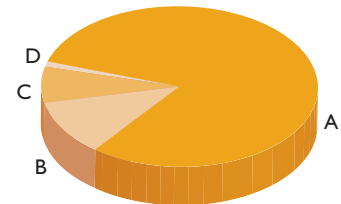


- A. 33% Institutional placements
- B. 17% Gain on securitization
- C. 22% Mortgage servicing
- D. 8% Investment income
- E. 10% Residual securitization
- F. 10% Gain on financial instruments

* Based on gross revenue

MORTGAGES UNDER ADMINISTRATION

(As at December 31, 2010)



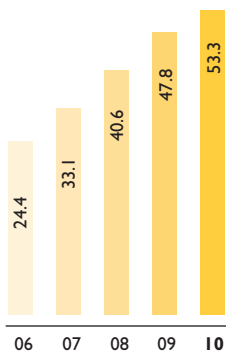
- A. 79% Insured
- B. 13% Multi-unit and commercial
- C. 7% Conventional and single-family residential
- D. 1% Bridge loans/Alt-A

86% Insured or conventional single-family residential

OUR 2010 PERFORMANCE AT A GLANCE

MORTGAGES UNDER ADMINISTRATION

(In \$ Billions)

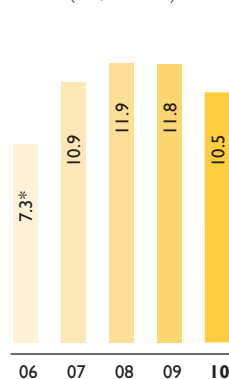


11.5%

Year-over-year growth
2009 to 2010

MORTGAGE ORIGINATIONS

(In \$ Billions)

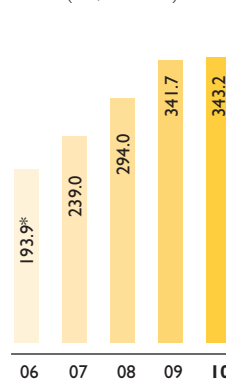


(11%)

Year-over-year growth
2009 to 2010

REVENUE

(In \$ Millions)

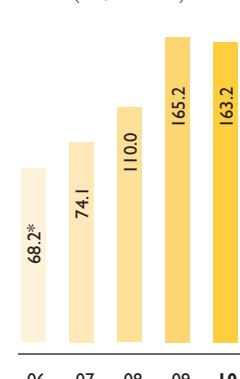


0.4%

Year-over-year growth
2009 to 2010

EBITDA

(In \$ Millions)



(1%)

Year-over-year growth
2009 to 2010

* 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 SHAREHOLDERS,

This past year was a time of significant accomplishment for First National Financial Corporation. During 2010, the Company successfully transitioned from an income trust structure to a dividend-paying corporation, while maintaining its positive trend of strong financial results. Additionally, in the second quarter, mortgages under administration reached \$50 billion, a significant milestone in the Company's history. These achievements reflect the fundamental strengths of our business strategy and our leadership position within the mortgage broker distribution channel.

DELIVERING SOLID RESULTS

- Mortgages under administration reached \$53.3 billion at year-end, growing by 11.5% from the \$47.8 billion established at the end of 2009.
- Revenue increased to \$343.2 million from \$341.7 million in 2009, reflecting the increased valuation of floating rate securitization transactions and higher mortgage servicing revenue.
- Net income and EBITDA both decreased by 1%; net income from \$163.5 million in 2009 to \$161.4 million and EBITDA from \$165.2 million in 2009 to \$163.2 million. The declines were a result of tighter mortgage spreads on mortgages originated for securitization offset by gains recognized on improving capital markets. Earnings were also decreased by marginally higher mortgage brokerage expenses.
- The Company paid out distributions of \$1.50 per unit during the year and declared a one-time special distribution in December of \$0.40, rewarding unitholders with the surplus cash flow generated from the business.
- In 2010, management initiated a conversion to a corporation, which was completed effective January 1, 2011, and set the initial annual dividend payment in the amount of \$1.25 per common share, payable on a monthly basis.

In 2010, First National maintained its market share and produced solid results, despite a slowing real estate market and increased competition from other lenders. Despite relatively tight spreads on new mortgage origination, we continued to grow the number of mortgages under administration, achieving a record year-end level of \$53 billion. Our ability to grow in such uncertain economic conditions confirms our position as Canada's leading non-bank mortgage lender and demonstrates the success of our business strategy.

First National achieved strong financial performance in 2010, almost matching the record results of 2009, which represented a period of wide spreads and reduced competition. The high demand for prime insured mortgages and profitable spreads on much of our origination recorded in the first three months of the year receded in both the second and third quarters. The resulting decline in Canada's housing market translated into lower revenue and net income than was recorded in the previous year. However, seasonal mortgage commitments returned to 2009 levels in the fourth quarter. The relative strength of our domestic economy and the widening of mortgage spreads to pre-crisis levels helps ensure that First National will continue to grow and profit in this environment.

Another key achievement this year was the Company's successful transition from an income trust to a corporate entity. The intention to convert to a dividend-paying corporation was first announced on March 25, 2010 and was overwhelmingly approved by First National Financial Income Fund's unitholders at a special meeting held on May 4, 2010. We are confident that this strategic change will facilitate a more attractive environment for First National's securities while broadening the potential investor base for the Company and positioning us for greater profitability and future growth.

INDUSTRY DEVELOPMENTS

Recessionary market conditions persisted throughout 2010. A slower domestic housing market, tighter spreads and increased competition continued to create sustained but slower growth and increased cash flow for First National. Following a record-breaking 2009, there were fewer real estate transactions available to finance in 2010, leading to reduced mortgage origination levels in both the single-family and multi-unit residential and commercial segments.

Although the demand for prime insured mortgages continued to be strong, supply fell off as economic pressures slowed down both the number of home purchases and house prices. Capital markets, which had improved markedly in the first quarter of 2010, fell back in the second and third quarters, while the fourth quarter showed more strength as we entered 2011. Although these and other domestic issues slowed the Canadian real estate market, competition for mortgage products was strong. Unlike 2009, when the Company's competitors operated tentatively, 2010 has evidenced a re-emergence of robust competition such that the Company now operates in a normalized market environment.

OUTLOOK

In a year characterized by continuing global economic weakness and fragile market conditions, First National achieved a record level of mortgages under administration and successfully completed its corporate conversion, the next logical growth step in the history of the Company. Although origination levels were lower than those experienced in 2009, going forward we anticipate increased cash flows and sustained growth in mortgages under management. And while the effects of the recession are still notable, we are confident in our Company's potential to continue growing.

LOOKING AHEAD

Going forward, First National will continue to operate according to our four key strategies for ongoing success:

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

These proven strategies will continue to produce strong results and growth, allowing First National to drive solid returns to shareholders as the Company grows and prospers.

Our success continues to be dependent on the guidance of our Board, the dedication and support of our shareholders and employees, as well as the loyalty of our customers. I would like to express my appreciation and gratitude to each of these groups for their confidence and continued support. Through our collective efforts, First National continues to perform despite the unsettled nature of the current economic environment. We are confident that by taking advantage of our new corporate structure and strictly adhering to a prudent business plan, First National is in a good position to achieve sustained future growth and success.

Sincerely,



Stephen Smith
Chairman and President

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 shareholders.

Sound corporate governance is fundamental for maintaining the confidence of investors and increasing shareholder 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 shareholders – 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 Company and oversees matters related to our strategic direction and assessing results relative to its goals and objectives. As such, 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 Company's corporate governance strategy.

Audit Committee

The Audit Committee's responsibilities include:

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

- Oversight and supervision of the adequacy of the Company'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 Company's senior executive officers and the remuneration of the Board of Directors;
- Developing the Company'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 First National'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

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. 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 Chair of The Historica-Dominion Institute. Mr. Smith has a M.Sc. (Econ.) from the London School of Economics and Political Science and a B.Sc. (Hons.) in Electrical Engineering from Queen's University.

Moray Tawse is Vice President, Mortgage Investments and Co-founder of First National. 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 until 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. and Scotia NewGrowth Corp.

John Brough served as President of both Wittington Properties Limited and Torwest Inc. 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 ten years he served as Senior Vice President and Chief Financial Officer.

He is a director of Kinross Gold Corporation, SilverWheaton Corp., Canadian REIT and Transglobe Apartment REIT. He has a B.A. (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 B.Comm. (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 conditions and results of operations is prepared as of March 1, 2011. 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, 2010 (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, 2009. 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 million. 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. Effective January 1, 2011, the Fund was wound up pursuant to a plan of arrangement as First National restructured from an income trust to a corporate structure ("the Conversion").

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
2010				
Fourth Quarter	\$ 9,980	\$ 4,170	\$ 0.33	\$ 300,683
Third Quarter	\$ 5,256	\$ 3,456	\$ 0.27	\$ 303,479
Second Quarter	\$ 9,565	\$ 7,465	\$ 0.59	\$ 300,743
First Quarter	\$ 5,714	\$ 4,364	\$ 0.34	\$ 119,620
2009				
Fourth Quarter	\$ 7,100	\$ 6,950	\$ 0.55	\$ 119,296
Third Quarter	\$ 7,092	\$ 5,192	\$ 0.41	\$ 116,951
Second Quarter	\$ 6,413	\$ 5,463	\$ 0.43	\$ 114,138
First Quarter	\$ 4,498	\$ 4,048	\$ 0.32	\$ 112,005

INVESTMENTS

At December 31, 2010, the Fund had an investment in 12,681,113 units (21.15%) of First National Financial LP at a cost of \$122,670. Under Canadian GAAP, the Fund is required to account for the investment in units using the equity method. During the year ended December 31, 2010, the Fund's equity earnings from FNFLP were \$34.2 million, amortization of identifiable assets inherent in the investment was \$9.5 million and the carrying value of this investment at December 31, 2010 was \$117.5 million. The Fund has also invested \$175,000 in FNFLP by way of an interest bearing note receivable.

STATEMENT OF DISTRIBUTABLE CASH

(in \$000s, except where noted)

	For the quarter ended		For the year ended	
	December 31 2010	December 31 2009	December 31 2010	December 31 2009
First National Financial LP				
Distributable Cash from First National Financial LP ⁽¹⁾	\$ 59,225	\$ 30,252	\$ 128,856	\$ 76,907
First National Financial Income Fund				
Weighted Average Share of Distributable				
Cash from First National Financial LP ⁽¹⁾	12,526	6,399	27,253	16,266
Distributable Cash per Unit (\$/Unit) ⁽¹⁾	0.99	0.50	2.15	1.28
Distributions Declared	9,828	5,390	24,094	18,388
Distributions Declared per Unit (\$/Unit)	0.78	0.42	1.90	1.45
Payout Ratio	79%	84%	88%	113%

(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 distribution to unitholders. See the FNFLP section in this MD&A for their determination.

DISTRIBUTIONS

The IPO 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 past four years. In 2010, the amount was \$0.40 per unit; in the prior three years the amount was between \$0.05 per unit and \$0.07 per unit. For the year, the Fund's distributions of approximately \$24.1 million were based on the distributions that the Fund received from FNFLP. The amount of regular monthly distributions declared in 2010 represents 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 quarter ended December 31, 2010, the payout ratio was 79%. For the year ended December 31, 2010, the payout ratio was 88%. These figures reflect the receipt of increased cash flows received on securitization transactions. In the third and fourth quarters of 2010, the Company chose to securitize a much smaller portion of its origination. Instead, more mortgages were placed with institutional investors and cash was received upfront. As a result, the Company had the benefit of large receipts of cash from its previous securitization transactions with much lower cash investment needed on new securitizations. Despite the large special distribution declared in December, the payout ratio in the fourth quarter is less than 100%. The ratio of distributions to net income at the FNFLP level, which management believes is an important ratio, was 71% for the year.

INCOME TAXES

In 2010, the Fund was a mutual fund trust for income tax purposes. As such, the Fund was only taxed on any amount of taxable income not distributed to unitholders. While it existed, the Fund distributed substantially all of its taxable income to its unitholders and complied with the provisions of the Income Tax Act (Canada) that permitted, 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 MD&A, on June 22, 2007, the federal government enacted previously announced legislation that would have had 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 \$8.2 million in June 2007. In the interim three years, the DRIP and lower provincial tax rates have had offsetting impacts on the liability, increasing it by \$0.1 million. The combined liability of \$8.6 million is expected to be drawn down beginning on January 1, 2011, as the Fund's successor 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 are also differences between the 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 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, 2010, these differences were such that the Fund recorded a future tax liability of \$10.4 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, 2010. 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, 2010, the Fund recorded a provision for future taxes on these differences of \$5.25 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.

OUTSTANDING SECURITIES OF THE FUND

At December 31, 2010, the Fund had 12,681,113 units and 175,000 debentures outstanding. On January 1, 2011 the Fund was wound up as part of the Conversion. The continuing public entity, First National Financial Corporation, had 59,967,429 shares and 175,000 debentures outstanding as at March 1, 2011.

As at December 31, 2010, FNFC held 47,286,316 exchangeable Class B LP units of FNFLP, each of which was exchangeable into one Fund Unit at no cost at any time at the option of FNFC, and each of which carried a Special Voting Right that entitled the holder to receive notice of, attend and vote at all meetings of unitholders of the Fund. Subsequent to year end, pursuant to the Conversion, these securities were cancelled and effectively replaced with 47,286,316 Class A public common shares of First National Financial Corporation.

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 this MD&A.

GUARANTEE

At December 31, 2010, the Fund's wholly-owned subsidiary, First National Financial Operating Trust, had provided guarantees to and subordinated their rights to receive payments from FNFLP in respect of FNFLP's \$125 million bank credit facility. Pursuant to the Conversion, this guarantee was removed and replaced with a guarantee from First National Financial Corporation.

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

The Company's financial results for 2010 were similar to those recorded in the 2009 comparative year. Lower volumes associated with a slowing real estate market together with relatively tighter spreads on prime mortgages, negatively affected revenues. 2010 featured continued growth in mortgages under administration, revenue and net income consistent with that recorded in the prior year. The demand for prime insured mortgages was strong throughout the year; however, supply was volatile as economic news and government monetary policy affected the normal seasonality of mortgage consumers. Capital markets, which had improved markedly in the first quarter of 2010, suffered in both the second and third quarter as global economic indicators became decidedly more negative. Although these fears and other domestic issues slowed the Canadian real estate market, competition for mortgage products was strong. Unlike 2009, when the Company's competitors operated tentatively, 2010 evidenced a re-emergence of robust competition such that the Company operated in a normalized market by the end of the year.

2010 RESULTS SUMMARY

- Mortgages under administration grew to \$53.3 billion at December 31, 2010 from \$47.8 billion at December 31, 2009, an annualized increase of 11.5%; the growth from September 30, 2010, when mortgages under administration were \$52.0 billion, was 2.5%, an annualized increase of 10%;
- The Canadian single-family real estate market proved resilient despite continued recessionary pressures and global economic worries. Total 2010 single-family mortgage originations for the Company decreased by 2% from \$8.5 billion in 2009 to \$8.3 billion for 2010. For the commercial segment, the year reflected a slower market, as the robust activity in 2009 moderated and, together with increased competition, volumes decreased 33% from \$3.3 billion to \$2.2 billion;
- Revenue for the year ended December 31, 2010 increased to \$343.2 million from \$341.7 million in 2009. The small growth of 0.4% is reflective of the increased valuation of floating rate securitization transactions and higher mortgage servicing revenue offset by the effect of lower origination volumes and tighter securitization spreads;
- Net income decreased by 1% from \$163.5 million in 2009 to \$161.4 million in 2010. This decrease is consistent with the change in revenues offset by marginally higher mortgage brokerage expenses;
- EBITDA decreased by 1% from \$165.2 million in 2009 to \$163.2 million in 2010 due to the same factors cited above for net income; and
- The Company paid out \$1.50 per unit of distributions during the year and declared a one-time special distribution in December of \$0.40, rewarding unitholders with the surplus cash flow generated from the business.

SELECTED QUARTERLY INFORMATION FOR RESULTS OF FNFLP

	Revenue	Net Income for the period	Net Income (\$/Unit)	Total Assets
2010				
Fourth Quarter	\$ 75,504	\$ 30,844	\$ 0.51	\$ 1,149,082
Third Quarter	\$ 87,549	\$ 35,982	\$ 0.60	\$ 982,627
Second Quarter	\$ 104,620	\$ 56,389	\$ 0.94	\$ 1,095,097
First Quarter	\$ 75,541	\$ 38,212	\$ 0.64	\$ 1,074,461
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

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 for the second quarter of 2010, in which the Company recognized large gains from holding securitization assets, including a one-time gain of \$21.9 million related to the change in the Company's estimate of ongoing Prime-BA spreads as described in detail subsequently in the MD&A. If this adjustment is added back, revenue and net income for these quarters would have been in line with seasonal expectations and a growing business. During this two-year period mortgage spreads tightened steadily throughout the quarters as Canadian capital markets returned to historical norms following the credit turmoil of 2007 and 2008. This trend is evident in both revenue and net income figures.

Total assets fluctuated between \$0.9 billion and \$1.2 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 2010	December 31 2009	December 31 2008
For the Period			
Income Statement Highlights			
Revenue	\$ 343,214	\$ 341,716	\$ 293,959
Brokerage fees	(103,020)	(98,677)	(105,757)
Other operating expenses	(76,971)	(77,807)	(78,527)
EBITDA ⁽¹⁾	163,223	165,232	109,675
Amortization of capital assets	(1,796)	(1,749)	(1,654)
Provision for income taxes	-	-	-
Net income	161,427	163,483	108,021
Distributions declared	114,444	86,953	81,233
Per Unit Highlights			
Net income per Unit	2.69	2.73	1.81
Distributions declared per Unit	1.91	1.45	1.36
At Period End			
Balance Sheet Highlights			
Total assets	1,149,082	1,067,690	737,065
Total long-term financial liabilities	\$ 178,849	\$ -	\$ -

(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, 2010, mortgages under administration totalled \$53.3 billion, up from \$47.8 billion at December 31, 2009, a rate of increase of 11.5%. This compares to \$52.0 billion at September 30, 2010, representing a quarter-over-quarter increase of 2.5% and an annualized increase of 10%.

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. By the end of 2009, mortgage spreads on fixed rate single-family mortgages had returned to pre-crisis levels; however, floating rate single-family mortgages continued to be priced at historically wide spreads. In 2007, such mortgages were priced at a discount to prime (a discount that reached a high of 0.90 percentage points that year). In 2009, these mortgages began the year priced at prime plus 0.80 percentage points as liquidity issues affected the funding costs for the large banks. 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. Throughout 2010 competition increased and the discount grew to 0.70 percentage points below prime. The Company chose to securitize much of this origination as it was able to earn a higher return than on an institutional placement. For the 2010 year, the Company originated for securitization approximately \$2.7 billion of floating rate single family mortgages in order to take advantage of these wider spreads. Although the bid from the NHA-MBS market for this product has remained consistent, the profitability of securitization at these spreads has decreased to a level that is comparable to that of an institutional placement. During the third quarter of 2010, the Company elected to securitize lower volumes of this product than what was securitized in the first two quarters of 2010. Instead, more of these mortgages will be sold to institutional investors. Management believes this strategy will reduce the risk to the Company of increased credit spread tightening, and provide the Company with more cash flow with only a marginal reduction to revenue. In the fourth quarter of 2010, the Company began a program to securitize fixed rate single-family mortgages through sales to the NHA-MBS market. The Company originated approximately \$95 million of mortgages for the program and securitized one pool of \$42 million late in the year.

LOWERING COSTS OF OPERATIONS

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).

Debenture Issuance

In the second quarter of 2010, the Fund issued \$175 million of five-year term senior secured debentures with an interest rate of 5.07% maturing on May 7, 2015. The Fund subsequently loaned the proceeds of the issuance through the Trust to FNFLP, which in turn repaid \$175 million of its bank indebtedness under the existing bank credit facility. Simultaneously with the issuance, the Company entered into a swap agreement to receive the 5.07% fixed coupon semi-annually and to pay a floating rate on a monthly basis, effectively converting the fixed rate debenture into a floating rate debt. Through these transactions the Company has maintained its overall maximum debt at \$300 million and has not increased its leverage. The Company has elected to undertake this initiative for a number of reasons: (1) the swapped floating rate on the debenture is significantly better than the spreads currently being offered by the Company's bank syndicate; (2) the debenture provides the Company with five years of certainty on a large portion of its interest costs, enabling management to better plan and make decisions about future investment opportunities and insulate the Company from credit market volatility during the five-year term; (3) strategically, the Company considers the ability to access such debt markets valuable – the debentures give the Fund a history as an issuer; and (4) the transaction allowed the Company to partially pay down the existing bank credit facility, giving the Company more borrowing capacity in the future while diversifying its sources of debt capital.

Preferred Share Issuance

Subsequent to year end, the Company, through FNFC (the new public corporation), issued 4,000,000 Series I Class A Preference shares for gross proceeds of \$100 million. The Company received net proceeds of \$96.7 million after issuance costs on January 25, 2011. These shares are rate reset preferred shares having a stated 4.65% annual dividend rate, subject to Board of Director approval, and a par of \$25 per share. The rate reset feature is at the discretion of the Company such that after the initial five-year term, the Company can choose to extend the shares for another five-year term at a fixed spread (2.07%) over the yield of the then relevant risk-free Government of Canada bond. While the investors in

these shares have an option on each five-year anniversary to convert their Series I holdings into Series 2 preference shares (which pay floating rate dividends), there are no redemption options for these shareholders. As such, the Company considers these shares to represent a permanent source of capital and will classify the shares as equity on its balance sheet. Management believes this capital will give the Company the opportunity to pursue a strategy of increased securitization, which requires upfront investment.

EMPLOYING INNOVATIVE SECURITIZATION TRANSACTIONS TO MINIMIZE FUNDING COSTS

Normalization of the Asset-Backed Commercial Paper ("ABCP") Market

As described in prior years' MD&A, ABCP funded by third-party sponsored ABCP conduits became frozen in August 2007 due to liquidity and credit concerns. Similar issues affected bank-sponsored ABCP conduits. The Company has continued to fund a portion of its assets (approximately \$1.2 billion of the \$53.3 billion of MUA as at December 31, 2010) with bank-sponsored ABCP. Although bank-sponsored ABCP is now trading efficiently in the marketplace, its cost has varied greatly in the past few 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 2009, ABCP spreads were volatile, beginning the year at 1.10 percentage points in excess of historical levels and then tightening during the year such that they ended at historical levels. The Company considers historical levels to be when ABCP traded at the same rates as Bankers' Acceptances rates ("BA"). In 2010, although global credit markets worsened, Canadian banks remained profitable and liquid such that their covenant underlying the value of bank-sponsored ABCP was perceived as strong. Accordingly, 30-day AAA-rated ABCP continued to trade 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 is calculated using assumptions about the cost of funding arranged through the ABCP market. At the end of 2010, the Company had approximately \$1.2 billion of mortgages under administration funded with ABCP, including all of its Alt-A mortgages. The Company's exposure to ABCP at December 31, 2010 (which excludes mortgages having mortgage rates linked to the Company's cost of ABCP) was approximately \$1.0 billion. As described above, advertised ABCP spreads narrowed during the course of the year. Management believes that much of the uncertainty in this market has now disappeared. The Company changed its assumption each quarter in 2010 to recognize this return to historical norms such that by year end its models assumed that ABCP will trade at rates comparable to BA. For 2010, the Company recorded unrealized gains of \$3.9 million with respect to the changing fair value of the Company's securitization receivables involving ABCP.

Permanent widening of the Prime lending rate (“Prime”) – Bankers’ Acceptances (“BA”) spread

Since the Company began securitizing floating rate mortgages indexed to Prime, it took on the risk of the spread between Prime and BA. As these floating rate mortgages are funded primarily with BA-based funding, the Company must make an assumption of this spread in its securitization models. To the extent that this assumption is not appropriate, the Company’s earnings will be subject to volatility. Historically this spread was 160 bps (if the BA rate was 0.50%, then Prime would have been approximately 2.10%). This spread is determined by the large chartered banks which set both Prime and BA rates and is set, ultimately, so that the banks can earn enough spread to earn sufficient profits to pay for their weighted average cost of capital and give shareholders a rate of return commensurate with the investment risk taken. The banks have typically priced BA at a relatively fixed spread to the Bank of Canada’s overnight rates; however, on December 9, 2008, the Bank of Canada lowered the rate at which it lends to banks on eligible assets by approximately 0.75%. The banks lowered their BA settings accordingly but only lowered Prime by 0.50%. The result was a higher spread between the two indices (approximately 1.85%). The Company believed this elevated spread was only a temporary measure to address the credit crisis, which peaked in the fourth quarter of 2008. Accordingly, by the end of the first quarter of 2009, the Company’s models assumed that the Prime – BA spread would revert to the historical norm of 1.60%.

Since December 2008, the Bank of Canada lowered its overnight rates several times. On each occasion the chartered banks left the Prime – BA spread at 1.85%. As time passed, it became more apparent that this spread would not change as the banks were faced with higher costs due to regulatory requirements for additional capital. At the same time, this period featured an uncertain economy and volatile credit markets. For the Company, the true test on the longevity of this “new” spread was the banks’ reaction to the Bank of Canada’s announced increase of its overnight rate on June 1, 2010. This increase of 0.25% was addressed by each of the five large Canadian banks with a commensurate increase in their Prime to 2.50%. Accordingly, as at June 1, 2010, the Company changed its assumption in its models to increase the Prime – BA spread to 1.85% and recorded an unrealized gain of \$21.9 million in the second quarter of 2010. This spread continued to be the norm through the rest of 2010 until the fourth quarter, when markets began pricing in the likelihood of another Bank of Canada increase as inflation and currency issues became more prevalent. Consequently, at December 31, 2010, Prime was 3.00% and CDOR was 1.20%. The Company believes that over a five-year horizon this spread will average approximately 1.85% and has used this spread in its models.

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 \$5 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 2009. The demand has continued into 2010 and allowed the Company to issue \$2.7 billion of floating rate single-family NHA-MBS pools 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 and ten-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/ten-year unamortizing terms with a federal 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS

KEY PERFORMANCE INDICATORS

The principal indicators used to measure 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 2010	December 31 2009	December 31 2010	December 31 2009
For the Period				
Revenue	\$ 75,504	\$ 88,280	\$ 343,214	\$ 341,716
Net income	30,844	44,768	161,427	163,483
EBITDA ⁽¹⁾	31,386	45,247	163,223	165,232
At Period End				
Total assets	1,149,082	1,067,690	1,149,082	1,067,690
Mortgages under administration	53,293,132	47,793,045	53,293,132	47,793,045

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

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 ahead of securitization sales. Normally the month after funding, the Company aggregates all relevant mortgages "warehoused" to date and creates a pool to sell to the NHA-MBS market. 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 two weeks of the subsequent month. The Company's credit facilities provide 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 2010	December 31 2009	December 31 2010	December 31 2009
For the Period				
Cash provided by (used in) operating activities	\$ 78,865	\$ (91,838)	\$ 194,832	\$ (83,549)
Add (deduct):				
Change in mortgages accumulated for sale between periods	(19,409)	122,302	(64,723)	161,966
Less:				
Capital expenditures	(231)	(212)	(1,253)	(1,510)
Distributable cash ⁽¹⁾	\$ 59,225	\$ 30,252	\$ 128,856	\$ 76,907

(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 provide the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2010, origination volume decreased from \$11.8 billion to \$10.5 billion, or 11%, 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.

The Company separates this revenue into two components: "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 additional 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 it 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 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.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

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 \$10.5 billion of originations for the year ended December 31, 2010, \$374 million was originated for ABCP conduits and other securitization vehicles and \$2.8 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 \$10.5 billion of originations for the year ended December 31, 2010, \$6.2 billion was placed with institutional investors and \$1.1 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 spread 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 "Gain on securitization" and "Gain 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 2010, 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 marginally. This timing difference required working capital funding of approximately \$6.4 million for the year (\$79.3 million for the year ended December 31, 2009). 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 the collection 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 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 receivable, 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 2010	December 31 2009	December 31 2010	December 31 2009
Mortgage Originations by Asset Class				
Single-family residential	\$ 2,106	\$ 2,018	\$ 8,324	\$ 8,468
Multi-unit residential and commercial	645	841	2,187	3,319
Total	2,751	2,859	10,511	11,787
Funding of Mortgage Originations by Source				
Institutional investors	1,912	1,101	6,244	6,519
NHA-MBS for institutional investors	351	629	1,081	2,609
NHA-MBS securitized by the Company	369	1,170	2,812	2,208
Securitization and internal resources ⁽¹⁾	119	(41)	374	451
Total	2,751	2,859	10,511	11,787
Mortgages Under Administration				
Single-family residential	36,948	31,880	36,948	31,880
Multi-unit residential and commercial	16,345	15,913	16,345	15,913
Total	53,293	47,793	53,293	47,793

(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.

Total mortgage origination volumes decreased in the year by 11% as multi-unit residential origination slowed down from a very strong 2009 market. Total commercial segment originations decreased by 34% from 2009. This is in comparison to the single-family segment, which declined a moderate 2% year over year. For the commercial segment, the Company experienced a slower market and more competition in 2010. With a record 2009 behind it, there were fewer real estate transactions available to finance in 2010. As well, competition, primarily from "schedule one" banks, re-entered this marketplace. Single-family volumes are slightly lower than the levels experienced in 2009 due to a resilient housing market and the Company's strong presence in the mortgage broker channel. Although this market was affected by stricter lending guidelines, a difficult economic environment and higher mortgage rates, the Company was able to leverage its broker relationships and produce solid origination figures. Origination for direct securitization in the NHA-MBS and CMB markets increased from \$2.2 billion in 2009 to \$2.8 billion in 2010. This was the result of the Company's decision to securitize most of its floating rate single-family origination as opposed to selling it to institutional investors. For the fourth

quarter of 2010 overall origination decreased by 4% to \$2.8 billion from \$2.9 billion in 2009. This decrease reflects a 4% increase in single-family origination figures between the periods together with a 23% decrease in the multi-unit residential and commercial segment and is consistent with the trends experienced throughout the year.

In the first quarter of 2010, Canadian capital markets saw improvement from a challenging 2009. This sentiment reversed in the second and third quarters as economic indicators, particularly in global markets, became more negative. Despite these challenges, the Bank of Canada's monetary policy acted to slow government stimulus and "re-establish the normal functioning of the overnight rate". Accordingly, the Bank of Canada raised its overnight target lending rate from 0.25% at the end of the first quarter to 1.00% by the end of the third quarter of 2010. Although economic indicators turned more positive in the fourth quarter of the year, worries about the speed of the recovery in Canada led the Bank of Canada to slow down the pace of increasing interest rates. The bond and mortgage markets moved in step with these indicators. For the Company, these conditions had significant impacts on its 2010 results. Most significantly, as described earlier in

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this MD&A, the Company concluded that these rate increases, together with the ensuing increase in the banks' prime lending rates, demonstrated a permanent increase in the Prime – BA spread. The Company adjusted its models accordingly and recognized higher per unit gains on securitization on the mortgages securitized than in previous periods (all other assumptions being equal). Given the Bank of Canada's reticence in raising interest rates, 2010 represented a year of historically low mortgage rates. As an originator of mortgages, this low rate environment made it easier for the Company to originate mortgages. The Company continued to see demand for mortgages and funding costs for 30-day ABCP normalized. Mortgage spreads that narrowed throughout 2009 grew somewhat wider in the latter part of the year as the banks' raised mortgage rates despite falling bond yields. However, the very large spreads that existed at the beginning of 2009 disappeared and for most of 2010 prime mortgage spreads were closer to the levels seen prior to the credit crisis in mid-2007 than those seen in the past two years.

The Company continued to profit from a stabilizing ABCP market. At December 31, 2009, 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 0.25 percentage points in excess of BA. By the end of December 2010, posted ABCP rates had come down such that quoted ABCP spreads were in fact lower than BA rates. More relevant is the cost of funds currently being charged by bank-sponsored ABCP conduits to the Company. This cost is now being invoiced at comparable levels to BA rates. The Company revised its assumption for ABCP costs such that its models assume 30-day ABCP will trade equivalent to 30-day BA rates in its calculation of the fair value of its securitization receivable. This resulted in an unrealized fair value gain of \$3.9 million recorded in the 2010 year.

Total revenues for the year ended December 31, 2010 increased by about 1% compared to the 2009 year, from \$341.7 million to \$343.2 million. This increase resulted from the positive gain earned from the Prime – BA spread adjustment described earlier in the MD&A, offset by the tighter securitization margins and lower volumes of commercial mortgage origination in the year compared to those experienced in 2009.

Placement Fees

Comparing the year ended December 31, 2010 to the year ended December 31, 2009, placement fee revenue decreased by 16% to \$103.6 million from \$123.9 million. This was largely due to the Company's strategy with respect to single-family floating rate mortgages. Beginning in the middle of the second quarter of 2009, these mortgages were originated for securitization as opposed to institutional placement. In the following 12-month period, the Company continued this strategy. During the third quarter of 2010, the profitability of these securitizations decreased with tighter mortgage spreads and the Company began to place a large share of such mortgages with institutions. For the whole year, the volume of residential origination for institutional placement decreased from \$6.1 billion to \$5.7 billion or 7%. The Company also saw decreased origination of multi-unit residential mortgages for the MBS program, which had volumes of \$1.1 billion in 2010 as the period evidenced a slowdown in real estate transactions in the marketplace. This compares to \$2.6 billion in 2009. Together with mortgages originated for institutional investors, origination volumes, which drive placement fees, decreased by 20% from 2009 to 2010. Per unit placements fees increased as a larger proportion of higher yielding ten-year term multi-unit mortgages were placed in 2010 compared to 2009.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue decreased 81% to \$9.6 million from \$51.8 million. The decrease was due primarily to decreased volumes of multi-unit residential mortgages originated for institutional MBS issuers. These volumes fell from \$2.6 billion in 2009 to \$1.1 billion or 58% and the margins realized in 2010 narrowed as competition for this product resurfaced. The Company also chose to directly securitize more of this type of origination in 2010 than in 2009. From these MBS programs, the Company recognized both a placement fee (described above) and ongoing interest-only strips on these mortgages. The Company has valued these strips at \$9.2 million, which is reflected in gains on deferred placement fees revenue. In 2009, the Company recorded \$37.7 million in revenue from these and similar programs. Gains were also lower 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 in early 2009. By the end of 2009 these spreads had returned to historical levels. On these mortgages, the Company recorded reduced gains on deferred placement fees of \$13.7 million for 2010 compared to 2009.

Gain on Securitization

Gain on securitization revenue increased 9% to \$60.2 million from \$55.4 million. The increase is due to increased volumes of floating rate single-family mortgages as described earlier in this MD&A. In 2010, the Company originated \$2.8 billion of single-family mortgages for inclusion in NHA-MBS pools. In 2009, the Company securitized \$2.1 billion of this product. Due to historically high spreads offered on these mortgages relative to funding costs, the Company was able to execute securitizations at favourable terms. For 2010, these spreads tightened throughout the year so that despite increased volume, the Company recognized approximately \$38.5 million in gains on securitization for such transactions. In 2009, the Company recorded \$53.8 million related to the securitization of such floating rate mortgages. As demand in the institutional markets increased, the Company also originated for direct securitization \$339 million (2009 – \$146 million) of fixed rate multi-unit MBS pools for gains of approximately \$17.4 million (2009 – \$6.7 million). Revenue for 2009 was also decreased by \$4.3 million as the credit loss assumption for the Alt-A program was increased to account for poor economic conditions.

Mortgage Servicing Income

Mortgage servicing income increased 15% to \$73.8 million from \$64.4 million. This was primarily due to the growth in the amount of the mortgage portfolio under administration, which grew by 12% year-over-year. The residential component grew by 16% and has a larger impact on servicing revenue than the commercial component (the price per unit is much higher on the residential than on the commercial portfolio). The Company also earned more net interest income on the trust funds it administers for its borrowers and investors. These funds earn the Company interest based on 30-day CDOR rates. These rates rose by approximately 0.75% during 2010.

Mortgage Investment Income

Mortgage investment income increased 15% to \$27.0 million from \$23.4 million. The change is due primarily to the increase of \$4.6 million of additional interest earned on securitization receivable and deferred placement fees receivable as these assets grew by 20% from December 31, 2009 to December 31, 2010. The remaining change is a combination of offsetting factors, including: different bond yields than in the comparative year (which affect the interest earned on these receivables), rising prime lending rates (which affect gross revenues on mortgage and loan investments) and increased amounts of mortgage and loan investments held during the year.

Residual Securitization Income

Residual securitization income increased 55% to \$35.6 million from \$22.9 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. This revenue has increased from \$5.7 million to \$7.0 million comparing the two periods as the Company has increased the size of its directly securitized portfolio. The other source is the excess of any 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 2010 is a result of the conservatism inherent in the Company's securitization models. The Company seeks 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 extra spread relates to various factors including lower ABCP costs of funding, lower prepayment speeds, receipts of interest penalties on prepayment and the general normalization of credit markets in the year.

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). 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.

The largest increase in the year pertained to the Company's decision to change the assumption of the Prime – BA spread in its securitization models. As described earlier in this MD&A, the Company believes that the Prime – BA spread will be wider for the foreseeable future and recorded an unrealized gain of \$21.9 million in the second quarter of 2010.

Despite the Bank of Canada's increases to its target overnight lending rate in mid-2010, global credit issues sent bond yields lower over the course of the year. Generally, five-year Government of Canada bond yields decreased from approximately 2.9% at the beginning of the year to 2.3% at the end of the year.

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Accordingly, the Company's on-balance sheet mortgages, securitization receivables and deferred placement receivables are more valuable on a comparative basis at year end than at the end of 2009. The Company has recorded unrealized gains related to holding these assets of \$1.9 million in 2010.

The decreased assumption for ABCP from 0.25 percentage points over BA to BA flat, as described earlier in this MD&A, has created an unrealized gain of \$3.9 million for the year. The Company also recognized a \$2.6 million gain in the year related to the change in value of \$13.5 million of mortgage investments categorized as held for trading and priced off of seven-year Government of Canada bonds. The lower bond yields made the value of these fixed rate mortgages more valuable. 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, but primarily positive effects, such that the Company recorded additional net gains of about \$2.6 million in the year. Generally, this net gain results from normalizing credit markets which increased the value of higher spread mortgages held over time.

Brokerage Fees Expense

Brokerage fees expense increased 4% to \$103.0 million from \$98.7 million. The increase is the result of lower origination volumes of single-family mortgages offset by the reversal of deferred brokerage fees from previous periods. While single-family mortgage origination volume was down just 2% from the prior year, the timing of warehousing and securitizing significant volumes of floating rate mortgages and higher per unit broker fees increased the expense from 2009. At the end of 2009, the Company had deferred \$3.9 million of broker fees on mortgages that were securitized in 2010. By the end of 2010, the amount of mortgages accumulated for sale to be securitized was lower, and only \$2.2 million of broker fees were deferred. This had the effect of decreasing 2009 expenses by \$3.4 million and increasing 2010 expenses by \$1.7 million. Without these movements, brokerage fees expense would have decreased by 1%. The remaining increase is due to higher per unit brokerage fees. Due to increased competition for a dwindling supply of mortgages during the summer months, the Company increased broker compensation programs to match other lenders' practices, particularly its loyalty management programs.

Salaries and Benefits Expense

Salaries and benefits expense decreased 10% to \$43.2 million from \$48.2 million. The decrease is due to 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 decreased origination in the year, particularly with respect to placement fees, this compensation decreased by \$5.2 million year-over-year. Excluding these amounts, the core salaries and benefits expense remained flat year-over-year, generally in

line with a slower increase in headcount and lower sales bonuses. As at December 31, 2010, the Company had 536 employees, compared to 519 as at December 31, 2009. 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 IPO.

Interest Expense

Interest expense increased 3% to \$13.8 million from \$13.4 million. As discussed in the "Liquidity and cash resources" section of this MD&A, the Company warehouses a portion of the mortgages it originates prior to settlement with the ultimate investor or sale to a securitization vehicle. The Company uses a portion of the debenture loan together with a credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The Company renewed the credit facility in May 2010 to coincide with the debenture issuance so that by the end the year the Company had a total commitment from this facility of \$125 million. The overall interest expense has increased from the prior year due to a more extensive securitization program which required the Company to fund mortgages for longer periods prior to securitization. These costs would have been higher but for two cost-saving measures: 1) the replacement of more expensive bank debt with cheaper interest from the debenture, which has saved the Company as much as 1.2% in marginal interest rates; and 2) the increased use of 30-day repurchase agreements instead of bank debt, which has saved the Company as much as 2.5% in marginal interest rates.

Other Operating Expense

Other operating expense increased 24% to \$20.3 million from \$16.4 million. During 2010, the Company expensed \$1.4 million of hedging costs associated with the direct securitization of multi-unit residential mortgages in the NHA-MBS market. These costs were not significant in 2009. In 2010, the Company recorded provisions for credit losses of \$0.6 million; in 2009 these provisions were \$1.3 million. The remaining change to this expense consists of various items including: \$0.6 million for professional fees related to the issuance of the debenture; \$0.3 million for conversion costs to a corporate structure; and \$0.5 million for higher insurance costs. The other \$1.0 million increase in these expenses represents a 6% growth rate and is due to additional servicing requirements of a larger portfolio of mortgages under administration.

Net Income and EBITDA

Net income decreased 1% to \$161.4 million from \$163.5 million. The decrease in earnings was a result of tighter mortgage spreads on mortgages originated for securitization offset by gains recognized on improving capital markets. EBITDA decreased 1% to \$163.2 million from \$165.2 million. The decrease was due to the same factors described for net income.

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

(\$000s except percent amounts)

Year ended	Residential		Commercial	
	December 31 2010	December 31 2009	December 31 2010	December 31 2009
Originations	\$ 8,323,373	\$ 8,468,296	\$ 2,187,410	\$ 3,318,925
Percentage change	(1.7%)		(34.1%)	
Revenue	\$ 268,402	\$ 240,263	\$ 74,812	\$ 101,453
Percentage change	11.7%		(26.3%)	
Income before income taxes and corporate non-allocated expenses	\$ 114,308	\$ 93,863	\$ 48,619	\$ 71,120
Percentage change	21.8%		(31.6%)	
Period ended	December 31 2010	December 31 2009	December 31 2010	December 31 2009
Identifiable assets	\$ 608,305	\$ 530,908	\$ 540,777	\$ 536,782
Mortgages under administration	\$ 36,948,100	\$ 31,879,946	\$ 16,345,032	\$ 15,913,099

RESIDENTIAL SEGMENT

Residential revenues increased by 11.7% although origination decreased 1.7% between 2010 and 2009. The higher revenue relative to the drop in origination is attributable to the large gain associated with the change in the assumption of the Prime – BA spread, which increased revenue by about \$22 million. The Company also earned \$14 million of residual securitization income in 2010 for this segment. These positive influences were offset by tighter margins on the Company's deferred placement fees and floating rate securitizations. Income before income taxes increased by 21.8% as the increased revenue flowed through to the bottom line. Identifiable assets have increased from those at December 31, 2009, due to an increase in hedging requirements of \$98 million needed at the end of 2010.

COMMERCIAL SEGMENT

Commercial revenues decreased by 26.3% from the prior year due to lower origination volumes and narrower mortgage spreads. These negative issues were offset by higher mortgage investment returns, more residual securitization income and an increase of \$2.7 million in unrealized gains on financial instruments as capital markets normalized. The decreased revenue affected the bottom line directly as only some operating costs decreased in step with revenue. Identifiable assets for the commercial sector remained consistent year-over-year as the Company's hedging requirements remained similar at the end of 2009 and 2010.

LIQUIDITY AND CAPITAL RESOURCES

The Company's liquidity strategy has been to use debt 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 combination of the \$175 million debenture financing and the Company's revolving bank credit facility are typically used 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 four banks for a total credit of \$125.0 million (2009 – \$378.3 million). This facility was renewed in May 2010 for a 364-day term. Bank indebtedness also includes borrowings obtained through securitization transactions, outstanding cheques and overdraft facilities. At December 31, 2010, the Company has entered into repurchase transactions with financial institutions to borrow \$174.3 million related to \$179.3 million of mortgages and NHA-MBS securities held in mortgages accumulated for sale on the balance sheet.

At December 31, 2010, outstanding bank indebtedness was \$30.2 million (December 31, 2009 – \$249.3 million). Together with the debenture financing of \$175 million (December 31, 2009 – \$Nil), this "combined debt" was used to fund \$139.5 million (December 31, 2009 – \$159.8 million) of mortgages accumulated for sale. At December 31, 2010, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$85.2 million (December 31, 2009 – \$98.1 million); (2) securitization

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receivables of \$157.4 million (December 31, 2009 – \$104.0 million); and (3) mortgage and loan investments of \$70.9 million (December 31, 2009 – \$54.7 million). The difference between “combined debt” and the mortgages accumulated for sale funded with it, which the Company considers a proxy for true leverage, has decreased between December 2009 and December 2010 and now stands at \$65.7 million (December 31, 2009 – \$89.5 million). This represents a debt-to-equity ratio of approximately 0.25 to 1, which the Company believes is at a conservative level. This ratio has decreased from 0.42 to 1 as at December 31, 2009 as the Company has increased 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 daily, 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, 2010, this investment was \$17.2 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 FNFLP stopped offering the Alt-A product, the Company has received repayment of approximately \$25.2 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, 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 from the Trust approximately \$65.6 million of defaulted mortgages over the past two years. Most of these mortgages were in the midst of the foreclosure process such that the Company liquidated \$56.8 million (face value) of these mortgages during the same period, experiencing credit losses at expected levels. In 2010, the Company repurchased \$24.7 million of defaulted mortgages from the program and liquidated \$27.3 million (face value) of such mortgages repurchased over the two-year period. At December 31, 2010, 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, maintaining its profitability through 2009 into 2010. 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 2010, the Company received approximately \$60 million of cash on an annualized basis from its servicing operations and \$83 million of cash flow from previously recorded securitization and deferred placement fees receivables. Together, on an after tax basis, this \$101 million of annual cash flow would be more than sufficient to support the almost \$75 million of annual dividends at the currently indicated rate of \$1.25 per share. Although a simplified analysis, it does highlight the sustainability of the Company's business model and distribution policy through periods of economic weakness.

As described earlier in this MD&A, the Fund's successor (FNFC) filed a prospectus and then issued 4 million Series 1 Preferred Shares at a price of \$25.00 per share for gross proceeds of \$100,000, before issue expenses. The net proceeds of \$96.7 million were invested in FNFLP as partners' capital. The issuance gives the Company additional capital, which will allow it to undertake greater volumes of securitization transactions directly and ultimately to reduce its reliance on institutional investors for funding.

FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company has elected to treat deferred placement fees and securitization receivables together with the cash collateral and subordinate short-term notes held by securitization trusts 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. This election has 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, 2010, the Company has \$98 million of notional 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, 2010, the Company had entered into \$335.5 million in notional value forward bond sales. The change in mark-to-market value of the total \$433.5 million of notional hedges from January 1, 2010 to December 31, 2010 has been expensed through the statement of income.

Upon the settlement of the debenture issuance, the Company entered into a float for fix swap. The swap requires the Company to pay CDOR+2.134% on a notional amount of \$175 million and to receive the debenture interest coupon (5.07%) semi-annually. This effectively converts the fixed rate semi-annual debenture-based loan payable into a floating rate monthly resetting note payable. Since the date when this swap was entered into, credit spreads have widened pursuant to poor domestic and global economic indicators and the value of this swap has increased to \$3.8 million as at December 31, 2010. The Company has documented this swap as a hedge for accounting purposes as the fixed leg of the swap matches the cash flow obligations under the debenture. Effectively, the unrealized gain of \$3.8 million on the swap has been excluded from earnings and been applied to increase the carrying value of the debenture note payable. The Company is also a party to two amortizing fix for float rate swaps that economically hedge the interest rate exposure related to certain mortgages held on balance sheet, which the Company has originated as replacement assets for its CMB activities. As at December 31, 2010, the notional value of these swaps are \$17.0 million and \$4.2 million. Market swap rates increased during the year such that the value of these swaps increased by approximately \$0.1 million. The amortizing swaps mature in September 2013 and July 2015.

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

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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 BA at its worst in 2008 but by the end of December 2010 were priced at a discount to BA. 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, 2010, the Company has various exposures to changing credit spreads. The Company has \$51 million of

exposure related to commercial mortgages originated originally for the CMBS market. As described earlier, there are \$1.0 billion of mortgages in securitization conduits that are exposed to BA – ABCP spread risk. In mortgages accumulated for sale there are \$300 million of mortgages that are susceptible to some degree of changing credit spreads.

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 quarter ended September 30, 2010, the Company purchased new computers and office and communication equipment primarily to support 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 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.

Payments Due By Period (in \$000s)

	Total	0-1 Year	1-3 Years	4-5 Years	After 5 Years
Lease Obligations	\$ 18,553	\$ 3,399	\$ 6,691	\$ 5,967	\$ 2,496
Servicing Liability	\$ 25,709	\$ 9,638	\$ 10,876	\$ 3,674	\$ 1,521
Total Contractual Obligations	\$ 44,262	\$ 13,037	\$ 17,567	\$ 9,641	\$ 4,017

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. The Debentures issued by the Fund are unconditionally guaranteed, jointly and severally, on a secured basis by each of the Trust, 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, 2010. 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 receivable 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 23% for residential mortgages and 35% for commercial floating rate mortgages. The Company assumes there is virtually no prepayment on commercial fixed rate mortgages. Actual prepayment experience has been consistent with these assumptions. 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, 2010 continue to be consistent with those used for the year ended December 31, 2009 and the quarters ended March 31, 2010, June 30, 2010 and September 30, 2010, with the exception of the Prime – BA spread assumption described previously in this MD&A and assumptions for prepayment and credit losses related to specific securitization programs. 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 of 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 March 31, 2009 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 have been 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 2007 and then moved even wider in 2008 before narrowing during the course of 2009 such that the spread between these instruments is insignificant as at December 31, 2010. 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 consistent with one-month BA rates. The Company must also estimate the spread between Prime and BA for the securitization of various Prime-based mortgages. As described earlier in this MD&A, the Company has changed its estimate of this spread effective June 1, 2010 to 1.85% from 1.60%.

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. For the Company, besides more detailed disclosure, there will be a significant change in its accounting policy regarding revenue recognition, particularly in accounting for securitization transactions. Under current GAAP, the Company's securitizations are all considered "true sales" for

MANAGEMENT'S DISCUSSION AND ANALYSIS

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. As described in the Revenue and Funding Sources of this MD&A, the Company differentiates revenue earned from transactions that provide the Company future cash flow streams. The Company discloses such transactions as either gains on securitization or gains on deferred placement fees. 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 likely 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 2010, the Company's project team completed its initial impact assessment and made system changes to gather financial information that will be required for the transition. The Company has involved its external auditors in the assessment of the impact of the new standards and produced the requisite documentation to support its position in adopting the new international accounting standards under IFRS so as to prepare an unaudited balance sheet as at December 31, 2009 under IFRS rules. While the treatment of most of the Company's securitization transactions now seems clear, there is still some discussion about the "derecognition" of NHA-MBS transactions. The Company's analysis indicates that the Company has retained the majority of the risk and reward, and accordingly, that these mortgages would remain on the balance sheet. However, the five big Canadian banks are also affected by this standard. Because the banks have significant influence on the accounting principles used in the Canadian financial industry and do not convert to IFRS until November 2011, the Canadian interpretation for the accounting for NHA-MBS under IFRS may be subject to change.

The Company has prepared its comparative 2010 financial statements as if NHA-MBS remains on the balance sheet when sold to the market. The balance sheets under IFRS as at December 31, 2010 and 2009 have a number of significant changes: 1) an increase in the amount of the Company's assets by approximately \$7.2 billion of mortgages (2009 – \$5.5 billion); 2) an increase in the Company's liabilities by an amount of \$7.3 billion (2009 – \$5.6 billion), which will consist primarily of 30-day resetting notes payable indexed to

30-day CDOR and ABCP rates set by the Company's counterparties; and 3) as described above, opening equity will be reduced by the extent of securitization receivable as at December 31, 2010 net of the reduction of the related servicing liability and deferred origination costs which had been expensed under Canadian GAAP. The Company has estimated the net securitization receivable to be approximately \$132 million (2009 – \$87 million) and the deferred origination costs to total \$44 million (2009 – \$30 million). If the Company's models underlying the securitization receivable were appropriate at December 31, 2010, the amount related to securitization will be earned by the Company over the next five to ten years as mortgage interest spread is received. The reduction in opening equity will be offset by an upward adjustment to the carrying value of the newly recorded \$7.2 billion (2009 – \$5.5 billion) of mortgage assets. Currently these assets are effectively held at par (excluding the effect of gain on securitization accounting). Under IFRS the Company will elect to treat the mortgages in ABCP conduits as held-for-trading, marking these to market at the end of each reporting period. The mortgages funded through NHA-MBS and CMB will be treated as loans and receivable. Accordingly, a portion of the costs of origination will be capitalized and amortized into earnings over their effective terms. The Company estimates these adjustments will increase opening equity by approximately \$44 million (2009 – \$30 million), such that in total opening equity at December 31, 2010 will be reduced by about \$88 million (2009 – \$57 million).

The Company has also prepared draft statements of income under IFRS for each quarter of 2010. These figures will be the basis for presentation of comparative financial information when IFRS is implemented in 2011. Generally the first three quarters featured large volumes of securitized mortgages and, accordingly, large gains on securitization. These revenues will be eliminated under IFRS and will be replaced with net interest margin from previously recorded securitization transactions. Because the Company has grown in the last five years and significantly increased the extent of its own securitization portfolio, the reversal of the gain on securitization revenue in these quarters is larger than the net interest income now recorded such that the restated net income under IFRS is lower than what was reported under Canadian GAAP in 2010. In the fourth quarter, the Company securitized lower volumes of its origination so that the net interest margin received under IFRS exceeds the value of the gain on securitization revenue recorded in that quarter.

In July 2010, the IFRS Interpretations Committee issued a staff paper which described their discussion of certain transition issues for "derecognition" accounting under IFRS. In particular, the extent of retroactive application of these standards for new adopters was debated. Currently the standard requires retroactive treatment for application of this accounting change, but only for transactions occurring after January 1, 2004. The Committee recommended that

instead of this fixed date, the date should be defined as the date of transition to IFRS (or January 1, 2010 for Canadian issuers). The Committee's recommendation has now been adopted in IFRS with an effective date of June 2011. The Company has chosen not to early adopt this standard and will account for the transition with retroactive application to January 1, 2004. The Company believes that to adopt this new standard would result in inconsistent financial information, particularly on the balance sheet. First National will continue to evaluate the impact of these new standards and report thereon in future MD&A.

Controls over Financial Reporting

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

Management evaluated, under the supervision of and with the participation of the Chairman and President, and Chief Financial Officer, the effectiveness of the Company's internal control over financial reporting based on the criteria set forth in the *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* issued by the Committee of Sponsoring Organizations of the Treadway Commission and, based on that evaluation, concluded that the Company's internal control over financial reporting was effective as of December 31, 2010 and that there were no material weaknesses that have been identified in the Company's internal control over financial reporting as of December 31, 2010. No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2010 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 losses than prime mortgages. In addition, risks associated with the structure of FNFC (the public entity as at January 1, 2011) include those related to the dependence on FNFLP, leverage and restrictive covenants, dividends which are not guaranteed and could fluctuate with FNFLP's performance, restrictions on potential growth, the market price of FNFC shares, 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 primarily prime mortgages and find funding through various channels to earn ongoing servicing or spread income. For the single-family residential segment, the Company relies on independent mortgage brokers for origination and several large institutional investors for sources of funding. These relationships are critical to the Company's success. For a more complete discussion of the risks affecting the Company's business, reference should be made to the Annual Information Form of the Fund and its successor (FNFC).

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 benefited from the transitional period, and would otherwise have been subject to the SIFT Rules in January 2011 had management not converted to a corporate structure on January 1, 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. See the description above under "Accrued Future Tax Liability on Intangible Assets" and "Accrued Future Tax Liability on Investment in FNFLP".

The Company believed that to remain a trust after the SIFT Rules came 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

MANAGEMENT'S DISCUSSION AND ANALYSIS

highest marginal personal tax rates. In order to provide the Company with the most flexibility, management initiated a conversion to a corporation, which was completed effective January 1, 2011. The plan used tax-free rollover provisions to reorganize the trust structure as described in the Management Information Circular filed on April 8, 2010. The plan of rearrangement was approved by the Board of Directors on March 25, 2010, and the Fund's unit-holders at the Company's special and annual general meeting on May 4, 2010. Subsequently, final court approval was obtained. Effective January 1, 2011, the Fund dissolved and the unitholders became shareholders of First National Financial Corporation.

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

MD&A represents management's expectations as of March 1, 2011, 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

The global economy is still somewhat unsettled but sentiment seems to point to slow improvement and recovery in 2011. For the mortgage industry, there are a number of significant issues which affect the clarity of management's outlook. 2011 will feature the transition to IFRS, which combined with new capital regulations for federally regulated banks and trust companies may have a significant impact on competitors of the Company and overall mortgage spreads. It is also unclear how quickly the Bank of Canada will act to slow inflation and move interest rates back to a more normalized environment. Recently, the Minister of Finance announced changes to mortgages regulations, generally introducing tighter lending criteria for insured mortgages. These measures will affect the volume of originations, but any reduction in origination volumes is anticipated to be marginal.

Generally, the Company sees overall origination volumes to be similar to 2010 as lower per unit mortgages will be offset by increased market share as competitors exit the market or slow down origination so as to maintain regulated capital ratios. The Company believes spreads, which tightened throughout 2010, will stabilize and will remain at these levels or widen to reflect higher costs of capital among the Company's competitors. Together with a more stable and efficient capital market, the Company sees opportunity for more direct securitization. The new issue of rate reset preferred shares, which the Company closed on January 25, 2011, provides the Company additional capital to pursue this strategy. Lastly, management forecasts that the portfolio of mortgages under administration, currently at approximately \$53 billion, will continue to grow and produce higher income and cash flow.

As described earlier, the Company restructured from an income trust structure and became a corporation on January 1, 2011. Beginning in 2011, the Company will replace its distributions with payments of after-tax dividends. In the fourth quarter, the Company reviewed its forecast for both earnings and cash flow going into 2011. Given management's view of increasing cash flows, the Company set the estimate of the annual dividend as a corporation at \$1.25 per annum. Management believes this dividend policy will be sustainable and will allow the Company to continue to pursue its growth objectives.

Management's Responsibility for Financial Reporting

The accompanying consolidated financial statements of First National Financial Income Fund for the period from January 1, 2010 to December 31, 2010 and the financial statements of First National Financial LP for the period January 1, 2010 to December 31, 2010 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 auditors. 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 2010 consolidated financial statements and First National Financial LP's 2010 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

Independent Auditors' Report

To the Unitholders of First National Financial Income Fund

We have audited the accompanying consolidated financial statements of First National Financial Income Fund, which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of income and unitholders' equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of First National Financial Income Fund as at December 31, 2010 and 2009 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

Toronto, Canada,
March 1, 2011

Chartered Accountants
Licensed Public Accountants

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

<i>As at December 31</i>	<i>2010</i>	<i>2009</i>
ASSETS		
Distributions receivable	\$ 6,765	\$ 2,219
Interest receivable (note 9)	1,374	–
Investment in First National Financial LP (note 4)	292,544	117,077
	300,683	119,296
LIABILITIES AND EQUITY		
Liabilities		
Distributions payable	6,658	2,219
Accounts payable and accrued liabilities	1,374	37
Debentures (note 9)	175,000	–
Future income taxes (note 6)	19,000	13,750
Total liabilities	202,032	16,006
Equity		
Unitholders' equity	98,651	103,290
	\$ 300,683	\$ 119,296

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>2010</i>	<i>2009</i>
REVENUE		
Equity income from investment in First National Financial LP	\$ 24,668	\$ 25,103
Interest income (note 9)	5,847	–
	30,515	25,103
EXPENSES		
Interest (note 9)	5,810	–
Income before income taxes	24,705	25,103
Provision for future income taxes (note 6)	5,250	3,450
Net income for the year	\$ 19,455	\$ 21,653
Unitholders' equity, beginning of year	103,290	100,024
Distributions (note 5)	(24,094)	(18,387)
Unitholders' equity, end of year	\$ 98,651	\$ 103,290
Average number of Units outstanding during the year	12,681,113	12,681,113
Earnings per Unit (note 8)		
Basic	\$ 1.53	\$ 1.71

See accompanying notes

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

<i>Years ended December 31</i>	<i>2010</i>	<i>2009</i>
OPERATING ACTIVITIES		
Net income for the year	\$ 19,455	\$ 21,653
Add (deduct) items not involving cash		
Provision for future income taxes	5,250	3,450
Equity income from investment in First National Financial LP	(24,668)	(25,103)
Distributions received from First National Financial LP	19,655	18,482
Net change in non-cash working capital balances related to operations	(37)	-
Cash provided by operating activities	19,655	18,482
INVESTING ACTIVITIES		
Loan to First National Financial LP	\$ (175,000)	\$ -
Cash used in investing activities	(175,000)	-
FINANCING ACTIVITIES		
Debentures issued	175,000	-
Distributions paid	\$ (19,655)	\$ (18,482)
Cash provided by (used in) financing activities	155,345	(18,482)
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, 2010 and 2009

(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"], 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 [after provision for the over-allotment option] was the issuance of 47,286,316 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 "GP"], the general partner, which holds a 0.01% interest in FNFLP. As at December 31, 2010, the Fund indirectly holds a 21.15% [2009 – 21.15%] interest in FNFLP and FNFC holds a 78.85% [2009 – 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 outstanding as at December 31:

	2010		2009	
	Number of Units	Amount	Number of Units	Amount
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.

Since the initial public offering, no Units have been redeemed.

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:

	2010	2009
Units outstanding	\$ 123,671	\$ 123,671
Note receivable (note 9)	175,000	–
Equity accounting adjustments		
Made prior to beginning of year	(6,594)	(13,310)
Equity earnings of FNFLP for the year	34,136	34,571
Amortization of purchase price discrepancy	(9,468)	(9,468)
Distributions received in the year	(24,201)	(18,387)
	\$ 292,544	\$ 117,077

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		
2009 regular distribution	\$ 0.125	\$ 1,585
2009 special distribution	0.050	634
January 2010	0.125	1,585
February 2010	0.125	1,586
March 2010	0.125	1,585
April 2010	0.125	1,585
May 2010	0.125	1,585
June 2010	0.125	1,585
July 2010	0.125	1,585
August 2010	0.125	1,585
September 2010	0.125	1,585
October 2010	0.125	1,585
November 2010	0.125	1,585
Distributions payable		
December 2010		
regular distribution	0.125	1,586
2010 special distribution	0.400	5,072
		\$ 26,313

NOTE 6

INCOME TAXES

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 25.00% 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 25.00% for 2014. Based on these new tax rates, the Fund accrued a future income tax liability of \$8,600 as at December 31, 2010 [2009 – \$8,600]. This liability will 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, 2010, FNFLP has a net taxable temporary difference pertaining to the Fund which will reverse after January 1, 2011, such that an accrual of \$10,400 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.

As described in note 10, the Fund will be wound up effective January 1, 2011. The tax liabilities above will be assumed by its successor, First National Financial Corporation [the "Corporation"].

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, the 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, 2010 of \$23,239 [2009 – \$240,704] and an authorized limit of \$125,000 [2009 – \$378,330]. No fee is charged for this guarantee.

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.

NOTE 9

DEBENTURES

On May 7, 2010, the Fund issued \$175,000 Series 1 senior secured debentures bearing interest at a rate of 5.07% per annum, payable semi-annually. The debentures mature on May 7, 2015 and are guaranteed, jointly and severally, by the Trust, FNFLP and the GP. The Fund loaned the full proceeds to the Trust at a rate of 5.09% per annum. The Trust loaned these proceeds to FNFLP at a rate of 5.1025% per annum. Both intercompany loans are payable on the same dates as the interest and principal payments on the debentures. FNFLP used the full proceeds of the loan to repay a portion of its bank indebtedness under its current credit facility. The costs relating to the debenture issuance have been borne by FNFLP.

NOTE 10

SUBSEQUENT EVENTS

Reorganization

Subsequent to year end, pursuant to a Plan of Arrangement [the "Arrangement"] and an amalgamation [the "Amalgamation"] effective January 1, 2011, the structure of the Fund and its investment in FNFLP was reorganized as follows:

- A new company [First National Financial Inc. ["FNFI"]] was formed;
- Unitholders of the Fund exchanged 12,681,113 Units in the Fund for Class A shares in FNFI on a one-for-one basis;
- The pre-Arrangement shareholders of the Corporation exchanged their shares in the Corporation for 48,077,950 shares of FNFI with the result that the Corporation became a wholly-owned subsidiary of FNFI;
- The Fund and the Trust were wound up; and
- The Corporation and FNFI were amalgamated and continued under the name "First National Financial Corporation".

Effectively, the Arrangement and the Amalgamation reorganized the ownership interests in FNFLP such that all such interests will be consolidated and held through the Corporation in the same ratio as previously held by the Fund and the Corporation, respectively. The continuing publicly traded entity will be First National Financial Corporation.

Issuance of preferred shares

On January 25, 2011, the Corporation issued 4 million Class A Series 1 Preferred Shares at a price of \$25.00 per share for gross proceeds of \$100,000, before issue expenses. Expenses of \$2,470 related to the issuance have been recorded in capital stock, which is net of income taxes recoverable of \$868. The net proceeds of \$96.7 million from the issuance were paid down to the FNFLP as a contribution of partner capital.

Holders of the Series 1 Preferred Shares are entitled to receive a cumulative quarterly fixed dividend yielding 4.65% annually for the initial term ending March 31, 2016. Thereafter, the dividend rate will be reset every five years at a rate equal to the 5-year Government of Canada yield plus 2.07%.

Holdings of Series 1 Preferred Shares have the right, at their option, to convert their shares into cumulative, floating rate Class A Preference Shares, Series 2 ["Series 2 Preferred Shares"], subject to certain conditions, on March 31, 2016 and on March 31 every five years thereafter. Holders of the Series 2 Preferred Shares will be entitled to receive cumulative quarterly floating dividends at a rate equal to the 3-month Government of Canada Treasury Bill yield plus 2.07%.

Independent Auditors' Report

To the Partners of First National Financial LP

We have audited the accompanying financial statements of First National Financial LP, which comprise the balance sheets as at December 31, 2010 and 2009, and the statements of income and retained earnings and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

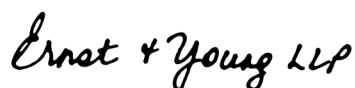
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of First National Financial LP as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

Toronto, Canada,
March 1, 2011

Chartered Accountants
Licensed Public Accountants

FIRST NATIONAL FINANCIAL LP

BALANCE SHEETS

(in \$000s)

<i>As at December 31</i>	2010	2009
ASSETS		
Accounts receivable and sundry (notes 8 and 14)	\$ 39,485	\$ 37,161
Mortgages accumulated for sale	318,791	383,257
Securitization receivable (note 3)	157,443	103,964
Deferred placement fees receivable (note 3)	85,181	98,121
Cash collateral and short-term notes held by securitization trusts (note 3)	40,686	45,112
Mortgage and loan investments (note 4)	70,911	54,737
Purchased mortgage servicing rights (note 5)	5,766	6,607
Securities purchased under resale agreements and owned (note 11)	426,336	333,705
Property, plant and equipment, net (note 6)	4,483	5,026
Total assets	1,149,082	1,067,690
LIABILITIES AND EQUITY		
Liabilities		
Bank indebtedness (note 7)	\$ 30,153	\$ 249,336
Obligations related to securities and mortgages sold under repurchase agreements (note 12)	174,258	221,937
Accounts payable and accrued liabilities (notes 8 and 14)	22,092	18,097
Distributions payable	31,988	10,494
Servicing liability (note 3)	25,709	21,022
Securities sold under repurchase agreements and sold short (note 11)	424,673	332,427
Debenture loan payable (notes 9, 14 and 15)	178,849	–
Total liabilities	887,722	853,313
Commitments and guarantees (note 10)		
Equity		
GP units (notes 1 and 19)	59	59
Class A LP units (notes 1 and 19)	120,171	120,171
Exchangeable Class B LP units (notes 1 and 19)	(22,940)	(22,940)
Retained earnings	164,070	117,087
Total equity	261,360	214,377
Total liabilities and equity	\$ 1,149,082	\$ 1,067,690

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>2010</i>	<i>2009</i>
REVENUE		
Placement fees	\$ 103,589	\$ 123,882
Gains on deferred placement fees <i>(note 3)</i>	9,566	51,805
Gains on securitization <i>(note 3)</i>	60,227	55,417
Mortgage investment income <i>(note 4)</i>	26,972	23,428
Mortgage servicing income	73,846	64,440
Residual securitization income <i>(note 3)</i>	35,574	22,853
Realized and unrealized losses on financial instruments <i>(notes 2 and 14)</i>	33,440	(109)
	343,214	341,716
EXPENSES		
Brokerage fees	\$ 103,020	\$ 98,677
Salaries and benefits	43,153	48,204
Interest	13,808	13,439
Management salaries	1,500	1,500
Other operating <i>(note 4)</i>	20,306	16,413
	181,787	178,233
Net income for the year	\$ 161,427	\$ 163,483
Retained earnings, beginning of year	117,087	40,557
Less distributions declared	(114,444)	(86,953)
Retained earnings, end of year	\$ 164,070	\$ 117,087
Earnings per unit <i>(note 17)</i>		
Basic	\$ 2.69	\$ 2.73

See accompanying notes

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

<i>Years ended December 31</i>	<i>2010</i>	<i>2009</i>
OPERATING ACTIVITIES		
Net income for the year	\$ 161,427	\$ 163,483
Add (deduct) items not affecting cash		
Non-cash portion of gains on securitization and gains on deferred placement fees	(80,868)	(121,565)
Amortization of securitization receivable and deferred placement fees receivable	81,517	48,019
Amortization of purchased mortgage servicing rights	841	2,024
Amortization of property, plant and equipment	1,796	1,749
Unrealized (gains) losses on financial instruments	(32,857)	32
Amortization of servicing liability	(7,024)	(5,743)
	124,832	87,999
Net change in non-cash working capital balances related to operations <i>(note 13)</i>	70,000	(171,548)
Cash provided by (used in) operating activities	194,832	(83,549)
INVESTING ACTIVITIES		
Additions to property, plant and equipment	\$ (1,253)	\$ (1,510)
Repayment of cash collateral and short-term notes, net	5,118	8,614
Investment in mortgage and loan investments	(74,082)	(82,924)
Repayment of mortgage and loan investments	60,554	101,063
Cash provided by (used in) investing activities	(9,663)	25,243
FINANCING ACTIVITIES		
Distributions paid	\$ (92,950)	\$ (87,403)
Obligations related to securities and mortgages sold under repurchase agreements	(47,679)	221,937
Proceeds from debenture loan	175,000	-
Securities purchased under resale agreements and owned, net	(92,631)	(106,401)
Securities sold under repurchase agreements and sold short, net	92,274	111,840
Cash provided by financing activities	34,014	139,973
Net decrease in bank indebtedness during the year	219,183	81,667
Bank indebtedness, beginning of year	(249,336)	(331,003)
Bank indebtedness, end of year	\$ (30,153)	\$ (249,336)
Supplemental cash flow information		
Interest paid	\$ 14,408	\$ 13,330

See accompanying notes

FIRST NATIONAL FINANCIAL LP NOTES TO FINANCIAL STATEMENTS

December 31, 2010 and 2009

(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, 2010, the Company had mortgages under administration of \$53,293,132 [2009 – \$47,793,045] and cash held in trust of \$527,624 [2009 – \$435,358]. Mortgages under administration are serviced for financial institutions such as banks, 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, 2010, the Company administered 174,483 mortgages [2009 – 155,401] for 95 institutional investors [2009 – 98] with an average remaining term to maturity of 44 months [2009 – 47 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 ["GAAP"] 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.

Adoptions of new accounting standards

2010

No significant new accounting policies were adopted during 2010.

2009

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 14.

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 Sections 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 agreements	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
Obligations 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.

on securitization is recorded. This includes securitizations through Asset-Backed Commercial Paper [“ABCP”], NHA-MBS and the Canada Mortgage Bonds [“CMB”] program. The Company also enters into transactions with institutional investors in which placement fees are received over time instead of only at the time of the mortgage sale. In these cases, the Company applies the same accounting methodology as it does with the direct securitization transactions; future expected cash flows are discounted to present value and a gain on deferred placement fee is recorded.

NOTE 3

SECURITIZATION AND DEFERRED PLACEMENT FEES RECEIVABLE

The Company enters into various sale transactions that provide it with an ongoing stream of cash flow based on the value of the mortgages sold or placed. The value of these streams is calculated and revenue is recorded on the transaction date. 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. When these future payments represent primarily the present value of future payments from direct securitization by the Company, where the Company is the principal risk taker, a gain

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 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

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future periods. These placement fees result from 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, 2010, the Company securitized \$3,651,937 [2009 – \$2,543,505] of mortgage loans to special purpose entities and other securitization vehicles, recognizing gains on securitization of \$60,227 [2009 – \$55,417]. Gains on securitization are net of securitization transactions costs of \$11,075 [2009 – \$9,638]. During the year ended December 31, 2010, the Company sold \$1,749,715 [2009 – \$4,606,051] of mortgage loans to institutional investors which created placement fees receivable in future periods, recognizing gains on deferred placement fees of \$9,566 [2009 – \$51,805]. These gains are net of losses from interest rate hedging of nil [2009 – losses of \$4,705].

The liability for implicit servicing on securitization was \$25,709 as at December 31, 2010 [2009 – \$21,022]. 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, 2010 amounted to \$7,024 [2009 – \$5,743] 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, 2010, the cash collateral was \$29,767 [2009 – \$32,178] and the short-term notes were \$10,919 [2009 – \$12,934].

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

	2010	2009
Prepayment rate	15%	13.5%
Discount rate	5.1%	5.4%

No credit loss assumption was used for insured mortgages as no loss is expected. For uninsured mortgages, the expected weighted average credit loss assumption used was 0.56% [2009 – 0.51%].

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

	2010	2009
Proceeds from new securitizations and deferred placements	\$ 5,401,652	\$ 7,149,556
Receipts on securitization and deferred placement fees receivable	\$ 120,663	\$ 71,126

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 in the tables below, 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
2010				
Fair value of securitization receivable and deferred placement fees receivable (FVO)	\$ 88,113	\$ 1,760	\$ 36,632	\$ 116,119
Average life (in months) ⁽¹⁾	56	19	29	43
Prepayment speed assumption (annual rate)	0.4%	38.4%	15.3%	25.5%
Impact on fair value of 10% adverse change	\$ 54	\$ 64	\$ 667	\$ 4,180
Impact on fair value of 20% adverse change	\$ 107	\$ 124	\$ 1,316	\$ 8,129
Residual cash flows discount rate (annual)	5.3%	4.6%	4.8%	5.1%
Impact on fair value of 10% adverse change	\$ 1,109	\$ 7	\$ 209	\$ 851
Impact on fair value of 20% adverse change	\$ 2,191	\$ 14	\$ 417	\$ 1,691
Expected credit losses	0.0%	0.0%	0.0%	0.0%
Impact on fair value of 10% adverse change	\$ 31	\$ 1	\$ 206	\$ 101
Impact on fair value of 20% adverse change	\$ 62	\$ 2	\$ 413	\$ 203
Spread assumption	0.5%	1.0%	0.6%	1.2%
Impact on fair value of 10% adverse change	\$ 8,858	\$ 176	\$ 3,840	\$ 11,585
Impact on fair value of 20% adverse change	\$ 17,717	\$ 352	\$ 7,680	\$ 23,170

	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

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

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These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in carrying value based on a 10% or 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in these tables, 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 par with 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 \$1,531.

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

2011	\$	94,562
2012		67,162
2013		42,114
2014		22,169
2015 and thereafter		16,617
	\$	242,624

Mortgages under administration are serviced as follows:

	2010	2009
Institutional investors	\$ 37,067,568	\$ 33,316,698
Securitization vehicles	11,560,845	9,445,142
CMBS conduits	4,664,719	5,031,205
	\$ 53,293,132	\$ 47,793,045

The Company's exposure to credit loss is limited to mortgages under administration totalling \$694,781 [2009 – \$858,023], of which mortgages of \$38,435 have principal and interest payments outstanding as at December 31, 2010 [2009 – \$60,928]. The Company incurred actual credit losses, net of recoveries, of \$3,689 during the year ended December 31, 2010 [2009 – \$3,736]. As at December 31, 2010, the Company has \$6,990 [2009 – \$9,296] 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, 2010, mortgage and loan investments consist primarily of commercial first and second mortgages held for various terms, the majority of which mature within one year:

Mortgage and loan investments consist of the following:

	2010	2009
Mortgage loans classified as loans and receivables	\$ 60,555	\$ 44,133
Mortgage loans designated as held-for-trading	10,356	9,604
Subordinated note	–	1,000
	\$ 70,911	\$ 54,737

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

The subordinated note was issued by a securitization trust not related to the Company. The note matured in November 2010.

The following table discloses the composition of the Company's portfolio of mortgage and loan investments by geographic region as at December 31, 2010:

Province	Portfolio balance	Percentage of portfolio
Alberta	\$ 4,158	5.86
British Columbia	4,669	6.58
Manitoba	11,428	16.12
Newfoundland	104	0.15
Nova Scotia	2,030	2.86
Ontario	36,698	51.75
Quebec	11,201	15.80
Saskatchewan	100	0.14
Yukon	523	0.74
	\$ 70,911	100.00

These balances are net of discounts of \$296 [2009 – \$674] and provisions for credit losses of \$4,831 [2009 – \$4,306]. The portfolio contains \$523 [2009 – \$869] of insured mortgages and \$70,388 [2009 – \$53,868] of uninsured mortgage and loan investments as at December 31, 2010.

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

Days	2010	2009
31 to 60	\$ 2,122	\$ 400
61 to 90	1,694	–
Greater than 90	7,739	5,956
	\$ 11,555	\$ 6,356

Of the above total amount, the Company considers \$5,968 [2009 – \$5,956] as impaired for which it has provided an allowance for potential loss of \$4,831 [2009 – \$4,306] as at December 31, 2010.

Allowance for loan losses

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

	2010	2009
Balance, beginning of year	\$ 4,306	\$ 3,437
Provisions for credit losses	525	1,313
Write-offs	–	(444)
Balance, end of year	\$ 4,831	\$ 4,306

Due to loan specific issues, the Company has experienced credit losses of \$525 for the year ended December 31, 2010 [2009 – \$1,313]. 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.

	2010					2009
	Within 1 year	Over 1 to 3 years	Over 3 to 5 years	Over 5 years	Book value	Book value
Residential	\$ 2,376	\$ 631	\$ 32	\$ –	\$ 3,039	\$ 5,524
Commercial	44,628	11,286	3,197	8,761	67,872	49,213
					\$ 70,911	\$ 54,737

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

2011	\$ 47,004
2012	10,598
2013	1,319
2014	3,229
2015 and thereafter	8,761
	\$ 70,911

Interest income for the year was \$8,722 [2009 – \$9,626] and is included in mortgage investment income on the statements of income and retained earnings.

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NOTE 5

PURCHASED MORTGAGE SERVICING RIGHTS

Purchased mortgage servicing rights consist of the following components:

	2010			2009		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Third-party commercial mortgage servicing rights	\$ 3,614	\$ 2,620	\$ 994	\$ 3,614	\$ 2,462	\$ 1,152
Commercial mortgage backed securities primary and master servicing rights	8,705	3,933	4,772	8,705	3,250	5,455
	\$ 12,319	\$ 6,553	\$ 5,766	\$ 12,319	\$ 5,712	\$ 6,607

The Company did not purchase any new servicing rights during the years ended December 31, 2010 and 2009. Amortization, including impairment, charged to income for the year ended December 31, 2010 was \$841 [2009 – \$2,024].

During the year ended December 31, 2009, management performed an impairment test on these assets and concluded that the Company's unamortized cost exceeded the fair market value and, as a result, the Company recorded an impairment charge of \$1,194. No impairment was recorded in 2010.

NOTE 6

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

	2010			2009		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Computer equipment	\$ 7,108	\$ 4,578	\$ 2,530	\$ 6,327	\$ 3,662	\$ 2,665
Office equipment	3,020	2,215	805	3,006	2,016	990
Computer software	2,306	1,577	729	1,869	1,259	610
Leasehold improvements	2,449	2,030	419	2,429	1,668	761
	\$ 14,883	\$ 10,400	\$ 4,483	\$ 13,631	\$ 8,605	\$ 5,026

NOTE 7

BANK INDEBTEDNESS

Bank indebtedness includes a one-year revolving line of credit of \$125,000 [2009 – \$378,330] maturing in May 2011, of which \$23,239 [2009 – \$240,704] was drawn at December 31, 2010 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.

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 tables present, by remaining term to maturity, the notional amounts and fair values of the swap contract that do not qualify for hedge accounting as at December 31, 2010 and 2009:

	2010			
	<i>Less than 3 years</i>	<i>3 to 5 years</i>	<i>Total notional amount</i>	<i>Fair value</i>
Interest rate swap contract	\$ 17,000	\$ 4,243	\$ 21,243	\$ (93)

	2009			
	<i>Less than 3 years</i>	<i>3 to 5 years</i>	<i>Total notional amount</i>	<i>Fair value</i>
Interest rate swap contract	\$ –	\$ 33,000	\$ 33,000	\$ (209)

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

DEBENTURE LOAN PAYABLE

On May 7, 2010, First National Financial Income Fund [the "Fund"] issued \$175 million of five-year term senior secured debentures with an interest rate of 5.07%, maturing on May 7, 2015. The debenture is secured on a pari-passu basis with the security under the one-year revolving line of credit described in bank indebtedness. The Fund loaned the net proceeds of the issuance through the Trust to FNFLP at an interest rate of 5.1025% per annum. The Company

has fully guaranteed the debentures on behalf of the Fund. The Company used the proceeds of the debenture loan to repay a portion of its bank indebtedness under its existing bank credit facility. On the same date, the Company entered into a swap agreement to receive a 5.07% fixed coupon and pay monthly CDOR+2.134%, effectively protecting the Company against changes in fair value due to changes in interest rates. The swap agreement has been designated as a fair value hedge and matures on the due date of the debenture loan. The costs relating to the debenture issue have been borne by the Company.

NOTE 10

**COMMITMENTS, GUARANTEES
AND CONTINGENCIES**

As at December 31, 2010, the Company has the following operating lease commitments for its office premises:

2011	\$	3,399
2012		3,523
2013		3,168
2014		3,033
2015 and thereafter		5,430
	\$	18,553

Outstanding commitments for future advances on mortgages with terms of one to 10 years amounted to \$2,166,166 as at December 31, 2010 [2009 – \$1,835,674]. 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.

The Company is a named defendant in several legal actions involving matters that arise in the ordinary course of its business activities. Management believes that any liability that may ultimately result from the resolution of these matters will not have a material adverse effect on the financial position or operating results of the Company and, accordingly, no provision has been recorded.

NOTE 11

**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 12

**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 1.4% and mature on or before January 17, 2011. This liability includes \$81,300 [2009 – \$62,500] for repo transactions related to mortgages carried by the Company in the form of NHA-MBS, and \$93,000 [2009 – \$159,500] 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 13

STATEMENTS OF CASH FLOWS

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

	2010	2009
Accounts receivable and sundry	\$ 1,641	\$ (10,068)
Mortgages accumulated for sale	64,723	(161,966)
Accounts payable and accrued liabilities	(17,858)	936
Distributions payable	21,494	(450)
	\$ 70,000	\$ (171,548)

NOTE 14

**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 to institutional investors the interest rate risk that exists prior to funding. The Company uses bond forwards [consisting of bonds sold short and bonds purchased under resale agreements] to manage any fixed interest rate exposure between the time a mortgage rate is committed to borrowers and the time the mortgage is sold to a securitization vehicle. 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 mortgages 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. Bank indebtedness, obligations related to debt and the debenture loan payable are all floating rate obligations indexed to 30-day CDOR; the funds held in trust earn the Company interest based on the same floating rate basis. Because both the indebtedness and funds held in trust have comparable values, with the liabilities being \$383,260 [2009 – \$471,273] at December 31, 2010 and funds held in trust being \$527,624 [2009 – \$435,358] on the same date, the Company considers the arrangement to be a natural hedge against short-term interest rate fluctuations.

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 2010 and 2009.

	Increase in interest rate		Decrease in interest rate	
	2010	2009	2010	2009
100 basis point shift				
Impact on net income and unitholders' equity	\$ 1,398	\$ 1,024	\$ 256	\$ 1,802
200 basis point shift				
Impact on net income and unitholders' equity	\$ 2,797	\$ 2,049	\$ 2,528	\$ 4,417

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, 2010, this revenue was \$2,639 [2009 – \$1,260].

As at December 31, 2010, the Company administered \$50,553 [2009 – \$68,025] of fixed rate commercial mortgages, of which it has a direct face value interest of \$10,903 [2009 – \$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 its 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 \$318,791 prime mortgages, of which 88% are insured, 2% are uninsured but sold on commitment to institutional investors, and the remainder are 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 47% and average yield of 7.9%, 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 four banks which provides for a total of \$125,000 in financing. Bank indebtedness also includes borrowings obtained through securitization transactions, outstanding cheques and overdraft facilities.

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.

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.

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

	2010			
	Level 1	Level 2	Level 3	Total
Financial assets				
Mortgages accumulated for sale	\$ —	\$ 318,791	\$ —	\$ 318,791
Securitization receivable	—	—	157,443	157,443
Deferred placement fees receivable	—	—	85,181	85,181
Cash collateral and short-term notes held by securitization trusts	—	—	40,686	40,686
Mortgage and loan investments	—	—	10,356	10,356
Interest rate swaps	—	3,849	—	3,849
Total financial assets	\$ —	\$ 322,640	\$ 293,666	\$ 616,306
Financial liabilities				
Securities sold under repurchase agreements and sold short	\$ 424,673	\$ —	\$ —	\$ 424,673
Mortgage commitments	—	330	—	330
Interest rate swaps	—	93	—	93
Total financial liabilities	\$ 424,673	\$ 423	\$ —	\$ 425,096
	2009			
	Level 1	Level 2	Level 3	Total
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

FIRST NATIONAL FINANCIAL LP
NOTES TO FINANCIAL STATEMENTS

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, 2010 that was estimated using a valuation technique based on assumptions that are not fully supported by observable market prices or rates was a gain of approximately \$32,817 [2009 – loss of \$656]. 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 gains of \$583 [2009 – losses of \$77]] of the Company's financial assets and financial liabilities for the years ended December 31, 2010 and 2009, 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:

	2010	2009
Mortgages accumulated for sale	\$ 257	\$ (3,279)
Securitization receivable	28,547	4,048
Deferred placement fees receivable	931	(1,658)
Cash collateral and short-term notes held by securitization trusts	692	(472)
Mortgage and loan investments	3,230	(2,651)
Securities owned and sold short	27	4,294
Mortgage commitments	(359)	(919)
Interest rate swaps	115	528
	\$ 33,440	\$ (109)

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, 2010. 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 2010</i>	<i>Investments</i>	<i>Realized and unrealized gain (loss) recorded in income</i>	<i>Repayments and amortization</i>	<i>Fair value as at December 31 2010</i>
Financial assets					
Securitization receivable	\$ 103,964	\$ 81,476	\$ 28,547	\$ (56,544)	\$ 157,443
Deferred placement fees receivable	98,121	11,102	931	(24,973)	85,181
Cash collateral and short-term notes held by securitization trusts	45,112	3,186	692	(8,304)	40,686
Mortgage and loan investments	9,604	–	3,230	(2,478)	10,356
Total financial assets	\$ 256,801	\$ 95,764	\$ 33,400	\$ (92,299)	\$ 293,666

	<i>Fair value as at January 1 2009</i>	<i>Investments</i>	<i>Realized and unrealized gain (loss) recorded in income</i>	<i>Repayments and 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	2,758	(472)	(11,372)	45,112
Mortgage and loan investments	12,389	–	(2,651)	(134)	9,604
Total financial assets	\$ 181,668	\$ 135,391	\$ (733)	\$ (59,525)	\$ 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 2010</i>	<i>Decrease in fair value 2010</i>
Financial assets		
Cash collateral and short-term notes held by securitization trusts	\$ 236	\$ (236)
Mortgage and loan investments	820	(820)
Total	\$ 1,056	\$ (1,056)

	<i>Increase in fair value 2009</i>	<i>Decrease in fair value 2009</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)

Derivative financial instrument and hedge accounting

The Company entered into a swap agreement to hedge the loan payable against changes in fair value by converting the fixed rate debt into a variable rate debt. The swap agreement has been designated as a fair value hedge and the hedging relationship is formally documented, including the risk management objective and measurement of effectiveness. The swap agreement is recorded at fair value with the changes in fair value recognized in income. Changes in fair value attributed to the hedged risk are accounted for as basis adjustments to the debenture loan payable and are recognized in income. Accordingly, accounts receivable and sundry have been increased by \$3,849 to account for the swap derivative, and the debenture loan payable has been increased by the same amount.

NOTE 15

CAPITAL MANAGEMENT

The Company's objective is to maintain a strong capital base so as to maintain investor, creditor and market confidence and sustain future development of the business. Management defines capital as the Company's equity, long-term debt and retained earnings. The Company's liquidity strategy has been to use debt to fund working capital requirements and to use cash flow from operations to fund longer-term assets, providing a relatively low leveraged balance sheet. 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. During the year, the Fund issued \$175 million of five-year term debentures at an interest rate of 5.07% per annum and the proceeds were used by the Company to reduce its revolving bank credit facility. The debentures were effectively hedged against CDOR+2.134%, reducing the future interest rate risk arising from bank credit facility spread. 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, 2010, the ratio was 0.80:1 [2009 – 2.20:1]. The Company was in compliance with the bank agreement throughout the year.

NOTE 16

INFORMATION ABOUT MAJOR CUSTOMERS

Placement fees, mortgage servicing income and gains on deferred placement fees revenue from three Canadian financial institutions represent approximately 35% [2009 – 41%] of the Company's total revenue. During the year ended December 31, 2010, the Company placed 54% [2009 – 51%] of all mortgages it originated with the same three institutional investors.

NOTE 17

EARNINGS PER UNIT

Earnings per unit are calculated as follows:

	<i>2010</i>	<i>2009</i>
Net income for the year available to unitholders	\$ 161,427	\$ 163,483
Number of equivalent unitholders [Class A and B (000s)]	59,967	59,967
Basic earnings per unit	\$ 2.69	\$ 2.73

FIRST NATIONAL FINANCIAL LP
NOTES TO FINANCIAL STATEMENTS

NOTE 18

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.

	2010		
	<i>Residential</i>	<i>Commercial</i>	<i>Total</i>
REVENUE			
Placement, securitization and servicing	\$ 255,879	\$ 60,362	\$ 316,241
Mortgage investment income	12,523	14,450	26,973
	<u>268,402</u>	<u>74,812</u>	<u>343,214</u>
EXPENSES			
Amortization	1,367	429	1,796
Interest	11,197	2,611	13,808
Other operating	141,530	23,153	164,683
Corporate non-allocated expenses	-	-	1,500
	<u>154,094</u>	<u>26,193</u>	<u>181,787</u>
Net income for the year	<u>114,308</u>	<u>48,619</u>	<u>161,427</u>
Identifiable assets	<u>608,305</u>	<u>540,777</u>	<u>1,149,082</u>
Capital expenditures	<u>\$ 878</u>	<u>\$ 375</u>	<u>\$ 1,253</u>
	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	<u>93,863</u>	<u>71,120</u>	<u>163,483</u>
Identifiable assets	<u>530,908</u>	<u>536,782</u>	<u>1,067,690</u>
Capital expenditures	<u>\$ 1,056</u>	<u>\$ 454</u>	<u>\$ 1,510</u>

NOTE 19

UNITHOLDERS' EQUITY

The following units are issued and outstanding:

	<i>Number of units</i>	<i>Amount</i>
GP units		
Units outstanding, January 1, 2010 and 2009	1	\$ 59
Units outstanding, December 31, 2010 and 2009	1	\$ 59
Class A LP units		
Units outstanding, January 1, 2010 and 2009	12,681,113	\$ 120,171
Units outstanding, December 31, 2010 and 2009	12,681,113	\$ 120,171
Class B LP units		
Units outstanding, January 1, 2010 and 2009	47,286,316	\$ (22,940)
Units outstanding, December 31, 2010 and 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 20

RELATED PARTY TRANSACTIONS

For the past few 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 \$21,627 as at December 31, 2010 [2009 – \$5,483].

NOTE 21

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. Based on the preliminary analysis of IFRS 1, "First time Adoption of International Financial Reporting Standards", the Company has identified the following significant exemptions that it expects to apply:

[i] IFRS 1 – Designation of previously recognized financial instruments. This exemption provides the opportunity for the Company to designate some of the mortgage pools out of the held-for-trading category to loans and receivables, and offset the income statement impact of the movement as a result of changes in the fair value of their assets.

[ii] IFRS 1 – Derecognition of financial assets and financial liabilities. This exemption is mainly applicable to the securitized assets and allows the Company to apply the IAS 39 derecognition requirements prospectively for transactions occurring on or after January 1, 2004. That is, for any derecognized non-derivative financial assets and liabilities under the existing Canadian GAAP before January 1, 2004, the Company will not have to recognize these items under IFRS.

The Company has finished its detailed analysis of the impact of the significant areas identified in phase one and phase two and has made system changes to produce the financial information under IFRS. The Company has also drafted the opening balance sheet under IFRS as at December 31, 2009 and the comparative statements of income and retained earnings and balance sheets for each quarter of 2010.

The most significant change in accounting policy for the Company is regarding revenue recognition, particularly for securitization transactions. Recently, the International Accounting Standards Board has finalized its amended IFRS 1 that requires first-time adopters to apply the derecognition requirements of IFRS prospectively from the date of transition, rather than from January 1, 2004, unless certain conditions are met. The amendment is effective from annual periods beginning on or after July 1, 2011. Accordingly, the Company has decided to apply the "derecognition" accounting retrospectively to January 1, 2004. Depending on the volumes of securitization transactions, the impact from the "derecognition" varies from quarter to quarter. Generally, the first three quarters featured large volumes of securitized mortgages and, accordingly, large gains on securitization. These revenues will be eliminated under IFRS and will be replaced with net interest rate spread from previously recorded securitization transactions. Because the Company has grown in the last five years and significantly increased the extent of its own securitization, the reversal of the gain on securitization revenue in these quarters is larger than the net interest income now recorded such that net income under IFRS will be lower. In the fourth quarter, the Company securitized lower volumes of its origination so that IFRS will have a smaller effect on that quarter's restated net income.

NOTE 22

SUBSEQUENT EVENTS

Reorganization

Subsequent to year end, pursuant to a Plan of Arrangement [the "Arrangement"] and an amalgamation [the "Amalgamation"] effective January 1, 2011, the Fund was wound up and its investment in FNFLP was reorganized as follows:

- A new company [First National Financial Inc. ["FNFI"]] was formed;
- Unitholders of the Fund exchanged 12,681,113 Units in the Fund for Class A shares in FNFI on a one-for-one basis;
- The pre-Arrangement shareholders of FNFC exchanged their shares in FNFC for 48,077,950 shares of FNFI with the result that FNFC became a wholly-owned subsidiary of FNFI;
- The Fund and the Trust were wound up; and
- FNFC and FNFI were amalgamated and continued under the name "First National Financial Corporation" [the "Corporation"].

Effectively, the Arrangement and the Amalgamation reorganized the ownership interests in FNFLP such that all such interests will be consolidated and held through the Corporation in the same ratio as previously held by the Fund and FNFC, respectively. The continuing publicly traded entity will be First National Financial Corporation.

Issuance of preferred shares

On January 25, 2011, the Corporation issued 4 million Class A Series 1 Preferred Shares at a price of \$25.00 per share for gross proceeds of \$100,000, before issue expenses. Expenses of \$2,470 related to the issuance have been recorded in capital stock, net of income taxes recoverable of \$868. The net proceeds of \$96.7 million from the issuance were paid down to FNFLP as a contribution of partner capital.

Holders of the Series 1 Preferred Shares are entitled to receive a cumulative quarterly fixed dividend yielding 4.65% annually for the initial term ending March 31, 2016. Thereafter, the dividend rate will be reset every five years at a rate equal to the 5-year Government of Canada yield plus 2.07%.

Holders of Series 1 Preferred Shares have the right, at their option, to convert their shares into Cumulative, Floating Rate Class A Preference Shares, Series 2 ["Series 2 Preferred Shares"], subject to certain conditions, on March 31, 2016 and on March 31 every five years thereafter. Holders of the Series 2 Preferred Shares will be entitled to receive cumulative quarterly floating dividends at a rate equal to the 3-month Government of Canada Treasury Bill yield plus 2.07%.

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EXCHANGE LISTING AND SYMBOL
TSX: FN

ANNUAL MEETING
May 4, 2011, 9 a.m. ET
TMX Broadcast & Conference Centre
The Gallery
The Exchange Tower
130 King Street West
Toronto, Ontario

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