ANNUAL REPORT 2018

FIRST NATIONAL

FINANCIAL CORPORATION

CORPORATE PROFILE

First National Financial is Canada's largest non-bank lender, originating and servicing both residential and commercial mortgages since 1988. Our broad range of mortgage solutions and unwavering commitment to innovative customer service has made First National a preferred choice for hundreds of thousands of borrowers and independent mortgage brokers from coast to coast. Our common shares trade on The Toronto Stock Exchange under the symbol FN, and our preferred shares trade under the symbols FN.PR.A and FN.PR.B.

Shareholders can find current and historical financial data and information on our business segments at **www.firstnational.ca**.

THE YEAR IN NUMBERS

OVER 300,000	Borrowers served by First National in 2018 across Canada.
$106.2 BILLION	Mortgages Under Administration (MUA) – the source of most of the Company's earnings – reached this all-time record at year-end 2018.
$1.2 BILLION	Revenue in 2018 grew 10% to a new annual record as strong productivity was assisted by the rising interest rate environment.
$166.4 MILLION	Net income in 2018 ($2.73 per share) reflected good execution despite tighter mortgage spreads and higher securitization activity, which reduced earnings from 2017 levels by 9%.
37%	The after-tax, Pre-Fair Market Value[1] return on shareholders' equity in 2018, a demonstration of the efficiency of the Company's business model.
$171.4 MILLION	Value of common share dividends declared in 2018, bringing the cumulative total to almost $1.3 billion since the Company's IPO in 2006.
$1.6 BILLION	The Company's market capitalization at December 31, 2018.

[1] Non-IFRS Measure. See MD&A for more details.

OUR MANAGEMENT TEAM

STEPHEN SMITH
Co-founder, Chairman and Chief Executive Officer

MORAY TAWSE
Co-founder and Executive Vice President

JASON ELLIS
Chief Operating Officer

HILDA WONG
Senior Vice President and General Counsel

JEREMY WEDGBURY
Senior Vice President, Commercial Mortgages

LISA WHITE
Senior Vice President, Mortgage Operations

ROBERT INGLIS
Chief Financial Officer

SCOTT MCKENZIE
Senior Vice President, Residential Mortgages

MESSAGE TO SHAREHOLDERS

Fellow Shareholders:

It seems like just yesterday that First National was conceived as an ambitious start-up on a mission to originate, fund and service mortgages. Yesterday is now 31 years ago and the time has passed quickly for those of us who were here at incorporation on March 31, 1988.

Moray and I are often asked whether we envisioned a day when this Company would become the largest non-bank mortgage lender in Canada. The truthful answer is no. We simply saw an opportunity and together with a small, highly talented team, vigorously pursued it.

In so doing, we were the beneficiaries of good timing. Our start up coincided with the emergence of the independent mortgage broker channel as a competitive force and the rise of the securitization market. However, the steady growth First National has achieved since – including in 2018 – is not happenstance. It is the result of building honest and trusting relationships with customers and partners over time and never sacrificing our principles in order to make short-term gains.

While I could extol the virtues of First National's business model, capital allocation strategies and risk-management systems, and certainly these attributes play a role in the Company's success, it is our caring, entrepreneurial culture that is the single most significant contributor to long-term performance and stability.

Culture is, of course, not static. It changes and grows with every new individual who joins our team, and with every new market situation we encounter and learn from in the course of each year. By the same token, culture cannot be taken for granted. It must be shaped and nurtured. We appreciate this and do so by maintaining a flat organizational structure void of cumbersome bureaucracy, promoting from within whenever possible, spending to develop our capabilities and talents and maintaining a consistent set of management priorities.

First National's first priority is to serve our customers. "Serve" has become a generic term, so to be more specific, we encourage our team to put responsiveness at the centre of their daily activities, we invest in time-saving, customer-facing technology embodied in MERLIN™ (for brokers) and MyMortgage (for residential borrowers), and we offer our commercial customers full access to our knowledge base to enhance their investment decision making.

Our principles-based approach delivered good results in 2018.

“It is our caring, entrepreneurial culture that is the single most significant contributor to long-term performance and stability.”

2018 IN REVIEW

Mortgages Under Administration (MUA) increased to $106.2 billion at December 31, 2018, 5% above the previous record set a year ago. This figure represents our investment, alone and in partnership with other institutions, in thousands of homes and commercial businesses in Canada. Single-family MUA reached $79.2 billion, while Commercial MUA of $27.0 billion was also record-setting.

By virtue of this performance, which was assisted by solid originations and mortgage renewals, First National added to its status as Canada's largest non-bank mortgage lender, and largest commercial mortgage lender. The bottom line results for our shareholders were also favourable.

On revenue of $1.2 billion, net income was $166.4 million or $2.73 per share. While earnings were lower than in 2017 due to tighter mortgage spreads and higher securitization activity, which delays the earnings process, profitability was solid.

During 2018, First National paid $171.4 million or $2.86 per common share of dividends. These figures include the payment of a special dividend of $1.00 per share in December. As a lender and as a publicly traded corporation, consistency and longevity matter, so we are pleased to note that this was First National's 30th consecutive year of profitable operations and the 12th consecutive year (since our initial public offering) of common share dividend increases. Since the IPO, almost $1.3 billion in total dividends and distributions have been paid to holders of our common equity. On a per share basis, First National has delivered $20.92 per share of dividends and distributions to common shareholders who purchased ownership at the IPO for $10 per unit. Combined with share price appreciation, we calculate the total return to IPO investors was 484% to December 31, 2018.

As a result of our efficient business model, 2018 after-tax Pre-Fair Market Value[1] return on shareholders' equity was 37%.

THE MARKETPLACE

Government policy interventions in the housing market have been significant over the past few years. In the fall of 2016, the Department of Finance introduced a stress test for borrowers of five-year, fixed-rate, high-ratio mortgages and eliminated insurability on single-family refinancing transactions. In early 2017, the Office of the Superintendent of Financial Institutions introduced new minimum capital adequacy standards for mortgage default insurers and, in early 2018, the Department of Finance amended Guideline B-20 – Residential Mortgage Underwriting Practices and Procedures to require users of conventional mortgages to qualify at interest rates higher than the actual rate offered by lenders.

Coupled with the implementation of foreign buyers' taxes in B.C. and Ontario, these fundamental changes made it harder for first-time borrowers to qualify for a mortgage, harder for those with a mortgage to switch to another financial institution, and harder to be an off-shore real estate speculator.

As a lender, we are supportive of policies that reduce excessive risk in the housing market, which, left unchecked, could spur an economic recession and result in significant personal hardship for many Canadians. With the reduction in home prices and re-sale volumes that we saw in the latter part of 2018, these policies appear to have hit their mark, especially because they were accompanied by three separate increases in the Bank of Canada's overnight rate during 2018.

While it is unclear at the time of writing if more interventions will be forthcoming in 2019, what is clear is that First National still has significant presence in the Canadian mortgage market and will continue to play a constructive role in helping our customers adjust to the changing environment.

SINGLE-FAMILY SOLUTIONS

First National's single-family team efficiently embraced each policy change. This allowed the Company to remain highly customer-focused throughout both 2017 and 2018. Working side-by-side with mortgage brokers, we maintained our response times to new origination opportunities and helped thousands of first-time buyers make the move into the market as prime borrowers. We also paid close attention to renewal opportunities, which grew as a result of First National's origination activities over the past few years.

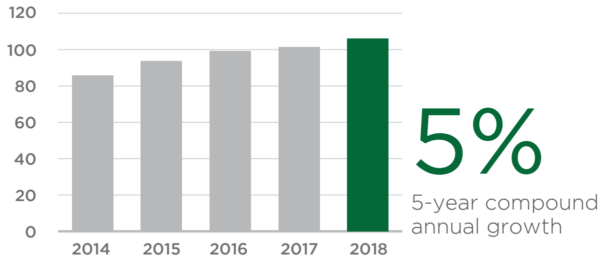
Recognizing an opportunity to expand our suite of mortgage solutions for our broker and borrower clients, the Company re-introduced its Excalibur branded mortgage program. Excalibur features expanded underwriting criteria designed to serve self-employed and other credit-worthy borrowers who may fall just outside traditional guidelines. Although we have initially limited the Excalibur program to the Ontario market, volumes surpassed our expectations as did positive product reviews from our partners and customers.

COMMERCIAL OPPORTUNITIES

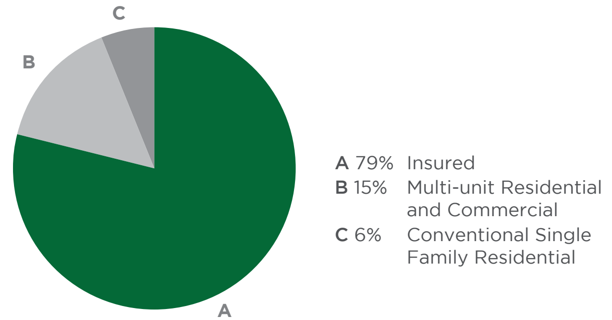
For the commercial lending team, 2018 was highly productive with new records set for annual originations. While clearly benefitting from strong market activity, First National has steadily improved its opportunity pipeline in recent years by developing deeper, more meaningful customer relationships. We've done this partly by sharing more of our knowledge to assist borrowers at the very earliest stages of their investment deliberation processes – an approach we call being "more than a lender" – so that they can stress-test their assumptions and easily investigate financing alternatives.

As Canada's largest commercial mortgage lender, First National participates across numerous commercial asset classes and with financing at every project stage – raw land acquisition, construction, term and property repositioning. The breadth of our offering and ability to make the right underwriting decisions decisively position us as a customer-focused commercial lender to borrowers who value responsiveness and choice.

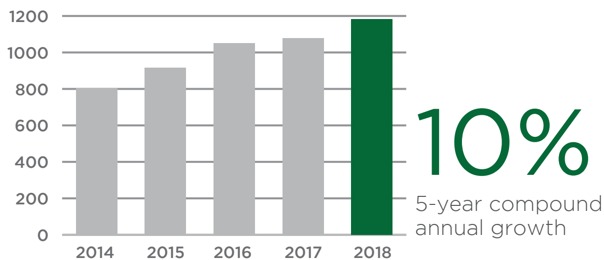
MORTGAGES UNDER ADMINISTRATION ($ Billions)



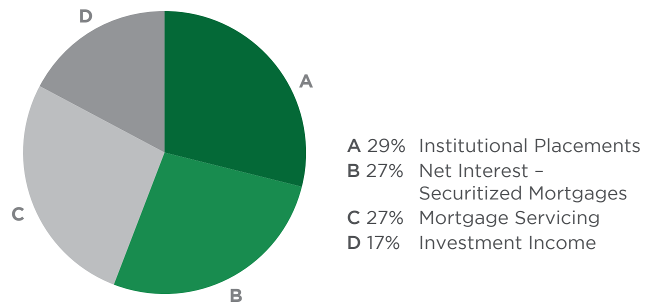
MUA BY ASSET TYPE



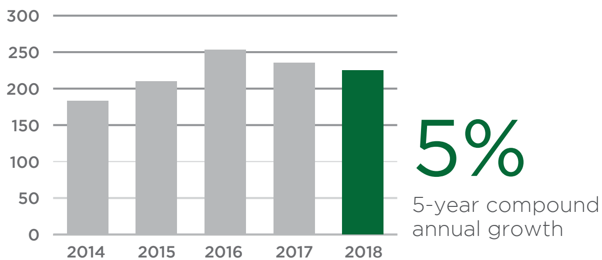
REVENUE
($ Millions)



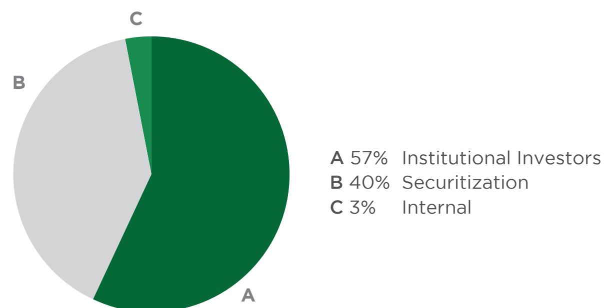
2018 REVENUE SOURCES PRIOR TO FAIR VALUE GAINS/LOSSES



NET INCOME
($ Millions)



2018 FUNDING SOURCES



FUNDING PARTNERSHIPS

Unlike traditional balance-sheet lenders who match their mortgage activities with customer deposits, First National has always used an institutional funding model. This unique approach means we deploy our own substantial balance sheet (over $36 billion of assets at year end), while also selectively partnering with other institutional investors to provide flexible, large-scale mortgage financing options to borrowers.

Thirty years of experience tells us that partnering with other institutional investors gives us much greater flexibility to cater to borrowers, irrespective of deal size and timing and at various points across the risk-return spectrum. First National's funding system is one of our greatest advantages and one we will continue to nurture by presenting outstanding investment opportunities to our partners and by expertly servicing each loan through its duration. I am pleased to say that our funding partnerships have never been stronger. The Company's long-standing status as an NHA-MBS issuer, approved CMHC lender and seller into the CMB program complements our institutional funding relationships by providing additional channels to access reliable, low-cost funding.

LOOKING AHEAD

Our outlook is published within Management's Discussion and Analysis. To preface this section, I would say that when it comes to forecasts, the best perspective is a balanced perspective that takes into account positives (such as immigration and employment levels, both of which are drivers of the housing market) and potential negatives (such as economic concerns that arose in November and were reflected in the capital markets).

Whatever comes our way in 2019, First National will operate with customers at the epicentre of its thinking. We will seek new customers, strive to capture every renewal opportunity, and work hard to give our customers and partners the industry's best service. As our long-term financial results have demonstrated, this thinking is beneficial to our fellow shareholders, whose interests are best served when customers are loyal to the First National franchise because they value our approach.

To live our customer mission, we will continue to invest in our most important assets: our employees and the proprietary First National "fintech" that we use to serve the market. Recognizing that many members of our team are young and value career advancement, we will provide in-class and on-line training, as well as mentoring, and use the results of our bi-annual employee survey to shape and enhance our workforce programs. We will also remain open to new employee-led ideas and innovations aimed at improving the business for all stakeholders.

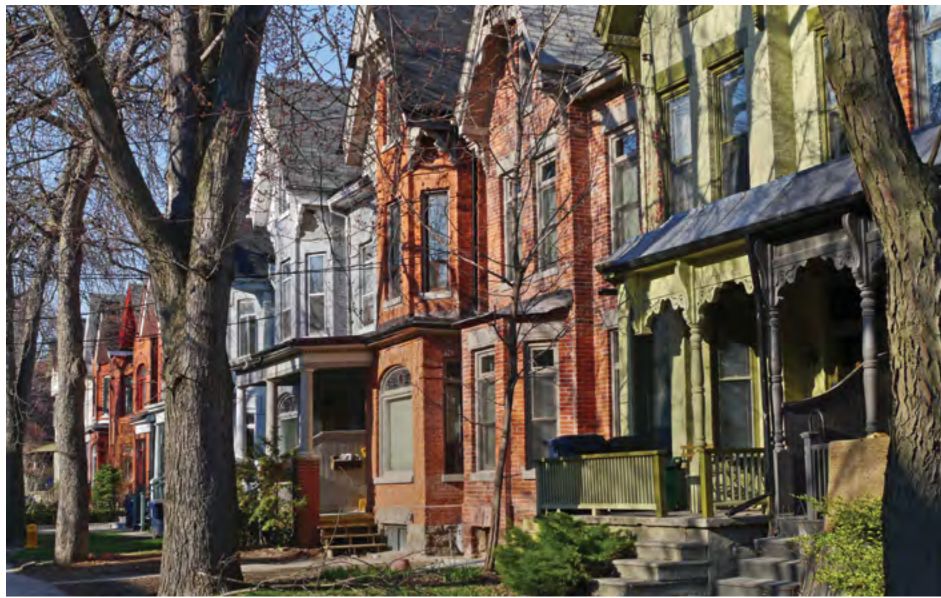
The Canadian mortgage market is a dynamic environment full of challenges and opportunity. We look forward to taking on those challenges and remain highly motivated to realize on future opportunities.

GIVING THANKS

I thank our dedicated Board of Directors for their wise counsel, our managers for leading with integrity, energy and intelligence and our employees for doing the incredibly hard work that goes into meeting customer needs and setting new performance records in competitive mortgage markets. Most especially, I thank our customers, partners and shareholders for choosing First National. We hope to reward each of you for your trust in us in 2019.

Yours sincerely,

Stephen Smith
Chairman and Chief Executive Officer



MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis ("MD&A") of financial condition and results of operations is prepared as of February 25, 2019. This discussion should be read in conjunction with the audited consolidated financial statements and accompanying notes of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the year ended December 31, 2018. The audited consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").

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

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

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

GENERAL DESCRIPTION OF THE COMPANY

First National Financial Corporation is the parent company of First National Financial LP ("FNFLP"), a Canadian-based originator, underwriter and servicer of predominantly prime residential (single-family and multi-unit) and commercial mortgages. With over $106 billion in mortgages under administration ("MUA"), First National is Canada's largest non-bank originator and underwriter of mortgages and is among the top three in market share in the mortgage broker distribution channel.

2018 RESULTS SUMMARY

Management is pleased with the results of 2018. Despite new mortgage insurance rules announced in late 2016 and tighter underwriting rules on uninsured mortgages required under OSFI's revised B-20 guidelines introduced in 2018, which the Company has adopted, single family origination increased 10% year over year in 2018. Combined with commercial segment origination and steady renewals, First National increased its total origination by 11% in the year compared to 2017. Despite this growth, tighter mortgage spreads and a trend toward increased securitization reduced normalized earnings by 9%.

- MUA grew to $106.2 billion at December 31, 2018 from $101.6 billion at December 31, 2017, an increase of 5%; the growth from September 30, 2018, when MUA was $105.0 billion, was also 5% on an annualized basis;
- Total new single-family mortgage origination was $12.2 billion in 2018 compared to $11.1 billion in 2017, an increase of 10%. The Company attributes this to the relaunch of its alternative lending product, Excalibur, and strong growth in the Toronto and Montreal regions. The commercial segment had a strong year with origination up 8% as volumes increased to $6.2 billion in 2018 from $5.8 billion in 2017. The Company attributes this to the continued development of its expertise in real estate across the country which increases the value proposition of its financial products to borrowers and investors alike. Overall new origination increased by 9% in the year;
- The Company took advantage of opportunities in the year to renew $6.1 billion of single-family mortgages. In 2017, the Company renewed $5.2 billion of single-family mortgages. For the commercial segment, renewals increased to $1.3 billion from $1.1 billion;

- Revenue for 2018 increased by 10% to $1.2 billion from $1.1 billion in 2017. The increase is related to the rising interest rate environment offset by lower revenue from gains on financial instruments. Because of higher interest rates, interest revenue on securitized mortgages increased by $131 million as the portfolio composition transitioned to mortgages with higher interest rate coupons. Higher interest rates also impacted mortgage investment income which was higher by $20 million. However because of changing interest rates and the adoption of hedge accounting in 2018, gains of financial instruments were lower by $53 million year over year. Without this component of revenue, revenue increased by 15%;
- Income before income taxes decreased from $285.4 million in 2017 to $227.4 million in 2018 because of changing capital markets conditions and the way new hedge accounting rules adopted in 2018 accounted for the related gains and losses on financial instruments. In aggregate, the impact from financial instruments decreased this measure by $53.1 million comparing 2017 to 2018;
- The Company's earnings before income taxes, depreciation and amortization and gains and losses on financial instruments ("Pre-FMV EBITDA") for the year decreased by 4%, from $234.3 million to $225.2 million in 2018. This measure was lower in 2018 largely due to tighter securitization margins and lower placement fee revenue both of which are the result of tightening mortgage spreads. Although the Company set a new record for overall origination, including renewal volume, in 2018, most of the additional origination was securitized. Securitization, while perhaps economically superior, delays the recognition of earnings when compared to a placement transaction; and
- Net income was $166.4 million (2.73 per common share) in 2018, compared to $209.7 million (3.42 per common share) in 2017. This was the Company's 30th consecutive year of profitable operations.

SELECTED QUARTERLY INFORMATION

Quarterly Results of First National Financial Corporation
($000s, except per share amounts)

	Revenue	Net Income for the period	Pre-FMV EBITDA for the period [1]	Net Income per Common Share	Total Assets
2018					
Fourth Quarter	**$312,039**	**$32,220**	**$55,780**	**$0.53**	**$36,037,127**
Third Quarter	**$321,835**	**$51,958**	**$62,989**	**$0.85**	**$35,597,827**
Second Quarter	**$290,935**	**$46,347**	**$56,048**	**$0.76**	**$35,794,066**
First Quarter	**$256,701**	**$35,902**	**$50,368**	**$0.59**	**$33,846,283**
2017					
Fourth Quarter	$270,015	$45,948	$61,093	$0.75	$32,776,278
Third Quarter	$284,315	$58,809	$51,826	$0.96	$31,548,130
Second Quarter	$292,200	$68,768	$68,275	$1.13	$30,832,883
First Quarter	$232,238	$36,127	$53,084	$0.58	$29,901,289

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

With First National's large portfolio of mortgages pledged under securitization, quarterly revenue is driven primarily by the gross interest earned on the mortgages pledged under securitization. The gross interest on the mortgage portfolio is dependent both on the size of the portfolio of mortgages pledged under securitization as well as mortgage rates. Because mortgage rates and MUA have both increased, revenue has also increased. Net income is partially dependent on conditions in bond markets, which affect the value of gains and losses on financial instruments arising from the Company's interest rate hedging program. Accordingly, the movement of this measurement between quarters is related to factors external to the Company's core business. By removing this volatility and analyzing Pre-FMV EBITDA, management believes a more appropriate measurement of the Company's performance can be assessed.

Generally, in the years after the credit crisis in 2008, the Company grew its origination volumes which provided larger servicing and securitization portfolios. To the extent the Company employed securitization strategies, net interest margins were locked in for five and ten year terms. These margins were wide in 2008 as financial institutions maintained mortgage rates despite a significant drop in the cost of funds. Since 2008, such margins have steadily declined with competitive pressures and new securitizations are at much tighter spreads. For the Company this has meant that as high spread securitization transactions have matured and been replaced with new securitizations, profitability has decreased. This trend is evident in the Pre-FMV EBITDA figures above. In the third quarter 2017, Pre-FMV EBITDA was lower than expected as placement fees were negatively affected by a rising interest rate environment. The Company earned $14.4 million as a gain on holding short bonds in the second quarter 2017. Consistent with the Company's reporting practice, this amount was deducted from earnings to determine Pre-FMV EBITDA. However this gain reduced the value of the hedged mortgages and when these were placed in the third quarter 2017, earnings were negatively affected. Using normalized earnings, third quarter 2018 earnings were 5% lower compared to those in the third quarter of 2017. The decrease was due to tighter mortgage spreads and more securitization which delays the earning's process in comparison to placement fees which are earned in the same period as origination. Fourth quarter 2018 earnings were lower by 9% for the same reasons.

OUTSTANDING SECURITIES OF THE CORPORATION

At December 31, 2018 and February 25, 2019, the Corporation had 59,967,429 common shares; 2,887,147 Class A preference shares, Series 1; 1,112,853 Class A preference shares, Series 2; and 175,000 April 2020 senior unsecured notes outstanding.

SELECTED ANNUAL FINANCIAL INFORMATION AND RECONCILIATION TO PRE-FMV EBITDA[1]

	2018	2017	2016
For the Year ended December 31, INCOME STATEMENT HIGHLIGHTS			
Revenue	**1,181,510**	1,078,768	1,049,818
Interest expense – securitized mortgages	**(646,069)**	(511,939)	(495,681)
Brokerage fees	**(75,354)**	(83,260)	(103,719)
Salaries, interest and other operating expenses	**(227,739)**	(193,032)	(169,129)
Deduct: realized and unrealized gains on financial instruments	**(3,162)**	(56,259)	(27,750)
Deduct: unrealized losses regarding mortgage investments	**(4,000)**	—	—
Pre-FMV EBITDA[1]	**225,186**	234,278	253,539
Amortization of intangible and capital assets	**(4,931)**	(5,135)	(7,160)
Add: realized and unrealized gains on financial instruments excluding those on mortgage investments	**7,162**	56,259	27,750
Provision for income taxes	**(60,990)**	(75,750)	(72,300)
Net income	**166,427**	209,652	201,829
Common share dividends declared	**171,407**	184,400	98,946
PER SHARE HIGHLIGHTS			
Net income per common share	**2.73**	3.42	3.28
Dividends per common share	**2.86**	3.08	1.65
At Year End BALANCE SHEET HIGHLIGHTS			
Total assets	**$36,037,127**	$32,776,278	$30,394,465
Total long-term financial liabilities	**$174,829**	$174,693	$174,556

Notes:

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

VISION AND STRATEGY

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

KEY PERFORMANCE DRIVERS

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

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

GROWTH IN PORTFOLIO OF MORTGAGES UNDER ADMINISTRATION

Management considers the growth in MUA to be a key element of the Company's performance. The portfolio grows in two ways: through mortgages originated by the Company and through third-party mortgage servicing contracts. Mortgage originations not only drive revenues from placement and interest from securitized mortgages, but perhaps more importantly, longer-term value from servicing rights, renewals and the growth of the customer base for marketing initiatives. As at December 31, 2018, MUA totalled $106.2 billion, up from $101.6 billion at December 31, 2017, an increase of 5%. The growth of MUA in the fourth quarter of 2018 on an annualized increase is also 5%.

GROWTH IN ORIGINATION OF MORTGAGES

Direct origination by the Company

The origination of mortgages not only drives the growth of MUA as described above, but leverages the Company's origination platform, which has a large fixed-cost component. As more mortgages are originated, the marginal costs of underwriting decrease. Increased origination satisfies demand from its institutional customers and produces volume for the Company's own securitization programs. In 2018, the Company's single-family origination grew at a steady rate. Whether it is the effect of OSFI guideline B-20 or gaining market share in the mortgage broker channel, the Company experienced higher origination in eastern Canada while its Calgary and Vancouver offices suffered from regional real estate related issues: Toronto (+19%), Vancouver (-3%), Calgary (-11%) and Montreal (+28%). In aggregate, the Company's single-family origination increased in 2018 by 10%. The commercial segment demonstrated steady growth as volume increased 8% over 2017. Together, overall new origination for 2018 increased 9% year over year.

Third Party Mortgage Underwriting and Fulfillment Processing Services

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

Relaunch of Excalibur Mortgage Products

In 2018, the Company relaunched its alternative single family ("Excalibur") mortgage products. Alternative lending describes single family residential mortgages that are originated using broader underwriting criteria than those applied in originating prime mortgages. Alternative borrowers are generally considered "A" quality borrowers in terms of their credit histories, but do not qualify for a prime mortgage because of non-conformities, such as the degree of income disclosure and verification required. The Excalibur program also includes a product for borrowers with recently remediated credit. These mortgages generally have higher interest rates than prime mortgages. Although the Company's original alternative program was discontinued in 2008 as a result of the credit crisis, First National's relationships with mortgage brokers and underwriting systems allowed it to seamlessly relaunch the product in the spring of 2018. To start, the product has been originated for placement with institutional investors and the Company earned a one-time placement fee and servicing income over the term of the mortgages. The Excalibur relaunch was rolled out gradually, starting in Ontario. Currently the program is open to include all Ontario brokers with a potential expansion to Western Canada in 2019.

RAISING CAPITAL FOR OPERATIONS

Bank Credit Facility

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

Preferred Share Issuance

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

EMPLOYING SECURITIZATION TRANSACTIONS TO MINIMIZE FUNDING COSTS

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

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

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

Period	Average Five Year Mortgage Spread for the Period
2006	1.12%
2007	1.50%
2008	2.68%
2009 - 2013	1.79%
2014	1.57%
2015	1.87%
2016	1.76%
2017	1.36%
2018	1.36%

The table shows an average spread of 1.12% in 2006. With the credit crisis, this spread ballooned to as high as 3.46% in 2008. Between 2009 and 2013, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In 2014, more competitive pressures took mortgage rates lower and compressed mortgage spreads to 2007 levels; however, in 2015, mortgage spreads quickly widened as a slowdown in economic growth and the Bank of Canada rate cut reduced bond yields dramatically. This trend continued into 2016, as optimism about the economy was mixed such that spreads remained at levels in excess of 1.8% until the third quarter when increased competition made for tighter spreads. With the recent strength in the economy and tougher mortgage rules, competition further increased and spreads have tightened significantly. While funding spreads have also improved, generally the advantage of securitization compared to placement with investors is not as pronounced as it was in the previous 10-year period. In 2018, the Company originated and renewed for securitization purposes approximately $9.0 billion of single-family mortgages and $1.1 billion of multi-unit residential mortgages. In 2018, the Company securitized through NHA-MBS approximately $8.2 billion of single-family mortgages and $0.7 billion of multi-unit residential mortgages.

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

Canada Mortgage Bonds Program

The CMB program is an initiative sponsored by CMHC whereby the CHT issues securities to investors in the form of semi-annual interest-yielding five- and 10-year bonds. Pursuant to the Company's approval as a seller into the CMB, the Company is able to make direct sales into the program. The ability to sell into the CMB has given the Company access to lower costs of funds on both single-family and multi-family mortgage securitizations. Because of the effectiveness of the CMB, many institutions have indicated their desire to participate. As a result, CHT has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is subject to these limitations. Beginning in July 2016, CHT effectively increased the price of the timely payment guarantees which CMB participants are required to purchase with the issuance of each CMB transaction. Although nominally CMB fees decreased, these rules require guarantee fees to be levied on the creation of NHA MBS pools being sold to the CMB. Prior to this rule change, the NHA MBS pools to be sold into the CMB were exempt from such fees. In aggregate, guarantee fees increased between 25% and 50% for CMB participants. This increase translates to approximately five basis points of cost over the term of the securitization. Since 2016, CMHC has also modified the tiered NHA MBS guarantee fee pricing structure, increasing the issuance threshold for increased fees from $7.5 billion to $9.0 billion. The tiered limit of $9.0 billion remains unchanged for 2019. In 2018, the Company, through its subsidiary First National Asset Management Inc. ("FNAM"), also took advantage of funding provided by the CMB, issuing three NHA MBS pools totaling $85 million and securitizing those pools in two 5-year CMB transactions.

ADOPTION OF NEW IFRS ACCOUNTING STANDARDS

IFRS 9 – Financial Instruments

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

Classifications and Measurement

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

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

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

Impairment

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

The key inputs in the measurement of ECL include Probability of Default, Loss Given Default and forecast of future economic conditions which involves significant judgment. Upon application of the impairment portion of IFRS 9, there has been no impact on the Company's earnings due to the high proportion of government insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends.

“Since going public in 2006, First National has been considered a high yielding dividend paying company.”

Hedge Accounting

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

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

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

IFRS 15 – Revenue from Contracts with Customers

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

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

KEY PERFORMANCE INDICATORS

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

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

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

	QUARTER ENDED		YEAR ENDED	
($000s)	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
FOR THE PERIOD				
Revenue	**312,039**	270,015	**1,181,510**	1,078,768
Income before income taxes	**44,050**	63,158	**227,417**	285,402
Pre-FMV EBITDA[1]	**55,780**	61,093	**225,186**	234,278
AT PERIOD END				
Total assets	**36,037,127**	32,776,278	**36,038,527**	32,776,278
Mortgages under administration	**106,151,363**	101,589,153	**106,151,363**	101,589,153

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

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

Determination of Common Share Dividend Payout Ratio

	QUARTER ENDED		YEAR ENDED	
($000s)	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
FOR THE PERIOD				
Net income attributable to common shareholders	**31,465**	44,972	**163,499**	205,331
Total dividends paid or declared on common shares	**88,202**	102,694	**171,407**	184,400
Dividends paid or declared on common shares, excluding special dividend	**28,235**	27,735	**111,440**	109,441
Total Common Share Dividend Payout Ratio	**280%**	228%	**105%**	90%
Regular Common Share Dividend Payout Ratio [1]	**90%**	62%	**68%**	53%
After-tax Pre-FMV Dividend Payout Ratio [2]	**72%**	65%	**70%**	67%

Note:
[1] This ratio is calculated by excluding the payment of the special dividends declared at the end of each year.
[2] This non-IFRS measure adjusts the net income used in the calculation of the "Regular common share dividend payout ratio" to after tax Pre-FMV earnings so as to eliminate the impact of changes in fair value by adding back losses on the valuation of financial instruments (except those on mortgage investments) and deducting gains on the valuation of financial instruments. The Company uses its aggregate effective tax rate to tax affect the impact of the valuation of financial instruments on this ratio.

For the year ended December 31, 2018, the common share payout ratio was 105% compared to 90% in 2017. However, in November of both 2018 and 2017, the Company declared a special dividend which represented the distribution of excess retained earnings generated over the course of several prior years. Including such dividends distorts the payout ratios. If the special dividends are excluded from the calculation, the payout ratios would have been 68% in 2018 and 53% in 2017. In both 2018 and 2017, the Company recorded gains on account of the changes in fair value of financial instruments. The gains are recorded in the period in which the prices on Government of Canada bond yields change; however, the offsetting economic impact is largely to be reflected in narrower spreads in the future from the mortgages pledged for securitization. Accordingly, management does not consider this revenue to be available for dividend payment. If the gains on financial instruments in the two years are excluded, the dividend payout ratio for 2018 would have been 70% compared to 67% in 2017.

The Company also paid $2.9 million of dividends on its preferred shares in 2018 compared to $2.7 million in 2017.

REVENUES AND FUNDING SOURCES

Mortgage Origination

The Company derives a significant amount of its revenue from mortgage origination activities. Most mortgages originated are funded either by placement with institutional investors or through securitization conduits, in each case with retained servicing. Depending upon market conditions, either an institutional placement or a securitization conduit may be the most cost-effective means for the Company to fund individual mortgages. In general, originations are allocated from one funding source to another depending on market conditions and strategic considerations related to maintaining diversified funding sources. The Company retains servicing rights on virtually all of the mortgages it originates, which provide the Company with servicing fees to complement revenue earned through originations. For the year ended December 31, 2018, new origination volume increased from $16.9 billion to $18.5 billion, or about 9%, compared to 2017.

Securitization

The Company securitizes a portion of its origination through various vehicles, including NHA-MBS, CMB and Asset-backed Commercial Paper (“ABCP”). Although legally these transactions represent sales of mortgages, for accounting purposes they do not meet the requirements for sale recognition and instead are accounted for as secured financings. These mortgages remain as mortgage assets of the Company for the full term and are funded with securitization-related debt. Of the Company’s $25.9 billion of new originations and renewals in 2018, $10.1 billion was originated for its own securitization programs.

Placement Fees and Gain on Deferred Placement Fees

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as “placement fees”. The present value of additional amounts expected to be received over the remaining life of the mortgage sold (excluding normal market-based servicing fees) is recorded as a “deferred placement fee”. A deferred placement fee arises when mortgages with spreads in excess of a base spread are placed. Normally the Company would earn an upfront cash placement fee, but investors prefer paying the Company over time as they earn net interest margin on such transactions. Upon the recognition of a deferred placement fee, the Company establishes a “deferred placement fee receivable” that is amortized as the fees are received by the Company. Of the Company’s $25.9 billion of new originations and renewals in 2018, $14.9 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

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

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

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

RESULTS OF OPERATIONS

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

($ millions)	QUARTER ENDED December 31, 2018	QUARTER ENDED December 31, 2017	YEAR ENDED December 31, 2018	YEAR ENDED December 31, 2017
MORTGAGE ORIGINATIONS BY SEGMENT				
New single-family residential	**2,760**	2,787	**12,231**	11,133
New multi-unit and commercial	**1,848**	1,645	**6,237**	5,770
Sub-total	**4,608**	4,432	**18,468**	16,903
Single-family residential renewals	**1,322**	1,124	**6,083**	5,219
Multi-unit and commercial renewals	**592**	257	**1,338**	1,127
Total origination and renewals	**$6,522**	$5,813	**$25,889**	$23,249
MORTGAGE ORIGINATIONS BY FUNDING SOURCE				
Institutional investors – new residential	**2,446**	1,254	**6,495**	6,240
Institutional investors – renew residential	**628**	564	**2,490**	2,688
Institutional investors – multi/commercial	**1,873**	1,271	**5,957**	5,342
NHA-MBS/CMB/ABCP securitization	**1,359**	2,449	**10,109**	8,199
Internal Company resources /CMBS	**216**	275	**838**	780
Total	**$6,522**	$5,813	**$25,889**	$23,249
MORTGAGES UNDER ADMINISTRATION				
Single-family residential	**79,166**	77,423	**79,166**	77,423
Multi-unit residential and commercial	**26,985**	24,166	**26,985**	24,166
Total	**$106,151**	$101,589	**$106,151**	$101,589

Total new mortgage origination volumes increased in 2018 compared to 2017 by 9%. Single-family volumes increased by 10% and commercial segment volumes increased by 8% year over year. The increase in the single-family segment is due to growth in eastern Canada which offset lower volumes experienced by the Company's Calgary and Vancouver offices, which together had volumes 6% lower than in 2017. When combined with renewals, total production increased from $23.2 billion in 2017 to $25.9 billion in 2018, or by 11%. The Company believes higher new single-family origination is partially the result of the relaunch of its Excalibur program which has added origination volume where there was none in 2017. Overall volumes were also affected favourably by a 28% increase in the Quebec market. In 2017 there was significant mortgage rate pressure in this region from local competitors. In 2018 this subsided so as to make the Company's products more competitive. The Company's expertise in mortgage underwriting drove commercial segment origination (including renewals) higher by 10% in 2018. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy with volume of $10.1 billion in 2018. Although the Company used such securitization funding to a greater degree in 2018 compared to 2017, the Company continued to grow origination for its arms-length investors so as to support its long-term strategy of maintaining diverse funding sources.

Net Interest - Securitized Mortgages

Comparing the year ended December 31, 2018 to the year ended December 30, 2017, "net interest – securitized mortgages" decreased by 2% to $144.1 million from $146.8 million. The decrease was due to a tighter weighted-average spread on the portfolio, offset by a larger portfolio of securitized mortgages year over year. The portfolio of securitized mortgages increased by 11% from $27.6 billion at December 31, 2017 to $30.6 billion by the end of December 2018. The increase in the securitized portfolio was offset by tighter securitization spreads as mortgage spreads to risk-free Government of Canada have decreased by about 0.50% since 2015. The impact of accounting for financial instruments has also affected this revenue. The consequence of large gains on financial instruments recognized in 2017 and 2016, is generally more expensive debt raised on the securitized mortgages. As the securitization transactions related to these debts performs, a lower net securitization margin is recorded. The Company estimates that the impact of this accounting treatment has decreased net interest – securitized mortgages by $11.3 million year over year.

Placement Fees

Placement fee revenue decreased by 2% to $141.9 million from $144.6 million in 2018. The decrease would be larger if the 2017 revenue was normalized for the impact of changing interest rates which arguably understated placement fee revenue that year. As described in the 2017 MD&A, the Company recorded about $14.4 million of gains on financial instruments in the second quarter of 2017 which detracted from placement fee revenue in the third quarter of 2017 (when the related mortgages were placed). If the amount is added back to 2017 revenues, placement fees were lower by 12% compared to 2018. This decrease resulted from a change in product mix with the re-introduction of the Excalibur program. Because the Excalibur mortgages are shorter term (typically 1 year), the fee for placement is lower on a per unit basis. With the Company's success at originating this product, average placement fees were adversely affected. The broker fees associated with Excalibur mortgages are also smaller such that despite the lower revenue, the origination is favorable to net income. First National was also successful in increasing single-family renewals by about 17% year over year; however, the Company elected to securitize a larger portion of these in 2018 compared to 2017 such that lower placement fees were earned on these mortgages. The decline was also the result of tightening mortgage spreads which reduced the per unit placement fee with a portion of the Company's institutional investors. These placements were transacted based on capital market conditions which were less favorable in 2018 compared to 2017. Commercial placement fees increase 3% year over year in line with higher volume.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue increased 17% to $11.7 million from $10.0 million. The gains related to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Although, volumes for these transactions increased by 33% from 2017, spreads on these transactions tightened such that the Company realized lower per unit gains.

Mortgage Servicing Income

Mortgage servicing income increased 4% to $146.2 million from $140.8 million. This increase was largely due to the third-party underwriting business which experienced an increase in the volume of mortgages processed, and the benefits associated with higher MUA.

Mortgage Investment Income

Mortgage investment income increased 23% to $84.3 million from $68.3 million. The increase was due primarily to an increase in market interest rates providing more investment income. The Company recorded mark-to-market losses of $4.0 million (2017 – credit losses of $4.0 million) regarding four non-performing properties in the commercial bridge portfolio in 2018. These were recorded as losses on financial instruments in 2018. In addition, the interest rates associated with the Company's mortgages warehoused prior to securitization were higher this year such that more interest income was earned during the warehousing period.

Realized and Unrealized Gains (Losses) on Financial Instruments

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

SUMMARY OF REALIZED AND UNREALIZED GAINS (LOSSES) ON FINANCIAL INSTRUMENTS	QUARTER ENDED		YEAR ENDED	
($000s)	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
Gains on short bonds used for the economic hedging program	**(14,285)**	1,383	**5,822**	35,467
Losses on mortgages held at fair value	**(1,000)**	(7,171)	**(4,000)**	(25,311)
Gains (losses) on interest rate swaps	**3,569**	9,276	**1,340**	47,133
Other gains (losses)	**—**	137	**—**	(1,030)
NET GAINS ON FINANCIAL INSTRUMENTS	**(11,716)**	3,625	**3,162**	56,259

In 2017, economic data turned positive and interest rates jumped higher with the expectations of a Bank of Canada increase in overnight rates. This meant that 5-year bond prices decreased so that generally the Company recorded large gains on its hedging program. This trend continued through the first three quarters of 2018 and bond yields increased steadily. However in November 2018, economic sentiment changed and bond yields decreased abruptly and returned to the same levels recorded at the beginning of the year. The impact of the movement in 2018 had a lower impact to the Company's gains and losses on financial instruments due to the adoption of hedge accounting such that a portion of both gains and losses recorded during the year were removed from the Company's statement of income.

In 2018, the Company recorded gains on these instruments of $5.8 million (2017 – $35.5 million). On its commercial segment hedges, the value of the Company's hedges increased by $3.2 million; however because of the designation of a hedge relationship, the amount was recorded in Other Comprehensive Income. This amount will be amortized into the Company's regular income over the terms of the related securitization and placement transactions. Because of the nature of the timing of such gains and losses within the year, $7.5 million of gains were amortized into the Company's income. For the residential segment, the Company has designated hedge relationships to protect the fair value of funded mortgages prior to securitization or placement. The $5.8 million gain above reflects the increase in value of short bonds used to hedge the Company's commitments for which the Company does not attempt to document a hedge relationship. The change in value related to funded mortgages that were hedged effectively in the year was deferred on the Company's balance sheet.

Brokerage Fees Expense

Brokerage fees expense decreased 9% to $75.4 million from $83.3 million. This decrease is explained by lower origination volumes of prime single-family mortgages for institutional investors and lower per unit broker fees in the residential segment. Despite the increase in overall single-family origination of 10%, origination for institutional investors increased by just 6%. This increase was largely the result of the relaunch of the Excalibur program. These mortgages are generally for 1 year terms and accordingly have a significantly lower broker fee per unit cost than a typical prime mortgage origination. Accordingly comparable broker costs where lower year over year based on origination volumes. For prime mortgage origination, per unit broker fees were also lower than in 2017. Generally in 2017, broker compensation for insured mortgages was abnormally high as the market competed for such mortgages after new insurance rules, announced in 2016, reduced the amount of insured mortgages available in the market. In 2018 fees returned to "normal" levels such that 2018 per-unit broker fees were generally 5% lower than in 2017. Portfolio insurance costs are also included in this expense line and were also lower than in 2017 as the Company was able to use previously purchased insurance policies to cover a portion of 2018's insurance requirements.

Salaries and Benefits Expense

Salaries and benefits expense increased by 2% to $99.7 million from $97.8 million. Salaries were higher by 2% and overall headcount increased by 5% (936 employees as at December 31, 2017 and 987 at December 31, 2018). Although overall headcount rose, much of the increase occurred in the fourth quarter and expenses for salaries grew by standard cost of living increases. These increases were offset by $1.4 million of lower compensation earned by commercial sales staff as spreads were tighter in the year. Management salaries were paid to the two senior executives (Co-founders) who together control about 74% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO") in 2006.

Interest Expense

Interest expense increased 51% to $69.9 million from $46.4 million. As discussed in the "Liquidity and Capital Resources" section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the investor or funding with a securitization vehicle. The Company used the senior unsecured notes together with a $1.25 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense increased from the prior year due to higher short-term interest rates pursuant to Bank of Canada announcements that increased short-term borrowing rates by 0.75% beginning in the third quarter of 2017. The Company also held higher balances of mortgages accumulated for securitization and mortgage and loan investments in 2018, which required greater use of the Company's credit facilities.

Other Operating Expenses

Other operating expenses increased by 17% to $63.0 million from $53.9 million. Other operating expenses increased by $6.9 million related to higher hedge expenses which increased in step with higher bond yields and a larger hedge book. Because of more mortgages originated for securitization, the Company carried notional hedges of approximately $2.0 billion during 2018. In addition, the rising interest rate environment which was prevalent during most of the year, created a steeper yield curve which made it more expensive to carry the short bonds the Company employs to mitigate interest rate risk associated with the Company's commitment and funded warehouse pipeline. The remaining increase in other operating expenses of $2.2 million reflects costs to support a growing business including information technology and the relaunch of the Excalibur program.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes decreased by 20% to $227.4 million from $285.4 million. This decrease was affected by changing capital markets. In 2018, the Company recorded $7.2 million of gains on financial instruments (excluding $4.0 million of losses related to mortgage and loan investments). In 2017, the Company recorded $56.3 million of gains on financial instruments. The change in these values accounted for a $49.1 million decrease in comparative income before income taxes. Pre-FMV EBITDA, which eliminates the impact of gains and losses on financial instruments, decreased by 4% to $225.2 million from $234.3 million. This decrease was partially the result of fair value accounting on placement fee revenues in the third quarter of 2017. As described in the 2017 MD&A, the Company recorded about $14.4 million of gains on financial instruments in the second quarter of 2017 which detracted from placement fee revenue in the third quarter of 2017 when the related mortgages were placed. If the amount is added back to 2017 Pre-FMV EBITDA, the decrease between 2018 and 2017 was 9%. The decrease in this normalized earning measure is the result of tighter securitization spreads. As described previously in this MD&A, the spread between the interest rates on prime mortgages and the cost of debt used to fund these assets, has become significantly narrower in the last two

“With the adoption of hedge accounting in 2018, management expects less volatile earnings going forward.”

years. This was particularly true for the third and fourth quarters of 2018 when Canadian banks maintained their offered mortgage rates despite a rising interest rate environment. Tight mortgage spreads not only affected the Company’s net margin from securitized mortgages, but placement fees as well as there was less spread to share with some of the Company’s institutional investors who securitize the mortgages that they purchase from First National. Lower net income from securitization and placement of prime mortgages was offset partially by increased earnings from mortgage servicing and the Excalibur program which was relaunched in early 2018. Although origination increased by approximately 10% from 2017, most of the additional volume was securitized by the Company. By securitizing mortgages instead of placing them with institutional investors, the Company delays the earning’s process: placement fee revenues are reduced and the costs of hedging and interest during the warehousing period are increased.

Provision for Income Taxes

The provision for taxes decreased by 20% to $61.0 million from $75.8 million. The provision decreased proportionately with net income before income taxes. The overall effective tax rate was marginally higher in 2018 as a provincial tax rate increased by 1% at the start of 2018.

Other Comprehensive Income

Beginning January 1, 2018, the Company adopted IFRS 9. As a part of this transition the Company began accounting for some of its interest rate risk mitigation strategies as hedges for reporting purposes. For the commercial segment, the Company hedges the interest rate risk associated with insured multi-residential mortgages. This hedging begins on commitment and ends when the Company either securitizes the mortgages (primarily through CMB funding) or places the mortgage with an institutional investor. As the Company determined that these hedges were effective, the Company recorded $3.2 million of net gains on such hedges in 2018 that would have been recorded in gains on financial instruments under the previous IFRS standard. The amount consisted of $19.7 million of gains and $16.5 million of losses. Because the losses pertained primarily to the fourth quarter of 2018 when bond prices rose significantly, the related mortgages have not yet been securitized or placed. Accordingly the losses were largely unamortized while the gains have been amortized. The net amortization of the values in OCI totaled $7.5 million for 2018 and has been reflected in the Company’s Net Income. The remaining OCI amount represents losses of $4.3 million which will be amortized in future periods.

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:

FOR THE QUARTER ENDED	RESIDENTIAL		COMMERCIAL	
($000s except percent amounts)	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
Originations and renewals	**18,314,129**	16,352,753	**7,574,443**	6,897,582
Percentage change	***12%***		***10%***	
Revenue	**913,301**	827,160	**268,209**	251,608
Percentage change	***10%***		***7%***	
Income before income taxes	**164,897**	215,370	**62,517**	70,032
Percentage change	***(23%)***		***(11%)***	
AS AT	December 31, 2018	December 31, 2017	December 31, 2018	December 31, 2017
Identifiable assets	**27,719,231**	25,653,160	**8,289,520**	7,093,342
Mortgages under administration	**79,165,363**	77,422,655	**26,985,711**	24,166,498

RESIDENTIAL SEGMENT

Overall residential origination including renewals increased by 12% between the 2018 and 2017 while residential revenues increased by 10%. Revenues in both quarters were affected by gains of fair value associated with rising interest rates. If revenues are normalized for these gains, revenue increased by 14%. Revenue growth exceeded the growth in origination as the Company's revenue from securitized mortgages in this segment increased by 21% as mortgage interest rates increased in the market. Net income before tax was also affected by fair value related amounts. Without the impact of these revenues, net income before tax decreased from $184.4 million in 2017 to $157.7 million in 2018 or by 14%. This was the result of tighter securitization margins and the Company's decision to securitize a larger portion of its residential origination in the year. The costs of underwriting, hedging and warehousing these mortgages are significant and there is only a marginal contribution to earnings on new transactions in the year of securitization. Identifiable assets increased from December 31, 2017, as the Company increased its investment in mortgages pledged under securitization by about $2.1 billion.

COMMERCIAL SEGMENT

2018 commercial revenues increased by about 7% compared to 2017. Without the impact of gains and losses on account of fair value, revenue increased by 11% year over year. This was in line with the increased origination and higher interest revenue on securitized mortgages of 16% year over year as the average mortgage rate in the securitized portfolio increased with the higher interest rate environment. Income before income taxes was also affected by fair value considerations. By excluding fair value gains and losses, this measure would have increased by 6% year over year as the large increases in origination evidenced in 2018 and 2017 created higher net securitization and servicing income, which more than offset lower placement fees. Identifiable assets increased from those at December 31, 2017, as the Company increased its investment mortgages pledged for securitization by $0.9 billion and mortgages accumulated for securitization by $0.3 billion. The reduction of $0.2 billion of its investment in mortgage investments was offset by an increase in hedging assets.

LIQUIDITY AND CAPITAL RESOURCES

The Company's fundamental liquidity strategy has been to invest in prime Canadian mortgages. Management's belief has always been that these mortgages are considered "AAA" by investors and should always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, when capital markets faltered and only the highest-quality assets were bid. As the Company's results in those years demonstrated, First National had little trouble finding investors to purchase its mortgage origination at profitable margins. Originating prime mortgages also allows the Company to securitize in the capital markets; however, this activity requires significant cash resources to purchase and hold mortgages prior to arranging for term debt through the securitization markets. For this purpose, the Company uses the combination of the $175 million unsecured notes and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) the origination costs associated with securitization, and (3) mortgage and loan investments. The Company has a credit facility with a syndicate of ten financial institutions for a total credit of $1.25 billion. This facility was extended in May 2018 for a five-year term maturing in March 2023. At December 31, 2018, the Company entered into repurchase transactions with financial institutions to borrow $1.3 billion related to $1.3 billion of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At December 31, 2018, outstanding bank indebtedness was $918.3 million (December 31, 2017 - $643.8 million). Together with the unsecured notes of $175 million (December 31, 2017 – $175 million), this "combined debt" was used to fund $902.0 million (December 31, 2017 - $556.1 million) of mortgages accumulated for sale or securitization. At December 31, 2018, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $41.6 million (December 31, 2017 – $41.3 million) and (2) mortgage and loan investments of $188.7 million (December 31, 2017 - $379.7 million). The difference between "combined debt" and the mortgages accumulated for sale or securitization funded by it, which the Company considers a proxy for "true leverage", has decreased between December 31, 2017 and December 31, 2018, and now stands at $191.1 million (December 31, 2017 – $262.4 million). This represents a debt-to-equity ratio of approximately 0.36:1. This ratio decreased from 0.48:1 at December 31, 2017. In general, in 2018, the Company used the cash from repayment of $191 million of mortgage and loan investments to (1) invest in $79 million of broker fees related to securitized mortgages and, (2) to pay the special dividend of $60 million in December 2018. The Company believes the ratio is appropriate given the nature of the assets which the debt is funding.

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

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

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

its ABCP and NHA-MBS programs, primarily to provide credit enhancements as required by rating agencies. The most significant portion of cash collateral is the investment made on behalf of the Company's ABCP programs. As at December 31, 2018, the investment in cash collateral was $75.9 million (December 31, 2017 - $66.4 million).

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

FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Commencing January 1, 2018, the Company has recorded mortgages accumulated for sale and mortgage and loan investments, as financial assets measured at "fair value through profit or loss" such that changes in market value are recorded in the consolidated statement of income. The mortgages accumulated for sale are held for very short periods and any change in value due to changing interest rates is the obligation of the ultimate institutional investor. Accordingly, the Company believes there will be little, if any, effect on its income related to the change in fair value of these mortgages. The majority of mortgages in mortgage and loan investments are uninsured commercial segment bridge loans. These are primarily floating rate loans that have mortgages terms of eighteen months or less. As the mortgages do not conform to conventional mortgage lending, there are few active quoted markets available to determine the fair value of these assets. The Company estimates fair value based upon: benchmark interest rates, credit spreads for similar products, creditworthiness and status of the borrower, valuation of the underlying real property, payment history, and other conditions specific to the rationale for the loan. Any favourable or unfavourable amounts will be recorded in the statement of income each quarter.

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. Prior to 2018, the Company did not attempt to adopt hedge accounting; however, with the introduction of IFRS 9 on January 1, 2018, the Company began designating hedging relationships such that the results of any effective hedging will not affect the Company's statement of income. See previous discussion in this MD&A under "Realized and Unrealized Gains (Losses) on Financial Instruments". As at December 31, 2018, the Company had about $1.3 billion of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund, and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages to be sold to the Company's other securitization vehicles. As at December 31, 2018, the Company had entered into $0.5 billion of notional value forward bond sales for this segment.

The Company is party to four interest rate swaps that economically hedge the interest rate exposure related to certain CMB transactions in which the Company has replacement obligations. As at December 31, 2018, the aggregate notional value of these swaps, maturing between June 2021 and September 2026, was $37.4 million. During 2018, the value of these swaps increased by $1.3 million.

As described above, the Company employs various strategies to reduce interest rate risk. In the normal course of business, the Company takes some credit spread risk. This is the risk that the credit spread at which a mortgage is originated changes between the date of commitment of that mortgage and the date of sale or securitization. This can be illustrated by the Company's experience with commercial mortgages originated for the CMBS market in the spring of 2007. These mortgages were originated at credit spreads designed to be profitable to the Company when sold to a bank-sponsored CMBS conduit. Unfortunately for the Company, when these mortgages funded, the CMBS market had shut down. The alternative to this

channel was more expensive, as credit spreads elsewhere in the marketplace for this type of mortgage had widened. The Company adjusted for market-suggested increases in credit spreads in 2007 and 2008 by adjusting the value of the mortgages downward. In 2009, the economic environment remained weak but did not worsen from the end of 2008. Overall credit spreads stopped widening such that the Company applied the same spreads to these mortgages and the Company did not record any additional unrealized losses or gains related to credit spread movement. Despite entering into effective economic interest rate hedges, the Company's exposure to credit spreads remained. This risk is inherent in the Company's business model and cannot be economically hedged.

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of June 2011 and continuing through the current period, it was priced at a discount to BAs. At the same time, the Company has leveraged on changing credit spreads. The success of this approach has been demonstrated through the increase in volume and profitability of the NHA-MBS program and significant increases in gains on deferred placement fees from the sale of prime insured mortgages. As at December 31, 2018, the Company had various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there were almost $2.2 billion of mortgages that are susceptible to some degree of changing credit spreads.

CAPITAL EXPENDITURES

A significant portion of First National's business model consists of the origination and placement or securitization of financial assets. Generally, placement activities do not require much capital investment as the Company acts primarily in the capacity of a broker. On the other hand, the undertaking of securitization transactions may require significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. For fixed assets, the business requires capital expenditures on technology (both software and hardware), leasehold improvements, and office furniture. During the year ended December 31, 2018, the Company purchased new computer equipment and software. In the long term, the Company expects capital expenditures on fixed assets will be approximately $5.0 million annually.

SUMMARY OF CONTRACTUAL OBLIGATIONS

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

	PAYMENTS DUE BY PERIOD				
($000s)	**Total**	0-1 Years	1-3 Years	4-5 Years	After 5 Years
Lease obligations	36,089	7,467	22,240	6,382	—

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company prepares its financial statements in accordance with IFRS, which requires management to make estimates, judgments and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and other assumptions that it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. The significant accounting policies of First National are described in Note 2 to the Company's annual consolidated financial statements as at December 31, 2018. The policies which First National believes are the most critical to aid in fully understanding and evaluating its reported financial results include the determination of the gains on deferred placement fees and the impact of fair value accounting on financial instruments.

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

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

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

As a mortgage lender, the Company invests in uninsured mortgages. When it funds these mortgages through securitization debt, it continues to be liable for any credit losses. The key inputs in the measurement of any ECL include Probability of Default, Loss Given Default and forecast of future economic conditions which involves significant judgment. Upon application of IFRS 9 with respect to impairment, there has been no impact on the Company's earnings. Because of the high proportion of government insured mortgages in its securitized portfolio and the low historical loss rates on the uninsured mortgages on which the Company lends, ECL has been determined to be insignificant.

FUTURE ACCOUNTING CHANGES

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

IFRS 16 – Leases

In January 2016, the IASB issued IFRS 16 – *Leases*, replacing IAS 17 – Leases. IFRS 16 requires lessees to recognize assets and liabilities for most leases instead of previous categories of finance leases, which are reported on the balance sheet, or operating leases, which are disclosed only in the notes to the financial statements, under IAS 17. IFRS 16 also set out enhanced guidance for the recognition, measurement, presentation and disclosure of the leasing activities. IFRS 16 is effective for annual periods beginning on or after January 1, 2019.

The Company's major leases are office space leases for its Toronto head office and four regional offices. The Company's various office equipment leases are insignificant for application of the new standard. Based on the preliminary assessment, the Company will record approximately $30 million as right-of-use asset as well as lease liability on its consolidated statements of financial position as of January 1, 2019.

Disclosure Controls and Internal Controls over Financial Reporting

The Company's disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company in reports filed under Canadian securities laws is recorded, processed, summarized and reported within the time periods specified under those laws, and include controls and procedures that are designed to ensure that information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

As of December 31, 2018, management evaluated, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, management concluded that the Company's disclosure controls and procedures, as defined by National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings, were effective as of December 31, 2018.

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

Management evaluated, under the supervision of and with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's internal control over financial reporting based on the criteria set forth in Internal Control – Integrated Framework (2013)issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and, based on that evaluation, concluded that the Company's internal control over financial reporting was effective as of December 31, 2018 and that no material weaknesses have been identified in the Company's internal control over financial reporting as of December 31, 2018. No changes were made in the Company's internal controls over financial reporting during the year ended December 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

RISKS AND UNCERTAINTIES AFFECTING THE BUSINESS

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

FORWARD-LOOKING INFORMATION

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as ''may'', ''will'', ''should'', ''expect'', ''plan'', ''anticipate'', ''believe'', ''intend'', ''estimate'', ''predict'', ''potential'', ''continue'' or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management's future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined in the ''Risk and Uncertainties Affecting the Business'' section. In evaluating this information, the reader should specifically consider various factors, including the risks outlined in the ''Risk and Uncertainties Affecting the Business'' section, which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management's expectations as of February 25, 2019, and is subject to change after such date. However, management and the Company disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

“The Company will continue to generate income and cash flow from its $30 billion portfolio of mortgages pledged under securitization and $73 billion servicing portfolio...”

OUTLOOK

Management is pleased with the results of 2018. Despite the addition of a new debt service qualifying test to B-20 underwriting guidelines in January 2018, the Company’s new single-family origination increased by 10%. New commercial mortgage origination increased by 8%. Including renewals, total origination was up 11% for the year ended December 31, 2018. While earnings, adjusted for fair value considerations related to hedging activities, were lower by 9%, a large part of this was the outcome of shifting mortgages to securitization programs from placement transactions. By securitizing mortgages instead of placing them directly with institutional investors, the Company delays the earning’s process: current period placement fee revenues are reduced and the costs associated with securitization are increased. In addition, the Company recognized significant gains related to hedging activities in 2017. The narrower margin on the related securitization is recognized over the remaining term of the mortgages and was partially reflected in 2018 earnings

Going into 2019, the Company is cautiously optimistic. Economic concerns arose in November 2018 and continued through to year end. Equity markets sold off and credit spreads widened. While perhaps too early to determine if these events are a harbinger for a recession, in the short term the consequences may be lessened at First National. Because the Company uses government sponsored funding programs such as NHA MBS and CMB, it expects these sources of funding to remain liquid and to outperform other debt instruments during a spread widening cycle. In addition, while the yields on underlying government bond benchmarks have fallen, mortgage lenders have been disciplined in the face of an uncertain economy and mortgage coupons have not fallen to the same extent. The consequence is a wider spread between the interest rates on prime mortgages and the costs of CMHC sponsored funding sources, despite increased credit spreads. Generally if persistent, these circumstances will provide the Company with greater securitization margins in 2019. It is unclear, however, how long this environment will last and whether competitive pressures will reduce these margins back to the levels experienced in 2018. The Company is confident that its strong relationships with mortgage brokers and diverse funding sources will continue to set First National apart from its competition. The Company will continue to generate income and cash flow from its $30 billion portfolio of mortgages pledged under securitization and $73 billion servicing portfolio and focus on the value inherent in its significant single-family renewal book.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

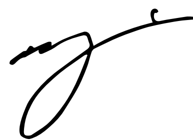
The management of First National Financial Corporation (the "Company") is responsible for the integrity, consistency and reliability of the consolidated financial statements and Management's Discussion and Analysis ("MD&A"). The consolidated financial statements have been prepared by Management in accordance with International Financial Reporting Standards.

We certify that we have reviewed the financial statements and information contained in the MD&A, and, based on our knowledge, they do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the statements and the annual report. Based on our knowledge, the financial statements together with MD&A and other financial information included in the annual report fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of the dates and for the periods presented. The preparation of financial statements involves transactions affecting the current period which cannot be finalized with certainty until future periods. Estimates and assumptions are based on historical experience and current conditions, and are believed to be reasonable.

We are responsible for establishing and maintaining internal control over financial reporting for the Company. We have designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. We evaluated, or caused to be evaluated under our supervision, the effectiveness of the Company's internal control over financial reporting at the financial year end and the Company has disclosed in its annual MD&A our conclusion about the effectiveness of internal control over financial reporting at the financial year-end based on that evaluation. We have also disclosed in the MD&A any change in our internal control over financial reporting that occurred during the year that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

The Board of Directors oversees that management fulfills its responsibility for financial reporting and internal control. The financial statements have been reviewed by the Audit Committee and approved by the Board of Directors. Ernst & Young LLP, the independent auditors appointed by the shareholders, has performed an independent audit of the Company's consolidated financial statements and provide their report which follows. The auditors have full and free access to, and meet at least quarterly with, the Audit Committee to discuss their audit and related matters.

Stephen Smith
Chairman and Chief Executive Officer



Robert Inglis
Chief Financial Officer
February 25, 2019

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of
First National Financial Corporation

OPINION

We have audited the consolidated financial statements of First National Financial Corporation and its subsidiaries (collectively the Company), which comprise the consolidated statement of financial position as at December 31, 2018 and December 31, 2017, and the consolidated statements of income, comprehensive income, changes in equity and cash flows for the years then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects the consolidated financial position of the Company as at December 31, 2018 and December 31, 2017, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRSs).

BASIS FOR OPINION

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

OTHER INFORMATION

Management is responsible for the other information. The other information comprises:

- Management's Discussion and Analysis
- The information, other than the consolidated financial statements and our auditor's report thereon, in the Annual Report

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon. In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

We obtained Management's Discussion and Analysis prior to the date of this auditor's report. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact in this auditor's report. We have nothing to report in this regard.

The Annual Report is expected to be made available to us after the date of the auditor's report. If, based on the work we will perform on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact to those charged with governance.

RESPONSIBILITIES OF MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE FOR THE CONSOLIDATED FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs, 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.

In preparing the consolidated financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

AUDITOR'S RESPONSIBILITIES FOR THE AUDIT OF THE CONSOLIDATED FINANCIAL STATEMENTS

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to

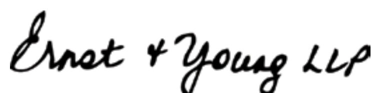
modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure, and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Andre de Haan.



Chartered Professional Accountants
Licensed Public Accountants

Toronto, Canada

February 25, 2019

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

As at December 31

(in thousands of Canadian dollars)	Notes	2018	2017
ASSETS			
Restricted cash	3	**577,096**	561,470
Cash held as collateral for securitization	3	**75,913**	66,413
Accounts receivable and sundry		**150,668**	144,159
Securities purchased under resale agreements	14	**2,188,149**	2,185,362
Mortgages accumulated for sale or securitization	5	**2,204,886**	1,789,765
Mortgages pledged under securitization	3	**30,567,036**	27,566,677
Deferred placement fees receivable	4	**41,584**	41,273
Mortgage and loan investments	6	**188,666**	379,713
Income taxes recoverable	19	**3,982**	—
Other assets	7	**39,147**	41,446
Total assets		**$36,037,127**	$32,776,278
LIABILITIES AND EQUITY			
LIABILITIES			
Bank indebtedness	9	**918,347**	643,828
Obligations related to securities and mortgages sold under repurchase agreements	15	**1,262,395**	1,200,135
Accounts payable and accrued liabilities	16	**124,451**	118,081
Securities sold short	14	**2,183,411**	2,180,253
Debt related to securitized and participation mortgages	10	**30,762,651**	27,834,080
Senior unsecured notes	12	**174,829**	174,693
Income taxes payable	18	**—**	7,191
Deferred tax liabilities	18	**78,800**	74,750
Total liabilities		**$35,504,884**	$32,233,011
EQUITY ATTRIBUTABLE TO SHAREHOLDERS			
Common shares	17	**122,671**	122,671
Preferred shares	17	**97,394**	97,394
Retained earnings		**315,294**	323,202
Accumulated other comprehensive income		**(3,116)**	—
Total equity		**$532,243**	$543,267
Total liabilities and equity		**$36,037,127**	$32,776,278

See accompanying notes

On behalf of the Board:

John Brough
Director

Robert Mitchell
Director

CONSOLIDATED STATEMENTS OF INCOME

Years ended December 31

(in thousands of Canadian dollars, except earnings per share)	Notes	2018	2017
REVENUE			
Interest revenue – securitized mortgages		**790,192**	658,783
Interest expense – securitized mortgages		**(646,069)**	(511,939)
Net interest – securitized mortgages	3	**144,123**	146,844
Placement fees		**141,887**	144,589
Gains on deferred placement fees	4	**11,747**	10,020
Mortgage investment income	6	**88,325**	68,276
Mortgage servicing income		**146,197**	140,841
Realized and unrealized gains on financial instruments	19	**3,162**	56,259
		$535,441	$566,829
EXPENSES			
Brokerage fees		**75,354**	83,260
Salaries and benefits		**99,735**	97,824
Interest		**69,949**	46,428
Other operating		**62,986**	53,915
		$308,024	$281,427
INCOME BEFORE INCOME TAXES		**227,417**	285,402
Income tax expense	18	**60,990**	75,750
NET INCOME FOR THE YEAR		**$166,427**	$209,652
NET INCOME ATTRIBUTABLE TO			
Shareholders		**166,427**	208,078
Non-controlling interests		**—**	1,574
		$166,427	$209,652
EARNINGS PER SHARE			
Basic	17	**2.73**	3.42

See accompanying notes

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years ended December 31

(in thousands of Canadian dollars)	2018	2017
NET INCOME FOR THE PERIOD	**166,427**	209,652
OTHER COMPREHENSIVE INCOME ITEMS THAT MAY BE SUBSEQUENTLY RECLASSIFIED TO INCOME		
Net gains from change in fair value of cash flow hedges	3,210	—
Reclassification of net gains to income	(7,466)	—
	(4,256)	—
Income tax recovery	1,140	—
Total other comprehensive income	(3,116)	—
Total comprehensive income	**$163,311**	**$ 209,652**

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

Years ended December 31

(in thousands of Canadian dollars)	Common shares	Preferred shares	Retained earnings	Accumulated other comprehensive Income	Total equity
BALANCE AS AT JANUARY 1, 2018	**122,671**	**97,394**	**323,202**	**—**	**543,267**
Net income	—	—	166,427	—	166,427
Other comprehensive income, net of tax	—	—	—	(3,116)	(3,116)
Dividends paid or declared	—	—	(174,335)	—	(174,335)
BALANCE AS AT DECEMBER 31, 2018	**$122,671**	**$97,394**	**$315,294**	**$(3,116)**	**$532,243**

	Common shares	Preferred shares	Retained earnings	Non-controlling interest	Total equity
BALANCE AS AT JANUARY 1, 2017	122,671	97,394	302,271	27,961	550,297
Comprehensive income	—	—	208,078	1,574	209,652
Dividends paid or declared	—	—	(187,147)	(1,535)	(188,682)
Redemptions by non-controlling interests	—	—	—	(28,000)	(28,000)
BALANCE AS AT DECEMBER 31, 2017	$122,671	$97,394	$323,202	—	$543,267

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31

(in thousands of Canadian dollars)	2018	2017
OPERATING ACTIVITIES		
Net income for the year	166,427	209,652
Add (deduct) items		
Deferred income tax expense	5,190	11,650
Non-cash portion of gains on deferred placement fees	(11,298)	(9,452)
Decrease (increase) in restricted cash	(15,626)	123,877
Net investment in mortgages pledged under securitization	(3,000,359)	(1,485,325)
Net increase in debt related to securitized mortgages	2,928,894	1,325,674
Provision for loan loss	—	2,740
Amortization of deferred placement fees receivable	10,987	11,082
Amortization of purchased mortgage servicing rights	—	664
Amortization of property, plant and equipment	4,931	5,135
Unrealized losses (gains) on financial instruments	25,157	(23,254)
	114,303	172,443
Net change in non-cash working capital balances related to operations	(425,261)	21,865
Cash provided by (used in) operating activities	$(310,958)	$194,303
INVESTING ACTIVITIES		
Additions to property, plant and equipment	(2,632)	(4,249)
Investment of cash held as collateral for securitization	(9,500)	(43,536)
Investment in mortgage and loan investments	(400,701)	(475,129)
Repayment of mortgage and loan investments	587,748	347,906
Cash provided by (used in) investing activities	$(174,915)	$(175,008)
FINANCING ACTIVITIES		
Dividends paid	(174,031)	(188,066)
Obligations related to securities and mortgages sold under repurchase agreements	62,260	190,563
Decrease in debt related to participation mortgages	(323)	(5,775)
Securities purchased under resale agreements, net	(2,787)	
Securities sold short, net	(23,595)	874,233
Redemption by non-controlling interests	—	(28,000)
Cash used in financing activities	$(138,476)	$(34,606)
Net increase in bank indebtedness during the year	(274,519)	(15,306)
Bank indebtedness, beginning of year	(643,828)	(628,522)
Bank indebtedness, end of year	$(918,347)	$(643,828)
SUPPLEMENTAL CASH FLOW INFORMATION		
Interest received	941,551	794,240
Interest paid	668,301	531,799
Income taxes paid	66,973	80,163

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

[in thousands of Canadian dollars, unless otherwise indicated]

December 31, 2018 and 2017

NOTE 1. GENERAL ORGANIZATION AND BUSINESS OF FIRST NATIONAL FINANCIAL CORPORATION

First National Financial Corporation [the "Corporation" or "Company"] is the parent company of First National Financial LP ["FNFLP"], a Canadian-based originator, underwriter and servicer of predominantly prime residential [single family and multi unit] and commercial mortgages. With over $106 billion in mortgages under administration as at December 31, 2018, FNFLP is a significant participant in the mortgage broker distribution channel.

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

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

[A] BASIS OF PREPARATION

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ["IFRS"]. The consolidated financial statements have been prepared on a historical cost basis, except for derivative financial instruments and financial assets and financial liabilities that are recorded at fair value through profit or loss ["FVTPL"] and measured at fair value. The carrying values of recognized assets and liabilities that are designated as hedged items in fair value hedges, and that would otherwise be carried at amortized cost, are adjusted to record changes in fair value attributable to the risks that are being in effective hedge relationships. The consolidated financial statements are presented in Canadian dollars and all values are rounded to the nearest thousand except when otherwise indicated. The consolidated financial statements were authorized for issue by the Board of Directors on February 25, 2019.

[B] BASIS OF CONSOLIDATION

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries, including FNFLP, First National Financial GP Corporation ["GP", the general partner of FNFLP], FNFC Trust, a special purpose entity ["SPE"] which is used to manage undivided co ownership interests in mortgage assets funded with Asset-Backed Commercial Paper ["ABCP"], First National Asset Management Inc. ["FNAM"], and First National Mortgage Corporation. The 2017 comparative financial information includes the financial statements of First National Mortgage Investment Fund [the "Fund"] and FN Mortgage Investment Trust [the "Trust"] until their termination on December 19, 2017.

FNAM is wholly-owned subsidiary of the GP, and an indirect subsidiary of the Company. FNAM is a NHA approved lender and NHA-MBS issuer in the capacity of an "aggregator". Its business model is to purchase mortgages from arms-length mortgage originators in order to create NHA-MBS pools, and subsequently sell these into the Canada Mortgage Bonds programs ["CMB"]. In 2018, FNAM issued three NHA-MBS pools totalling $85 million.

The Fund and the Trust were created in 2012 as special purpose vehicles to obtain exposure to a diversified portfolio of high yielding mortgages. Pursuant to the trustee's determination, both the Fund and the Trust were terminated on December 19, 2017. While the Fund and Trust operated, because of its status as the sole seller of assets to the Fund and its rights as promoter, the Company determined that it had de facto control of both the Fund and the Trust, and therefore, consolidated the operations and net assets of the Fund and the Trust until termination. Non controlling interests in the Fund and the Trust were shown as a separate component of equity on the consolidated statements of financial position to distinguish them from the equity of the Company's shareholders. The net income attributable to non-controlling interests is also separately disclosed on the consolidated statements of comprehensive income. On termination, the Company effectively purchased the interest in the Fund and Trust from the non-controlling interests.

The Company did not consolidate, in its financial statements, three SPEs over which the Company does not have control. The SPEs are sponsored by third-party financial institutions which acquire assets from various sellers including mortgages from the Company. The Company earns interest income from the retained interest related to these mortgages. As at December 31, 2018, the Company recorded, on its consolidated statements of financial position, its portion of the assets of the SPEs amounting to $801 million [2017 – $800 million]. The Company also recorded, in its consolidated statements of comprehensive income, interest revenue – securitized mortgages of $27.9 million [2017 – $8.2 million] and interest expense – securitized mortgages of $22.3 million [2017 – $7.7 million] related to its interest in the SPEs.

The consolidated financial statements have been prepared using consistent accounting policies for like transactions and other events in similar circumstances. All intercompany assets and liabilities, equity, income, expenses and cashflows relating to transactions between these companies are eliminated in full on consolidation.

[C] USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including contingencies, at the date of the consolidated 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 those that require reporting of financial assets and financial liabilities at fair value.

[D] SIGNIFICANT ACCOUNTING POLICIES

Financial Instruments

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

Classification and measurement of financial assets

IFRS 9 requires that all financial assets are measured at either fair value through profit or loss ["FVTPL"], fair value through OCI ["FVOCI"], or amortized cost, based on the contractual cash flow characteristics of the financial assets and the business model under which the financial assets are managed.

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

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

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

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

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

Classifications and measurement of financial liabilities

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

	IFRS 9	IAS 39
Obligations related to securities and mortgages sold under repurchase agreements	FVTPL	FVTPL
Securities sold short	FVTPL	FVTPL
Debt related to securitized mortgages	Amortized Cost	Amortized Cost
Servicing liabilities	Amortized Cost	Amortized Cost
Senior unsecured notes	Amortized Cost	Amortized Cost

Impairment

IFRS 9 introduces an expected credit loss ["ECL"] impairment model applicable to all debt instruments within financial assets classified as amortized cost or FVOCI, as well as certain off-balance sheet loan commitments. Prior to January 1, 2018, credit losses were recognized under an incurred loss model. The IFRS 9 ECL approach has three stages: Stage 1 – the credit risk has not increased significantly since initial recognition such that an allowance for credit loss is recognized and maintained equal to 12 months of expected credit loss; Stage 2 – the credit risk has increased significantly since initial recognition, and the allowance for credit loss is increased to cover full lifetime expected credit loss; and Stage 3 – a financial asset is considered credit-impaired and the allowance for credit loss continues to be the full lifetime expected credit loss, with interest revenue calculated on the carrying amount [net of the allowance for credit loss], rather than the gross carrying value of the financial assets.

The Company assesses the credit risk of the mortgages based on the expected repayments of principal and interest. All mortgages with arrears that are less than 30 days past due are included in Stage 1 whereas mortgages with principal in arrears between 31 to 90 days are included in Stage 2. Mortgages in these two stages are not considered to be impaired, and the Company recognizes a 12-month ECL for Stage 1 mortgages and a lifetime ECL for Stage 2 mortgages. When a mortgage is in arrears for over 90 days or the Company has issued a legal demand for repayment, there is an expectation of a detrimental impact on the estimated cash flows and, therefore, the Company considers the mortgages as impaired and includes in Stage 3.

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

Hedge accounting

On January 1, 2018, the Company adopted hedge accounting within IFRS 9 for certain mortgage commitments and funded mortgages. Hedge accounting has been applied prospectively from that date. The Company did not apply hedge accounting prior to January 1, 2018.

The Company uses a combination of short Government of Canada bonds and bond repo arrangements to manage exposure to interest rate risk associate with mortgage commitments and funded mortgages held prior to securitization. In addition, the Company uses interest rate swaps to manage exposure to interest rate risk for mortgages in SPEs. The Company documents a hedging relationship between the hedging instrument and the hedged item at inception when the relationship is established. The Company also assesses the effectiveness of the hedges at both the hedge inception and on an ongoing basis. Any ineffectiveness of any hedging relationship is recognized immediately in the consolidated statements of income.

Cash flow hedges

The Company applies cash flow hedge accounting for the anticipated funding of its multi-unit residential commercial segment mortgages. At the time of mortgage commitment, the Company shorts Government of Canada bonds as the hedging instrument to

hedge the cash flows on the anticipated future debt to be arranged through securitization of these mortgages obtained through CMB, disclosed as debt related to securitized mortgages. The Company also uses the same hedging strategy when placing mortgages with institutional investors who plan to use CMB funding. The effective portion of the change in the fair value of the designated hedging instrument qualifying as a cash flow hedge is recognized in other comprehensive income ["OCI"] in the consolidated statements of comprehensive income. When the hedge relationship is terminated, the cumulative amounts recognized in OCI are amortized into interest expense – securitized mortgages over the term of the securitized debt, or amortized against placement fees from institutional investors. Any change in fair value of the hedge determined as ineffective is recognized immediately in regular income.

Fair value hedges

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

In the case of the swaps and short bonds used to hedge funded mortgages, changes in fair value of the hedged item, to the extent that the hedging relationship is effective, are offset by changes in the fair value of the hedging instrument, both of which are recognized in regular income. At hedge unwind, the realized change in the value of the hedging instrument is adjusted to the carrying value of the hedged mortgages, and amortized into interest revenue over the term of the hedged mortgages. Any changes in the fair value of an ineffective hedge will be immediately recorded in regular income.

REVENUE RECOGNITION

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

Interest revenue and expense from mortgages pledged under securitization

The Company enters into securitization transactions to fund a portion the mortgages it originated. Upon transfer of these mortgages to securitization vehicles, the Company receives cash proceeds from the transaction. These proceeds are accounted for as debt related to securitized mortgages and the Company continues to hold the mortgages on its consolidated statements of financial position, unless:

[i] substantially all of the risks and rewards associated with the financial instruments have been transferred, in which case the assets are derecognized in full; or

[ii] a significant portion, but not all, of the risks and rewards have been transferred. The asset is derecognized entirely if the transferee has the ability to sell the financial asset; otherwise the asset continues to be recognized to the extent of the Company's continuing involvement.

Where [i] or [ii] above applies to a fully proportionate share of all or specifically identified cash flows, the relevant accounting treatment is applied to that proportion of the mortgage.

For securitized mortgages that do not meet the criteria for derecognition, no gain or loss is recognized at the time of the transaction. Instead, net interest income is recognized over the term of the mortgages. Interest revenue – securitized mortgages represents interest portion of mortgage payments received and accrued by borrowers and is net of the amortization of capitalized origination costs. Interest expense – securitized mortgages represents the costs to finance these mortgages, net of the amortization of debt discounts and premiums.

Capitalized origination fees and debt discounts or premiums are amortized on an effective yield basis over the term of the related mortgages or debt.

Derecognition

A financial asset is derecognized when:

- The right to receive cash flows from the asset has expired; or
- The Company has transferred its rights to receive cash flows from the assets or has assumed an obligation to pay the cash flows, received in full without material delay to a third party under a "pass-through" arrangement; and either [a] the Company has transferred substantially all the risks and rewards of the asset or [b] the Company has neither transferred nor retained substantially all of the risks and rewards of the asset, but has transferred control of the asset.

PLACEMENT FEES AND DEFERRED PLACEMENT FEES RECEIVABLE

The Company enters into placement agreements with institutional investors to purchase the mortgages it originates. When mortgages are placed with institutional investors, the Company transfers the contractual right to receive mortgage cash flows to the investors. Because it has transferred substantially all the risks and rewards of these mortgages, it derecognizes these assets. The Company retains a residual interest representing the rights and obligations associated with servicing the mortgages. Placement fees are earned by the Company for its origination and underwriting activities on a completed transaction basis when the mortgage is funded. Amounts immediately collected or collectible in excess of the mortgage principal are recognized as placement fees. When placement fees and associated servicing fees are earned over the term of the related mortgages, the Company determines the present value of the future stream of placement fees and records a gain on deferred placement fees and a deferred placement fees receivable. Since quoted prices are generally not available for retained interests, the Company estimates values based on the net present value of future expected cash flows, calculated using management's best estimates of key assumptions related to expected prepayment rates and discount rates commensurate with the risks involved.

MORTGAGE SERVICING INCOME

The Company services substantially all of the mortgages that it originates whether the mortgage is placed with an institutional investor or transferred to a securitization vehicle. In addition, mortgages are serviced on behalf of third-party institutional investors and securitization structures. For all mortgages administered for investors or third parties, the Company recognizes servicing income when services are rendered. For mortgages placed under deferred placement arrangements, the Company retains the rights and obligations to service the mortgages. The deferred placement fees receivable is the present value of the excess retained cash flows over market servicing fee rates and is reported as deferred placement revenue at the time of placement. Servicing income related to mortgages placed with institutional investors is recognized in income over the life of the servicing obligation as payments are received from mortgagors. Interest income earned by the Company from holding cash in trust related to servicing activities is classified as mortgage servicing income. The amortization of any servicing liabilities is also recorded as mortgage servicing income.

The Company provides underwriting and fulfillment processing services for mortgages originated by a large Canadian bank through its mortgage broker distribution channel. The Company recognizes servicing income when the services are rendered and the underwritten mortgages have been funded.

MORTGAGE INVESTMENT INCOME

The Company earns interest income from its interest-bearing assets including deferred placement fees receivable, mortgage and loan investments and mortgages accumulated for sale or securitization. Mortgage investment income is recognized on an accrual basis.

BROKERAGE FEES

Brokerage fees are primarily fees paid to external mortgage brokers. Brokerage fees relating to mortgages placed with institutional investors are expensed as incurred, and those relating to mortgages recorded at amortized cost are capitalized to the carrying cost of the related mortgages and amortized over the term of the mortgages.

MORTGAGES PLEDGED UNDER SECURITIZATION

Mortgages pledged under securitization are mortgages that the Company has originated and funded with debt raised through the securitization markets, and have been classified at amortized cost. The Company has a continuous involvement in these mortgages, including the right to receive future cash flows arising from these mortgages. Origination costs, such as brokerage fees and bulk insurance premiums that are directly attributable to the acquisition of such assets, are deferred and amortized over the term of the mortgages on an effective yield basis.

DEBT RELATED TO SECURITIZED AND PARTICIPATION MORTGAGES

Debt related to securitized mortgages represents obligations related to the financing of mortgages pledged under securitization. This debt is measured at its amortized cost using the effective yield method. Any discount/premium and issuance costs on raising these debts that is directly attributable to obtaining such liabilities is deferred and amortized over the term of the debt obligations.

Debt related to participation mortgages represents obligations related to the financing of a portion of commercial mortgages included in mortgage and loan investments. These mortgages are subject to participation agreements with other financial institutions such that the Company's investment is subordinate to the other institutions' investment. The Company has retained various rights and a proportionately larger share of the interest earned on these mortgages, such that the full mortgage has been recorded on the Company's consolidated statements of financial position with an offsetting debt. This debt is recorded at face value and measured at its amortized cost.

MORTGAGES ACCUMULATED FOR SALE OR SECURITIZATION

Mortgages accumulated for sale are mortgages funded for the purpose of placing with investors and are classified as FVTPL and are recorded at fair value. These mortgages are held for terms usually not exceeding 90 days.

Mortgages accumulated for securitization are mortgages funded pending arrangement of term debt through the Company's various securitization programs and are measured at amortized cost.

SECURITIES SOLD SHORT AND SECURITIES PURCHASED UNDER RESALE AGREEMENTS

Securities sold short consist typically of the short sale of government of Canada bonds. Bonds purchased under resale agreements consist of the purchase of a bond with the commitment from the Company to resell the bond to the original seller at a specified price. The Company uses the combination of bonds sold short and bonds purchased under resale agreements to economically hedge its mortgage commitments and the portion of funded mortgages that it intends to securitize in subsequent periods.

Bonds sold short are classified as FVTPL and are recorded at fair value. The effective yield payable on bonds sold short is recorded as hedge expense in other operating expenses. Bonds purchased under resale agreements are carried at cost plus accrued interest, which approximates their 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 hedge expense. Transactions are recorded on a settlement date basis.

MORTGAGE AND LOAN INVESTMENTS

Mortgage and loan investments are non-derivative financial assets with fixed or determinable payments, and are classified as FVTPL. The mortgages are measured at management's best estimate of the net realizable value. Changes in fair value are recognized immediately in the consolidated statement of 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 a computer license, which is straight-line over 10 years

Property, plant and equipment are subject to an impairment review if there are events or changes in circumstances that indicate the carrying amount may not be recoverable.

GOODWILL

Goodwill represents the price paid for the Corporation's business in excess of the fair value of the net tangible assets and identifiable intangible assets acquired in connection with the IPO. Goodwill is reviewed annually for impairment or more frequently when an event or change in circumstances indicates that the asset might be impaired.

RESTRICTED CASH

Restricted cash represents principal and interest collected on mortgages pledged under securitization that is held in trust until the repayment of debt related to these mortgages is made in a subsequent period.

BANK INDEBTEDNESS

Bank indebtedness consists of bank indebtedness net of cash balances or deposit with banks.

CASH HELD AS COLLATERAL FOR SECURITIZATION

Cash held as collateral for securitization represents cash-based credit enhancements held by various securitization vehicles, including FNFC Trust and a Canadian Trust Company acting as the title custodian for the Company's NHA MBS program.

SERVICING LIABILITY

The Company places mortgages with third-party institutional clients, and retains the rights and obligations to service these mortgages. When the service related fees are paid upfront by a third party, the Company records a servicing liability. The liability represents the portion of the upfront fee required to earn a market rate of servicing over the related mortgage term. This is similar to the method which the Company uses to calculate deferred placement fees. Since quoted prices are generally not available for retained interests, the Company estimates its value based on the net present value of future expected cash flows, calculated using management's best estimates of key assumptions related to expected prepayment rates and discount rates commensurate with the risks involved. The Company earns the related servicing fees over the term of the mortgages on an effective yield basis.

INCOME TAXES

The Company accounts for income taxes in accordance with the liability method of tax allocation. Under this method, the provision for income taxes is calculated based on income tax laws and income tax rates substantively enacted as at the dates of the consolidated statements of financial position. The income tax provision consists of current income taxes and deferred income taxes. Current and deferred taxes relating to items in the Company's equity are recorded directly against equity.

Current income taxes are amounts expected to be payable or recoverable as the result of operations in the current year and any adjustment to tax payable or tax recoverable amounts recorded in previous years.

Deferred income taxes arise on temporary differences between the carrying amounts of assets and liabilities on the consolidated statements of financial position and their tax bases. Deferred tax liabilities are generally recognized for all taxable temporary differences and deferred tax assets are recognized to the extent that future realization of the tax benefit is probable. Deferred taxes are calculated using the tax rates expected to apply in the periods in which the assets will be realized or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to offset exists in the entity.

EARNINGS PER COMMON SHARE

The Company presents earnings per share ["EPS"] amounts for its common shares. EPS is calculated by dividing the net earnings attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the year.

NOTE 3. MORTGAGES PLEDGED UNDER SECURITIZATION

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

As part of the ABCP transactions, the Company provides cash collateral for credit enhancement purposes as required by the rating agencies. Credit exposure to securitized mortgages is generally limited to this cash collateral. The principal and interest payments on the securitized mortgages are paid by the Company to the structured entities monthly over the term of the mortgages. The full amount of the cash collateral is recorded as an asset and the Company anticipates full recovery of these amounts. NHA MBS securitizations may also require cash collateral in some circumstances. As at December 31, 2018, the cash held as collateral for securitization was $75,913 [2017 – $66,413].

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

	2018	
	Carrying amount of securitized mortgages ($)	**Carrying amount of associated liabilities ($)**
Securitized mortgages	**30,385,005**	**30,876,519**
Capitalized hedge loss	**12,578**	**—**
Capitalized origination costs	**169,453**	**—**
Debt discounts	**—**	**(113,868)**
	$30,567,036	**$30,762,651**
Add		
Principal portion of payments held in restricted cash	**521,690**	**—**
	$31,088,726	**$30,762,651**

	2017	
	Carrying amount of securitized mortgages ($)	**Carrying amount of associated liabilities ($)**
Securitized mortgages	27,427,239	27,914,097
Mark-to-market adjustment	(1,683)	—
Capitalized origination costs	141,121	—
Debt discounts	—	(80,340)
	$27,566,677	$27,833,757
Add		
Principal portion of payments held in restricted cash	514,793	—
Participation debt	—	323
	$28,081,470	$27,834,080

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

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

The changes in capitalized origination costs for the years ended December 31 are summarized as follows:

	2018	2017
OPENING BALANCE, JANUARY 1	**141,121**	138,940
Add: new origination costs capitalized in the year	**103,222**	70,716
Less: amortization in the year	**(74,890)**	(68,535)
ENDING BALANCE, DECEMBER 31	**$169,453**	$141,121

During the year ended December 31, 2018, the Company invested in mortgages that were transferred into the securitization vehicles with principal balances as of December 31, 2018 of $7,418,415 [2017 – $5,928,283].

The contractual maturity profile of the mortgages pledged under securitization programs is summarized as follows:

2019	4,233,634
2020	3,794,321
2021	5,356,973
2022	6,624,587
2023 and thereafter	10,375,490
	$30,385,005

The following table summarizes the mortgages pledged under securitization that are 31 days or more past due as at December 31:

	2018	2017
ARREARS DAYS		
31 to 60	**48,902**	35,652
61 to 90	**4,814**	5,841
Greater than 90	**16,380**	28,707
	70,096	70,200

All the mortgages listed above are insured, except for two mortgages which are uninsured and have a total principal balance of $605 as at December 31, 2018 [2017 – $289]. The Company's exposure to credit loss is limited to uninsured mortgages with principal balances totalling $1,251,236 [2017 – $1,106,796], before consideration of the value of underlying collateral. Virtually all such mortgages are conventional prime single-family mortgages, with an 80% or less loan to value ratio at origination, and verified borrower income. Accordingly, the expected credit loss related to these mortgages is insignificant, and the Company has not provided any allowance for ECL for the year ended December 31, 2018.

NOTE 4. DEFERRED PLACEMENT FEES RECEIVABLE

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

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

During the year ended December 31, 2018, $2,655,764 [2017 – $2,005,667] of mortgages were placed with institutional investors, which created gains on deferred placement fees of $11,747 [2017 – $10,020]. Cash receipts on deferred placement fees receivable for the year ended December 31, 2018 were $12,979 [2017 – $12,772].

The Company estimates that the expected undiscounted cash flows to be received on the deferred placement fees receivable will be as follows:

2019	11,893
2020	9,638
2021	7,700
2022	5,752
2023 and thereafter	12,519
	$47,502

NOTE 5. MORTGAGES ACCUMULATED FOR SALE OR SECURITIZATION

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

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

	2018	2017
Mortgages accumulated for securitization	**2,170,416**	1,770,275
Mortgages accumulated for sale	**34,470**	19,490
	$2,204,886	$1,789,765

The Company's exposure to credit loss is limited to $321,341 [2017 – $569,571] of principal balances of uninsured mortgages within mortgages accumulated for securitization, before consideration of the value of underlying collateral. As at December 31, 2018, none of these mortgages are in arrears past 31 days. These are conventional prime single-family mortgages similar to the mortgages described in note 3. Accordingly the expected credit loss related to these mortgages is insignificant.

NOTE 6. MORTGAGE AND LOAN INVESTMENTS

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

Mortgage and loan investments are measured at FVTPL, and are recorded on a fair value basis. Any changes in fair value are immediately recognized in income. The Company recorded a fair value loss of $4,000 for the year ended December 31, 2018. The mortgages were classified as loans and receivables prior to the adoption of IFRS 9, and a $4,000 credit loss related to these mortgages was recorded as an offset to mortgage investment income on the consolidated statement of income for the year ended December 31, 2017.

The following table discloses the composition of the Company's portfolio of mortgage and loan investments by geographic region as at December 31, 2018:

Province/Territory	Portfolio balance	Percentage of portfolio
Alberta	**5,678**	3.01
British Columbia	**17,855**	9.46
Manitoba	**21,162**	11.22
New Brunswick	**2,678**	1.42
Newfoundland and Labrador	**56**	0.03
Nova Scotia	**4,046**	2.15
Nunavut	**134**	0.07
Ontario	**108,654**	57.58
Quebec	**27,993**	14.84
Saskatchewan	**122**	0.07
Yukon	**288**	0.15
	$188,666	100.00%

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

	2018	2017
ARREARS DAYS		
31 to 60	**4,871**	13,433
Greater than 90	**39,232**	43,974
	$44,103	$57,407

"Mortgage and loan investments consist primarily of commercial first and second mortgages held for various terms..."

The portfolio contains $13,133 [December 31, 2017 — $15,145] of insured mortgages and $175,533 [December 31, 2017 — $364,568] of uninsured mortgage and loan investments as at December 31, 2018. Of the uninsured mortgages, approximately $39,941 [December 31, 2017 — $49,693] have principal balances in arrears of more than 30 days. Three of these mortgages are non-performing and the Company has stopped accruing interest. These mortgages had a total original principal balance of $44,001 and are recorded at a fair value of $25,262 as at December 31, 2018 [December 31, 2017 — four mortgages, original principal balance of $48,600, and fair value of $32,001].

The maturity profile in the table below is based on the earlier of contractual renewal or maturity dates.

						2018	2017
	2019	2020	2021	2022	2023 and thereafter	Book value	Book value
Residential	**11,647**	**924**	**8,254**	**5,261**	**10,441**	**36,527**	34,820
Commercial	**113,366**	**33,173**	**1,800**	**2,057**	**1,743**	**152,139**	344,893
	$125,013	**$34,097**	**$10,054**	**$7,318**	**$12,184**	**$188,666**	$379,713

Interest income earned for the year was $17,654 [2017 – $18,610] and is included in mortgage investment income on the consolidated statements of income.

NOTE 7. OTHER ASSETS

The components of other assets are as follows as at December 31:

	2018	2017
Property, plant and equipment, net	**9,371**	11,670
Goodwill	**29,776**	29,776
	$39,147	$41,446

The recoverable amount of the Company's goodwill is calculated by reference to the Company's market capitalization, mortgages under administration, origination volume, and profitability. These factors indicate that the Corporation's recoverable amount exceeds the carrying value of its net assets and accordingly, goodwill is not impaired.

NOTE 8. MORTGAGES UNDER ADMINISTRATION

As at December 31, 2018, the Company managed mortgages under administration of $106,151,363 [2017 – $101,589,153], including mortgages held on the Company's consolidated statements of financial position. Mortgages under administration are serviced for financial institutions such as banks, insurance companies, pension funds, mutual funds, trust companies, credit unions and securitization vehicles. As at December 31, 2018, the Company administered 306,221 mortgages [2017 – 301,492] for 111 institutional investors [2017 – 103] with an average remaining term to maturity of 40 months [2017 – 41 months].

Mortgages under administration are serviced as follows:

	2018	**2017**
Institutional investors	**59,768,374**	59,601,263
Mortgages accumulated for sale or securitization and mortgage and loan investments	**2,387,285**	2,190,393
Deferred placement investors	**12,441,436**	11,125,228
Mortgages pledged under securitization	**30,385,005**	27,427,239
CMBS conduits	**1,169,263**	1,245,030
	$106,151,363	$101,589,153

The Company's exposure to credit loss is limited to mortgage and loan investments as described in note 6, securitized mortgages as described in note 3 and uninsured mortgages held in mortgages accumulated for securitization as described in note 5. As at December 31, 2018, the Company has included in accounts receivable and sundry $86 [2017 – $86] of uninsured non performing mortgages.

The Company maintains trust accounts on behalf of the investors it represents. The Company also holds municipal tax funds in escrow for mortgagors. Since the Company does not hold a beneficial interest in these funds, they are not presented on the consolidated statements of financial position. The aggregate of these accounts as at December 31, 2018 was $630,166 [2017 – $670,259].

NOTE 9. BANK INDEBTEDNESS

Bank indebtedness includes a revolving credit facility of $1,250,000 [2017 – $1,060,000] maturing in March 2023. At December 31, 2018, $918,347 [2017 – $643,828] was drawn, of which the following have been pledged as collateral:

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

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

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

NOTE 10. DEBT RELATED TO SECURITIZED AND PARTICIPATION MORTGAGES

Debt related to securitized mortgages represents the funding for mortgages pledged under the NHA-MBS, CMB and ABCP programs. As at December 31, 2018, debt related to securitized mortgages was $30,762,651 [2017 – $27,833,757], net of unamortized discounts of $113,868 [2017 – $80,340]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

As at December 31, 2018, the Company did not record any debt related to participation mortgages [December 31, 2017 – $323].

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

NOTE 11. 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 uses interest rate swaps to manage interest rate exposure relating to variability of interest earned on mortgages pledged under securitization. The swap agreements that the Company enters into are interest rate swaps 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 contracts outstanding as at December 31, 2018 and 2017:

2018

	Less than 3 years	3 to 5 years	6 to 10 years	Total notional amount	Fair value
Interest rate swap contracts	**$2,011,026**	**$1,634,911**	**$20,671**	**$3,666,608**	**$40,549**

2017

	Less than 3 years	3 to 5 years	6 to 10 years	Total notional amount	Fair value
Interest rate swap contracts	$1,138,520	$3,139,547	$10,370	$4,288,437	$57,565

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 consolidated statements of financial position.

NOTE 12. SENIOR UNSECURED NOTES

On April 9, 2015, the Company issued $175 million of new senior unsecured notes for a five-year term maturing on April 9, 2020. The notes bear interest at 4.01% payable in equal semi-annual payments commencing October 9, 2015. The net proceeds of the issuance [$174.3 million, net of financing fees] have been invested in FNFLP.

NOTE 13. COMMITMENTS, GUARANTEES AND CONTINGENCIES

As at December 31, 2018, the Company has the following operating lease commitments for its office premises:

2019	7,467
2020	7,418
2021	7,238
2022 and thereafter	13,966
	$36,089

Outstanding commitments for future advances on mortgages with terms of one to 10 years amounted to $1,192,677 as at December 31, 2018 [2017 – $1,634,058]. 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 that are currently under administration. Certain of these commitments have been sold to institutional investors while others will expire before being drawn down. Accordingly, these amounts do not necessarily represent future cash requirements of the Company.

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

NOTE 14. SECURITIES TRANSACTIONS UNDER REPURCHASE AND RESALE AGREEMENTS

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

NOTE 15. 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 or securitization. The current contracts are with financial institutions, are based on bankers' acceptance rates and mature on or before January 31, 2019.

NOTE 16. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

The major components of accounts payable and accrued liabilities are as follows as at December 31:

	2018	2017
Accrued liabilities	**15,303**	39,195
Accrued dividends payable	**10,249**	9,946
Accrued interest on securitization debt	**57,777**	43,940
Servicing liability	**17,981**	18,876
Swap liabilities	**23,141**	6,124
	$124,451	$118,081

Accrued interest on securitization debt is the interest due on securitization related debt due subsequent to year end.

NOTE 17. SHAREHOLDERS' EQUITY

[a] Authorized

Unlimited number of common shares

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

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

[b] Capital stock

Balance, December 31, 2018 and 2017

	#	$
Common shares	**59,967,429**	**$122,671**
Preferred shares	**4,000,000**	**$97,394**

[c] Preferred shares

On January 25, 2011, the Company 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.

Holders of Class A Series 1 Preferred Shares have the right, at their option, to convert their shares into cumulative, floating rate Class A Preferred Shares, Series 2 ["Series 2 Preferred Shares"], subject to certain conditions, on March 31, 2021 and on March 31 every five years thereafter. As of December 31, 2018, there were 2,887,147 Series 1 preferred shares and 1,112,853 Series 2 preferred shares outstanding with a total carrying value of $97,394.

Holders of the Class A Series 1 Preferred Shares receive a cumulative quarterly fixed dividend at a rate equal to the five year Government of Canada yield plus 2.07%. The dividend rate may be reset every five years, as and when approved by the Board of Directors. The current dividend rate on the Class A Series 1 shares is 2.79% annually for a new five year term ending March 31, 2021.

Holders of the Series 2 Preferred Shares will be entitled to receive cumulative quarterly floating dividends at a rate equal to the three month Government of Canada Treasury bill yield plus 2.07%, as and when declared by the Board of Directors.

Both classes of Preferred Shares do not have voting rights, are redeemable only at the option of the Company, and are therefore classified as equity. The par value per preferred share is $25.

[d] Earnings per share

	2018	**2017**
Net income attributable to shareholders	**166,427**	208,078
Less: dividends declared on preferred shares	**(2,928)**	(2,747)
Net earnings attributable to common shareholders	**163,499**	205,331
Number of common shares outstanding	**59,967,429**	59,967,429
Basic earnings per common share	**$2.73**	$3.42

NOTE 18. INCOME TAXES

The major components of deferred tax expense for the years ended December 31 consist of the following:

	2018	2017
Related to origination and reversal of timing differences	**4,857**	11,650
Increase in future tax rates	**333**	—
	$5,190	$11,650

The major components of current income tax expense for the years ended December 31 consists of the following:

	2018	2017
Income taxes relating to the current year	**56,100**	64,100
Income taxes related to the prior year	**(300)**	—
	$55,800	$64,100

The effective income tax rate reported in the consolidated statements of comprehensive income varies from the Canadian tax rate of 26.64% for the year ended December 31, 2018 [2017- 26.52%] for the following reasons:

	2018	2017
COMPANY'S STATUTORY TAX RATE	**26.64%**	26.52%
Income before income taxes	**227,417**	285,402
Income tax at statutory tax rate	**60,584**	75,689
Increase (decrease) resulting from		
Income not subject to tax	**—**	(111)
Permanent differences	**316**	291
Changes in future tax rates	**333**	(39)
Tax recovery from prior years	**(300)**	—
Other	**57**	(80)
INCOME TAX EXPENSE	**$60,990**	$75,750

The movement in significant components of the Company's deferred tax liabilities and assets for the years ended December 31, 2018 and 2017 are as follows:

	As at January 1, 2018	Recognized in income and OCI	As at December 31, 2018
DEFERRED INCOME TAX (ASSETS) LIABILITIES			
Deferred placement fees receivable	10,946	132	11,078
Capitalized broker fees	37,610	7,411	45,021
Unamortized discount on debt related to securitized mortgages	21,306	9,043	30,349
Unrealized gains on interest rate swaps	17,866	(11,981)	5,885
Other	77	(13)	64
Carrying values of mortgages pledged under securitization in excess of tax values	(446)	22	(424)
Cumulative eligible capital property	(4,561)	300	(4,261)
Servicing liability	(5,006)	216	(4,790)
Fair value adjustments not deducted for tax purposes	(3,042)	(1,080)	(4,122)
Total	**$74,750**	**$4,050**	**$78,800**

The amount recognized in income and OCI consists of income tax expense of $5,190 recorded in income and a recovery of $1,140 record in OCI related to unrealized losses on cash flow hedges.

	As at January 1, 2017	Recognized in income	As at December 31, 2017
DEFERRED INCOME TAX (ASSETS) LIABILITIES			
Deferred placement fees receivable	11,660	(714)	10,946
Capitalized broker fees	38,015	(405)	37,610
Carrying values of mortgages pledged under securitization in excess of tax values	5,671	(6,117)	(446)
Unamortized discount on debt related to securitized mortgages	15,331	5,975	21,306
Unrealized gains on interest rate swaps	4,787	13,079	17,866
Other	589	(512)	77
Cumulative eligible capital property	(4,908)	347	(4,561)
Servicing liability	(4,749)	(257)	(5,006)
Loan loss reserves not deducted for tax purposes	(3,296)	254	(3,042)
Total	$63,100	$11,650	$74,750

The calculation of taxable income of the Company is based on estimates and the interpretation of tax legislation. In the event that the tax authorities take a different view from management, the Company may be required to change its provision for income taxes or deferred tax balances and the change could be significant.

NOTE 19. 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 is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's exposure to the risk of changes in market interest rates relates primarily to the Company's mortgages accumulated for securitization.

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 transfer of the mortgage to the related securitization vehicle or sale to an institutional investor. Primary among these strategies is the Company's decision to sell mortgages at the time of commitment, passing on interest rate risk that exists prior to funding to institutional investors. The Company uses synthetic bond forwards [consisting of bonds sold short and bonds purchased under resale agreements] to manage interest rate exposure between the time a mortgage rate is committed to the borrower and the time the mortgage is sold to a securitization vehicle and the underlying cost of funding is set. 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 reduced future spread on mortgages pledged under securitization 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 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 2018 and 2017.

	Decrease in interest rate[1]		Increase in interest rate	
	2018	**2017**	**2018**	**2017**
100 BASIS POINT SHIFT				
Impact on net income and equity attributable to shareholders	**$4,816**	$1,946	**$(4,816)**	$(958)
200 BASIS POINT SHIFT				
Impact on net income and equity attributable to shareholders	**$9,632**	$10,875	**$(9,632)**	$(1,917)

[1] Interest rate is not decreased below 0%.

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. As at December 31, 2018, 96% [2017 – 96%] of the pledged mortgages were insured mortgages. See details in note 3. The Company's exposure is further mitigated by the relatively 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 consolidated statements of financial position. The Company does not have significant concentration of credit risk within any particular geographic region or group of customers.

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 location, borrower exposure and the underlying type of real estate. This diversity and the priority ranking of the Company's rights mitigate the potential size of any single credit loss.

Securities purchased under resale agreements are transacted with large regulated Canadian institutions such that the risk of credit loss is very remote. Securities transacted 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. The Company's credit facilities are typically drawn to fund: [i] mortgages accumulated for sale or securitization, [ii] origination costs associated with mortgages pledged under securitization, [iii] cash held as collateral for securitization, [iv] costs associated with deferred placement fees receivable and [v] mortgage and loan investments. The Company has a credit facility with a syndicate of eleven financial institutions, which provides for a total of $1,250,000 in financing.

The Company finances the majority of its mortgages with debt derived from the securitization markets, primarily NHA MBS, ABCP and CMB. Debt related to NHA-MBS and ABCP securitizations reset monthly such that the receipts of principal on the mortgages are used to pay down the related debt within a 30 day period. Accordingly, these sources of financing amortize at the same rate as the mortgages pledged thereunder, providing an almost perfectly matched asset and liability relationship.

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.

Customer concentration risk

Placement fees and mortgage servicing income from one Canadian financial institution represent approximately 9.0% [2017 – 9.9%] of the Company's total revenue.

Fair value measurement

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

Level 1 – quoted market price observed in active markets for identical instruments;

Level 2 – quoted market price observed in active markets for similar instruments or other valuation techniques for which all significant inputs are based on observable market data; and

Level 3 – valuation techniques in which one or more significant inputs are unobservable.

Valuation methods and assumptions

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

[a] Mortgages and loan investments

Mortgages and loan investments are measured at FVTPL. The fair value of these mortgages is based on non-observable inputs, and is measured at management's best estimated of the net realizable value.

[b] Deferred placement fees receivable

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

[c] Securities owned and sold short

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

[d] Servicing liability

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

[e] Other financial assets and financial liabilities

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

[f] Fair value of financial instruments not carried at fair value

The fair value of these financial instruments are determined by discounting projected cash flows using market industry pricing practices, including the rate of unscheduled prepayment. Discount rates used are determined by comparison to similar term loans made to borrowers with similar credit. This methodology will reflect changes in interest rates which have occurred since the mortgages were originated. These fair values are estimated using valuation techniques in which one or more significant inputs are unobservable [Level 3], and are calculated for disclosure purposes only.

Carrying value and fair value of selected financial instruments

The fair value of the financial assets and financial liabilities of the Company approximates its carrying value, except for mortgages pledged under securitization, which has a carrying value of $30,567,036 [2017 – $27,566,677] and a fair value of $31,071,851[2017 – $27,557,542], debt related to securitized and participation mortgages, which has a carrying value of $30,762,651 [2017 – $27,834,080], and a fair value of $30,574,471 [2017 – $27,748,498], and senior unsecured notes, which have a carrying value of $174,829 [December 31, 2017 – $174,693], and a fair value of $175,856 [December 31, 2017 – $176,372].

The following tables represent the Company's financial instruments measured at fair value on a recurring basis as at December 31:

	2018			
	Level 1	**Level 2**	**Level 3**	**Total**
FINANCIAL ASSETS				
Mortgages accumulated for sale	**—**	**34,470**	**—**	**34,470**
Mortgage and loan investments	**—**	**—**	**188,666**	**188,666**
Interest rate swaps	**—**	**51,410**	**—**	**51,410**
Total financial assets	**—**	**$85,880**	**$188,666**	**$274,546**
FINANCIAL LIABILITIES				
Securities sold short	**—**	**2,183,411**	**—**	**2,183,411**
Interest rate swaps	**—**	**4,784**	**—**	**4,784**
Total financial liabilities	**—**	**$2,188,195**	**—**	**$2,188,195**

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

In estimating the fair value of financial assets and financial liabilities using valuation techniques or pricing models, certain assumptions are used, including those that are not fully supported by observable market prices or rates [Level 3]. The amount of the change in fair value recognized by the Company in net income for the year ended December 31, 2018 that was estimated using a valuation technique based on assumptions that are not fully supported by observable market prices or rates was approximately a loss of $4,000 [2017 – $26,342]. Although the Company's management believes that the estimated fair values are appropriate as at the date of the consolidated statements of financial position, those fair values may differ if other reasonably possible alternative assumptions are used.

Transfers between levels in the fair value hierarchy are deemed to have occurred at the beginning of the period in which the transfer occurred. Transfers between levels can occur as a result of additional or new information regarding valuation inputs and changes in their observability. During 2018 and 2017, the Company did not have any transfers between levels.

The following table presents changes in the fair values, including realized gains of $32,942 [2017 – $33,006] of the Company's financial assets and financial liabilities for the years ended December 31, 2018 and 2017, all of which have been classified as FVTPL:

	2018	**2017**
FVTPL mortgages	**(4,000)**	(25,312)
Deferred placement fees receivable	**—**	(1,030)
Securities sold short	**6,189**	35,468
Interest rate swaps	**1,340**	47,133
	$3,529	$56,259

The above table includes an unrealized fair value loss of $4,000 on the mortgage and loan investments. These mortgages were classified as loan and receivables under IAS 39 prior to January 1, 2018, but have now been classified as FVTPL under IFRS 9. Accordingly, there is no gain or loss reported in 2017 with respect to mortgage and loan investments. The mortgages pledged under securitization that were classified as FVTPL in 2017 have now been classified as amortized cost with the transition to IFRS 9. Accordingly, there is no gain or loss reported in 2018 with respect to mortgages pledged under securitization.

The Company does not have any assets or liabilities that are measured at fair value on a non recurring basis.

Movement in Level 3 financial instruments measured at fair value

The following tables show the movement in Level 3 financial instruments in the fair value hierarchy for the years ended December 31, 2018 and 2017. The Company classifies financial instruments to Level 3 when there is reliance on at least one significant unobservable input in the valuation models.

	Fair value as at December 31, 2017 under IAS 39	Fair value as at January 1, 2018 under IFRS 9	Investments	Unrealized loss recorded in income	Payment and amortization	Fair value as at December 31, 2018
FINANCIAL ASSETS						
FVTPL mortgages	2,986,097	—	—	—	—	—
Deferred placement fees receivable	41,273	—	—	—	—	—
Mortgage and loan investments	—	379,713	44,294	(4,000)	(231,341)	188,666
	$3,027,370	$379,713	$44,294	$(4,000)	$(231,341)	$188,666

	Fair value as at January 1, 2017	Investments	Unrealized loss recorded in income	Payment and amortization	Fair value as at December 31, 2017
FINANCIAL ASSETS					
FVTPL mortgages	2,663,756	1,612,325	(25,312)	(1,264,672)	2,986,097
Deferred placement fees receivable	43,933	9,452	(1,030)	(11,082)	41,273
Mortgage and loan investments	41,858	10,049	—	(51,907)	—
	$2,749,547	$1,631,826	$(26,342)	$(1,327,661)	$3,027,370

NOTE 20. CAPITAL MANAGEMENT

The Company's objective is to maintain a 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 common share capital and retained earnings. FNFLP has a minimum capital requirement as stipulated by its bank credit facility. The agreement limits the debt under bank indebtedness together with the unsecured notes to four times FNFLP's equity. As at December 31, 2018, the ratio was 1.90:1 [2017 – 1.39:1]. The Company was in compliance with the bank covenant throughout the year.

NOTE 21. EARNINGS BY BUSINESS SEGMENT

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

	2018		
	Residential	**Commercial**	**Total**
REVENUE			
Interest revenue – securitized mortgages	**607,672**	**182,520**	**790,192**
Interest expense – securitized mortgages	**(495,386)**	**(150,683)**	**(646,069)**
Net interest – securitized mortgages	**112,286**	**31,837**	**144,123**
Placement and servicing	**236,636**	**63,195**	**299,831**
Mortgage investment income	**61,821**	**26,504**	**88,325**
Realized and unrealized gains on financial instruments	**7,171**	**(4,009)**	**3,162**
	417,914	**117,527**	**535,441**
EXPENSES			
Amortization	**3,943**	**988**	**4,931**
Interest	**54,659**	**15,290**	**69,949**
Other operating	**194,414**	**38,730**	**233,144**
	253,016	**55,008**	**308,024**
INCOME BEFORE INCOME TAXES	**164,898**	**62,519**	**227,417**
Identifiable assets	**27,719,231**	**8,288,120**	**36,007,351**
Goodwill	**—**	**—**	**29,776**
Total assets	**27,719,231**	**8,288,120**	**36,037,127**
CAPITAL EXPENDITURES	**1,842**	**790**	**2,632**

	2017		
	Residential	**Commercial**	**Total**
REVENUE			
Interest revenue – securitized mortgages	500,789	157,994	658,783
Interest expense – securitized mortgages	(382,604)	(129,335)	(511,939)
Net interest – securitized mortgages	118,185	28,659	146,844
Placement and servicing	237,041	58,409	295,450
Mortgage investment income	47,452	20,824	68,276
Realized and unrealized gains (losses) on financial instruments	41,878	14,381	56,259
	444,556	**122,273**	**566,829**
EXPENSES			
Amortization	4,074	1,061	5,135
Interest	37,635	8,793	46,428
Other operating	187,477	42,387	229,864
	229,186	**52,241**	**281,427**
INCOME BEFORE INCOME TAXES	215,370	70,032	285,402
Identifiable assets	25,653,160	7,093,342	32,746,502
Goodwill	—	—	29,776
Total assets	25,653,160	7,093,342	32,776,278
CAPITAL EXPENDITURES	**2,974**	**1,275**	**4,249**

NOTE 22. RELATED PARTY AND OTHER TRANSACTIONS

The Company has servicing contracts in connection with several originated commercial mezzanine mortgages subsequently sold to various entities controlled by a senior executive and shareholder of the Company. The Company services these mortgages during their terms at market commercial servicing rates. During the year, the Company originated $128,465 of new mortgages for the related parties. The related parties also funded several mortgage related progress draws totalling $9,149 on existing mortgages originated by the Company. All such mortgages, which are administered by the Company, have a balance of $121,556 as at December 31, 2018 [December 31, 2017 – $61,034]. As at December 31, 2018, three of the mortgages are secured by real estate in which the Company is also a subordinate mortgage lender.

A senior executive and shareholder of the Company has a significant investment in a mortgage default insurance company. In the ordinary course of business, the insurance company provides insurance policies to the Company's borrowers at market rates. In addition, the insurance company has also provided the Company with portfolio insurance at market premiums. The total bulk insurance premium paid in 2018 was $2,339 [2017 – $494], net of third-party investor reimbursement. The insurance company has also engaged the Company to service a portfolio of mortgages at market commercial servicing rates. As at December 31, 2018, the portfolio had a balance of $1,625 [2017 – $3,822].

NOTE 23. FUTURE ACCOUNTING CHANGES

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

IFRS 16 – Leases

In January 2016, the IASB issued IFRS 16 – *Leases*, replacing IAS 17 – *Leases*. IFRS 16 requires lessees to recognize assets and liabilities for most leases instead of previous categories of finance leases, which are reported on the balance sheet, or operating leases, which are disclosed only in the notes to the financial statements, under IAS 17. IFRS 16 also set out enhanced guidance for the recognition, measurement, presentation and disclosure of the leasing activities. IFRS 16 is effective for annual periods beginning on or after January 1, 2019.

The Company's major leases are office space leases for its Toronto head office and four regional offices. The Company's various office equipment leases are insignificant for application of the new standard. Based on the preliminary assessment, the Company will apply IFRS 16 on a modified retrospective approach, and record approximately $30 million as right-of-use asset as well as lease liability on its consolidated statements of financial position as of January 1, 2019.

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 to maintaining the confidence of investors and increasing shareholder value. As such, First National is committed to the highest standards of integrity, transparency, compliance and discipline.

These standards define the relationships among all of our stakeholders – Board, management and shareholders – and are 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, oversees matters related to our strategic direction and assesses results relative to our goals and objectives. As such, the Board has adopted several policies that reflect recommended 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 follow 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 Governance 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 auditor 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), Robert Mitchell and Robert Pearce

GOVERNANCE COMMITTEE

The Governance Committee's responsibilities include:

- Periodically assessing and making recommendations on the Company's approach to governance issues;
- Assisting in the development of governance policies, practices and procedures for approval by the Board of Directors;
- Reviewing conflicts of interest and transactions involving related parties of the Company; and
- Periodically reviewing the composition and effectiveness of the Board of Directors.

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

Committee Members
Barbara Palk (Chair), Duncan Jackman and Robert Pearce

BOARD OF DIRECTORS

STEPHEN SMITH

Stephen Smith, one of Canada's leading financial services entrepreneurs, is the Chairman, Chief Executive Officer and Co-Founder of First National Financial Corporation. He has been an innovator in the development and utilization of various securitization techniques to finance mortgage assets as well as a leader in the development and application of information technology in the mortgage industry.

Mr. Smith is Chairman of Canada Guaranty Mortgage Insurance Company, which he owns in partnership with Ontario Teachers' Pension Plan. He is the largest shareholder in Equitable Bank, one of Canada's leading alternative lenders and the country's ninth largest bank. Mr. Smith is a member of the Board of Governors of the Royal Ontario Museum, the Board of Directors of the C. D. Howe Institute, E L Financial Corporation and the Canada Infrastructure Bank. He is also Chairman of Historica Canada, producer of the Heritage Minutes and publisher of The Canadian Encyclopaedia. In 2012, Mr Smith received the Queen Elizabeth II Diamond Jubilee Medal for contributions to Canada.

In 2015, Queen's University announced the naming of The Stephen J.R. Smith School of Business at Queen's University in honour of Mr. Smith and his historic $50-million donation to the school.

Mr. Smith holds a B.Sc (Hons.) in Electrical Engineering from Queen's University and a M.Sc. in Economics from the London School of Economics.

MORAY TAWSE

Mr. Tawse is Executive Vice President and Secretary of the Corporation, Executive Vice President of First National and Co-founder of First National. Mr. Tawse directs the operations of all of First National's commercial mortgage origination activities. With over 30 years of experience in the real estate finance industry, Mr. Tawse 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.

JOHN BROUGH

John Brough was President of both Torwest, Inc. and Wittington Properties Limited, real estate development companies, from 1998 to December 31, 2007. Prior thereto, from 1996 to 1998, Mr. Brough was Executive Vice President and Chief Financial Officer of iSTAR Internet, Inc. Prior thereto, from 1974 to 1996, he held a number of positions with Markborough Properties, Inc., his final position being Senior Vice President and Chief Financial Officer which position he held from 1986 to 1996. Mr. Brough is an executive with over 40 years of experience in the real estate industry. He is currently a director and Chairman of the Audit and Risk Committee of Kinross Gold Corporation. Mr. Brough was formerly a director and Chairman of the Audit Committee of Canadian Real Estate Investment Trust from 2008 to 2018. He holds a Bachelor of Arts degree (Economics) from the University of Toronto and is a Chartered Professional Accountant and a Chartered Accountant. He is also a graduate of the Institute of Corporate Directors – Director Education Program at the University of Toronto, Rotman School of Management. Mr. Brough is a member of the Institute of Corporate Directors and Chartered Professional Accountants of Ontario and Chartered Professional Accountants of Canada.

DUNCAN JACKMAN

Mr. Jackman is the Chairman, President and Chief Executive Officer of E-L Financial Corporation Limited, an investment and insurance holding company and has held similar positions with E-L Financial since 2003. Mr. Jackman is also the Chairman and President of Economic Investment Trust Limited and United Corporations Limited, both closed-end investment corporations, and has acted in a similar capacity with these corporations since 2001. Mr. Jackman sits on a number of public and private company boards. Prior to 2001, Mr. Jackman held a variety of positions including portfolio manager at Cassels Blaikie and investment analyst at RBC Dominion Securities Inc. Mr. Jackman holds a Bachelor of Arts from McGill University.

ROBERT MITCHELL

Mr. Mitchell President has been President of Dixon Mitchell Investment Counsel Inc., a Vancouver-based investment management company since 2000. Prior to that, Mr. Mitchell was Vice President, Investments at Seaboard Life Insurance Company. Mr. Mitchell has an MBA from the University of Western Ontario, a Bachelor of Commerce (Finance) from the University of Calgary and is a CFA charterholder. Mr. Mitchell sits on the board of Equestrian Canada.

BARBARA PALK

Ms. Palk retired as President of TD Asset Management Inc. in 2010 following a 30-year career in institutional investment and investment management. She currently serves as a Director of TD Asset Management USA Funds Inc. in New York, the Ontario Teachers' Pension Plan and Crombie Real Estate Investment Trust. Her previous board experience includes the Canadian Coalition for Good Governance, whose Governance Committee she chaired, Greenwood College School, the Investment Counselling Association of Canada, the Perimeter Institute, the Shaw Festival, UNICEF Canada and Queen's University, where she was the Chair of the board of Trustees. Ms. Palk is a member of the Institute of Corporate Directors, a Fellow of the Canadian Securities Institute and a CFA charterholder. She holds a Bachelor of Arts (Honours, Economics) degree from Queen's University, and in 2004 was named one of Canada's Top 100 Most Powerful Women.

ROBERT PEARCE

Robert Pearce serves on the board of directors of Canada Guaranty Mortgage Insurance Company, First American Payment Systems and CPI Card Group. Mr. Pearce spent 26 years with BMO Bank of Montreal from 1980 to 2006, most recently holding the position of President and Chief Executive Officer, Personal and Commercial Client Group. He also served on the board of directors of MasterCard International from 1998 to 2006 and as Chairman of the Canadian Bankers' Association from 2004 to 2006. Mr. Pearce holds a BA from the University of Victoria and an MBA from the University of British Columbia. Mr. Pearce brings to the board over 30 years of operational and leadership experience in the financial services industry.

STAKEHOLDER INFORMATION

CORPORATE ADDRESS

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ANNUAL MEETING

May 8, 2019, 9:00 a.m. EDT
TMX Broadcast Centre
The Gallery
The Exchange Tower
130 King Street West
Toronto, Ontario

SENIOR EXECUTIVES OF FIRST NATIONAL FINANCIAL LP

Stephen Smith
Co-founder, Chairman and Chief Executive Officer

Moray Tawse
Co-founder and Executive Vice President

Jason Ellis
Chief Operating Officer

Robert Inglis
Chief Financial Officer

Scott McKenzie
Senior Vice President, Residential Mortgages

Jeremy Wedgbury
Senior Vice President, Commercial Mortgages

Lisa White
Senior Vice President, Mortgage Operations

Hilda Wong
Senior Vice President and General Counsel

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AUDITORS

Ernst & Young LLP, Toronto, Ontario

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INVESTOR RELATIONS WEBSITE

www.firstnational.ca

REGISTRAR AND TRANSFER AGENT

Computershare Investor Services Inc.,
Toronto, Ontario
1.800.564.6253

EXCHANGE LISTING AND SYMBOLS

Common shares: (TSX) FN
Class A Series 1 Preference Shares: (TSX) FN.PR.A
Class A Series 2 Preference Shares: (TSX) FN.PR.B

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