

FIRST NATIONAL

FINANCIAL CORPORATION



Report to Shareholders

Period Ended March 31, 2014

Fellow Shareholders:

First National achieved solid performance in the first quarter of 2014. Mortgages under Administration (“MUA”) stood at a record \$77 billion, up 12% from March 31, 2013, an increase that reflected higher mortgage originations and characteristically strong renewal rates.

Despite severe winter weather in eastern and central Canada, and mortgage rate competition initiated by our largest competitors, single family mortgage originations of \$1.8 billion increased 13% from last year’s first quarter. Commercial segment mortgage originations were, in contrast, lower than last year by 11%, but at \$717 million, were within an acceptable range.

Revenue increased 19% to \$172.7 million from \$145.2 million in the first quarter of 2013. This positive performance reflected higher interest revenues on year-over-year growth in the Company’s securitization portfolio and mortgage investment income.

Pre-Fair Market EBITDA, which is a non-IFRS measure which we use to gauge underlying performance as it removes realized and unrealized gains and losses on financial instruments, was up 12% to \$41.4 million in the first quarter. Including the losses on financial instruments of \$8.2 million (loss of \$3.4 million in the first quarter of 2013), income before income taxes of \$31.3 million was \$0.1 million higher than in 2013. Net earnings in the first quarter were \$0.35 per common share in 2014 compared to \$0.36 per common share in 2013. These ratios include losses on financial instruments which reduced the Company’s earnings as Government of Canada bond yields fell in both periods.

First National declared dividends of \$0.36 per common share in the first quarter. As is typically the case in the first quarter, the Company paid out more free cash than it generated on account of working capital investments related to tax installments and the payment of 2013 accruals for employee bonuses. Accordingly, the first quarter payout ratio was 331%. Excluding these working capital amounts, this ratio would have been approximately 96%.

In recognition of the Company’s long-term growth in cash flow and positive outlook, the Board of Directors announced an increase in our common share dividend starting with the payment on April 15, 2014 for shareholders of record at March 31st. The new rate is \$0.125 per month or \$1.50 per share annualized.

Looking forward, the Company anticipates higher origination volumes in the second and third quarter, compared to the first quarter as the spring and summer seasons typically lead to more favorable buying conditions. This growth will be moderated by continued price competition and narrower margins. Despite positive spreads for mortgage funding, this competitive market may impact the spreads the Company earns on securitization. Overall, the Company plans to realize on the significant mortgage renewal opportunities available in upcoming quarters while focusing on sustainable profitability. Cash flow from our \$18 billion portfolio of mortgages pledged under securitization should help to maximize the Company’s financial performance.

Sincerely,

Stephen Smith
Chairman, President and Chief Executive Officer
First National Financial Corporation

Moray Tawse
Executive Vice President
First National Financial Corporation

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis of financial condition and results of operations is prepared as of April 29, 2014. This discussion should be read in conjunction with the unaudited consolidated financial statements of First National Financial Corporation (the "Company" or "Corporation" or "First National") as at and for the three months (the "period") ended March 31, 2014 and the notes thereto. This discussion should also be read in conjunction with the audited consolidated financial statements and notes thereto of the Company for the year ended December 31, 2013. The unaudited 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", "Adjusted Cash Flow", and "Adjusted Cash Flow per Share" 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 \$77 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.

Commencing in 2013, First National has also consolidated its interest in First National Mortgage Investment Fund (the "Fund"), which it launched in late 2012. Although the Company owns about 16% of the units issued by the Fund, because of its status as sole seller to the Fund and its rights as promoter, IFRS deems that First National exercises control over the Fund. The Fund was created to obtain economic exposure to a diversified portfolio of primarily commercial mezzanine mortgages. Through the Fund's consolidation, the Company has effectively taken on a portfolio of about \$66 million (December 31, 2013 - \$69 million) of mortgages. Because of the Company's small proportionate interest in the Fund's units, it has also recorded a \$45 million (December 31, 2013 - \$45 million) non-controlling interest in equity which offsets these assets.

First Quarter 2014 Results Summary

The Company was pleased with its results for the first quarter of 2014. The Canadian real estate market remained solid despite continued debate about an overheated housing market. This was evidenced in the single-family segment where First National's origination was up more than 13% when compared to the first quarter of 2013. Although new originations from the commercial segment were lower, together the Company increased overall origination by 5%. These volumes and consistent renewal rates have enabled the Company to grow its MUA and build the value of its portfolio of securitized mortgages.

- MUA grew to \$77.0 billion at March 31, 2014 from \$68.5 billion at March 31, 2013, an increase of 12%; the growth from December 31, 2013, when MUA was \$75.6 billion, was approximately 2%, an annualized increase of 7%;
- The Canadian single-family real estate market, which was markedly slow in the first quarter of 2013, turned more favourable for the rest of 2013 into 2014. Single-family mortgage originations for the Company increased by over 13% to \$1.8 billion in the first quarter of 2014 from \$1.6 billion in 2013. The commercial segment had a slower start to the year as transactions dropped off in this market; volumes decreased by 11%, from \$809 million in 2013 first quarter to \$717 million in the 2014 first quarter. Together, overall origination increased by just under 5% year over year;
- The Company took advantage of its renewal opportunities in the quarter, renewing \$441 million of single-family mortgages. Although retention rates were similar in each quarter, in the 2013 comparative quarter the Company renewed \$767 million of single-family mortgages on more renewal opportunities. For the commercial segment in the first quarter, 2014 renewals grew to \$274 million from \$153 million in 2013.
- During the first quarter of 2014, the Company used the Canada Mortgage Bonds ("CMB") program to successfully securitize about \$173 million of multi-unit mortgages in the 10-year program and \$73 billion mortgages in the five-year term program. First National also securitized \$29 million of mortgages for CMB replacement purposes in the quarter;
- Revenue for the first quarter of 2014 increased to \$172.7 million from \$145.2 million in the 2013 comparative quarter. The growth of 19% is reflective of a growing business, particularly from higher interest revenues on the Company's securitized mortgage portfolio. Interest revenue from securitized mortgages increased revenue by over \$30 million or about 21% year over year;
- Income before income taxes in the first quarter was relatively flat 2014 when compared to 2013. This measure increased by less than 1%, from \$31.2 million in 2013 to \$31.3 million in 2014. The small increase was due in part to losses on financial instruments as a consequence of falling yields in the bond market which negatively affected the carrying value of the Company's economic hedges. While both quarters were affected adversely, the impact in the 2014 quarter was more severe;
- Without the impact of the losses on financial instruments, which have been significant, the Company's earnings before income taxes, depreciation and amortization ("Pre-FMV EBITDA") for the first quarter increased by 12%, from \$36.9 million in 2013 to \$41.4 million in 2014. This increase is due to the steady growth of the Company's core business, including increased net margin on securitized mortgages and mortgage investment income.

Outstanding Securities of the Corporation

At March 31, 2014 and April 29, 2014, the Corporation had 59,967,429 common shares, 4,000,000 Class A preference shares, Series 1 and 175,000 debentures outstanding.

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 |
|----------------|-----------|------------------------------|--|-----------------------------------|--------------|
| 2014 | | | | | |
| First Quarter | \$172,705 | \$23,061 | \$41,388 | \$0.35 | \$21,683,307 |
| 2013 | | | | | |
| Fourth Quarter | \$200,928 | \$41,821 | \$53,401 | \$0.66 | \$20,569,217 |
| Third Quarter | \$200,522 | \$39,399 | \$56,124 | \$0.63 | \$19,930,780 |
| Second Quarter | \$229,830 | \$67,845 | \$51,193 | \$1.10 | \$18,793,683 |
| First Quarter | \$145,228 | \$23,036 | \$36,864 | \$0.36 | \$17,163,697 |
| 2012 | | | | | |
| Fourth Quarter | \$156,092 | \$33,491 | \$41,765 | \$0.54 | \$15,022,236 |
| Third Quarter | \$181,573 | \$32,047 | \$40,597 | \$0.51 | \$14,311,584 |
| Second Quarter | \$156,983 | \$18,099 | \$39,610 | \$0.28 | \$13,682,980 |

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

Given First National's large amount of MUA and portfolio of mortgages pledged under securitization, quarterly revenue under IFRS is driven primarily by mortgage servicing revenue growth and the gross interest earned on the mortgages pledged under securitization. Servicing revenue will change as the third-party portfolio of mortgages grows or contracts. The gross interest on the mortgage portfolio is dependent both on the size of the portfolio of mortgages pledged under securitization as well as weighted average mortgage rates. All of these factors have increased over the last 24 months as the Company has steadily increased MUA and its portfolio of securitized mortgages. Net income is also dependent on conditions in the debt markets, which affect the value of gains and losses on financial instruments arising from the Company's interest rate hedging program. Accordingly, the movement of this measurement between quarters is related to factors external to the business of the Company (primarily conditions in the bond markets). By removing this volatility and analyzing Pre-FMV EBITDA, a clearer view of the Company's performance can be assessed.

Generally, in the last eight quarters the Company has endeavoured to grow its origination volumes in order to build its servicing portfolio and to enable it to securitize larger amounts of mortgages in the NHA-MBS market. This longer-term strategy has been successful and Pre-FMV EBITDA has grown steadily to over \$197 million for 2013. The table above shows a trend of growing income reflecting typical Canadian seasonality: slower first quarters and stronger subsequent quarters.

Selected Annual Financial Information for the Company's Fiscal Year

(\$000s, except per share amounts)

| | December 31, 2013 | December 31, 2012 | December 31, 2011 |
|---|----------------------|----------------------|----------------------|
| For the Year then ended | | | |
| Income Statement Highlights | | | |
| Revenue | 776,508 | 628,613 | 464,020 |
| Interest expense – securitized mortgages | (323,236) | (246,736) | (184,291) |
| Brokerage fees | (84,420) | (115,978) | (81,480) |
| Salaries, interest and other operating expenses | (127,404) | (106,547) | (91,642) |
| Add (deduct): realized and unrealized (gains) losses on financial instruments | (43,866) | (6,153) | 18,485 |
| Pre-FMV EBITDA ⁽¹⁾ | 197,582 | 153,199 | 125,092 |
| Amortization of capital assets | (2,374) | (2,059) | (1,856) |
| Amortization of intangible assets | (5,563) | (6,468) | (7,968) |
| Add (deduct): realized and unrealized gains (losses) on financial instruments | 43,866 | 6,153 | (18,485) |
| Provision for income taxes | (61,410) | (40,500) | (26,292) |
| Net Income | 172,101 | 110,325 | 70,491 |
| Dividends declared | 90,294 | 80,859 | 109,022 |
| Per Share Highlights | | | |
| Net Income per common share | 2.75 | 1.76 | 1.10 |
| Dividends per common share | 1.38 | 1.27 | 1.25 |
| At Year End | | | |
| Balance Sheet Highlights | | | |
| Total assets | 20,569,217 | 15,022,236 | 11,927,270 |
| Total long-term financial liabilities | 179,195 | 181,275 | 184,689 |

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

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

Growth in Portfolio of Mortgages under Administration

Management considers the growth in 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 values such as servicing fees, mortgage administration fees, renewal opportunities and the growth of the customer base for marketing initiatives. As at March 31, 2014, MUA totalled \$77.0 billion, up from \$68.5 billion at March 31, 2013, an increase of 12%. This compares to \$75.6 billion at December 31, 2013, representing a quarter-over-quarter increase of 2% and an annualized increase of about 7%.

Growth in Origination of Mortgages

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 are decreased. The Company can also decide to securitize more mortgages to take advantage of its origination in periods of wider mortgage spreads. Prior to 2008, when the capital markets experienced some significant turbulence, the prime mortgages that the Company originated had tight spreads such that the Company's strategy was to sell these mortgages on commitment to institutional investors and retain the servicing. This strategy changed with the challenges in the credit environment. The Company elected to invest in more mortgages directly and earn the mortgage spread for itself through securitization. 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 | 1.76% |
| 2010 | 1.75% |
| 2011 | 1.76% |
| 2012 | 1.92% |
| 2013 | 1.75% |
| First quarter 2014 | 1.48% |

The table lists 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 2011, liquidity issues at financial institutions diminished and the competition for mortgages increased such that spreads remained consistently higher than pre-crisis levels. In mid 2011, the United States credit rating was downgraded and interest rates fell significantly, accounting for wider spreads in 2012 which tightened once again in 2013. However in 2014, more competitive pressures have taken mortgage rates lower and compressed spreads to 2007 levels. Since 2007, the Company has chosen to employ more of its origination in its securitization strategy to take advantage of these spreads recently using a larger portion of its renewal volume to achieve its annual targets. However, current spreads are still profitable and the Company will continue to take some of its new origination, in both the single-family and multi-family segments, for securitization purposes. In the first quarter of 2014, the Company originated and renewed for securitization purposes approximately \$1.3 billion of single-family mortgages and \$192 million of multi-unit residential mortgages in order to take advantage of these spreads. In the first quarter of 2014, the Company securitized through NHA-MBS approximately \$375 million of floating rate single-family mortgages, \$805 million of fixed rate single-family mortgages and \$189 million of fixed rate multi-unit residential mortgages.

Lowering Costs of Operations

Innovations in Systems and Technology

The Company has always used technology to provide for efficient and effective operations. This is particularly true for its MERLIN underwriting system, Canada's only web-based, real-time broker information system. By creating a paperless, 24/7 commitment management platform for mortgage brokers, the Company is now ranked among the top three lenders by market share in the broker channel. This has translated into increased single-family origination volumes and higher closing ratios (the percentage of mortgage commitments the Company issues that actually become closed mortgages).

Increase of Bank Credit Facility

The Company uses a revolving line of credit with a syndicate of banks. At March 31, 2014, the commitment under the facility totalled \$1 billion up from \$570 million at the end of 2013. This facility enables the Company to fund the increasing amount of mortgages accumulated for securitization. The entire facility is floating rate and has a four-year term. The Company has elected to undertake this increased debt for a number of reasons: (1) the transaction increases the amount of debt available to fund mortgages originated for securitization purposes; (2) the debt is revolving and can be used and repaid as the Company requires, providing more flexibility than the debenture debt, which is always fully drawn; (3) the four-year term extension gives the Company a committed facility that strategically extends the maturity of this debt beyond that of the debenture in 2015; and (4) the cost of borrowing reflects the Company's BBB issuer rating.

Preferred Share Issuance

On January 25, 2011, the Company issued 4,000,000 1 Class A preference shares, Series 1 for gross proceeds of \$100 million. The Company received net proceeds of \$97.4 million after issuance costs net of deferred tax assets of \$0.9 million. These shares are rate reset preferred shares having a stated 4.65% annual dividend rate, subject to Board of Director approval, and a par value of \$25 per share. The rate reset feature is at the discretion of the Company such that after the initial five-year term, the Company can choose to extend the shares for another five-year term at a fixed spread (2.07%) over the yield of the then-relevant Government of Canada bond. While the investors in these shares have an option on each five-year anniversary to convert their Series 1 holdings into Series 2 preference shares (which pay floating rate dividends), there are no redemption options for these shareholders. As such, the Company considers these shares to represent a permanent source of capital and classifies the shares as equity on its balance sheet. Management believes this capital will give the Company the opportunity to pursue its strategy of increased securitization, which requires upfront investment.

Employing Innovative Securitization Transactions to Minimize Funding Costs

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

The Company has been involved in the issuance of NHA-MBS since 1995. This program has been very successful, with over \$10 billion of NHA-MBS issued. In December 2007, the Company was approved by Canada Mortgage and Housing Corporation (“CMHC”) as an issuer of NHA-MBS and as a seller into the CMB program. Issuer status has provided the Company with a funding source that it can access independently. Perhaps more importantly, seller status for the CMB gives the Company direct access to the CMB. Generally, the demand for high-quality fixed and floating rate investments increased significantly with the turmoil in 2009. This demand has continued into 2014 and allowed the Company to fund almost \$1.5 billion of mortgages through the NHA-MBS and CMB programs during the quarter. In August 2013, CMHC announced that it would be limiting the amount of guarantees it would issue on NHA-MBS pools created for sale to the “market”. CMHC indicated that the amount of guarantees it was providing for such market pools (primarily any pool not sold to the Canada Housing Trust (“CHT”) for the CMB) was growing significantly. In order to better control the absolute amount of risk that it takes on in this respect, CMHC will implement policies to allocate the amount of guarantees it provides in future. The current amount being allocated to each issuer is approximately the amount that First National is using each month, but the new policies could restrict the amount of growth the Company can plan for in the MBS market. These rules are similar to the CMB allocation rules described below, which have been in place since 2008.

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. Because of the similarities to a traditional Government of Canada bond (both have five- and 10-year unamortizing terms and a federal government guarantee), the CMB trades in the capital markets at a modest premium to the yields on Government of Canada bonds. 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. The Company also enjoys demand for mortgages from investment dealers who sell directly into the CMB. Because of the effectiveness of the CMB, there have been requests from approved CMB sellers for larger issuances. CHT has indicated that it will not unduly increase the size of its issuances and has created guidelines through CMHC that limit the amount that can be sold by each seller into the CMB each quarter. The Company is subject to these limitations.

Key Performance Indicators

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

- Earnings before income taxes, depreciation and amortization, and losses and gains on financial instruments (“Pre-FMV EBITDA”⁽¹⁾); and
- Adjusted cash flow from operations (“Adjusted Cash Flow”).

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

| | Quarter ended | |
|--------------------------------|-------------------|-------------------|
| | March 31, 2014 | March 31, 2013 |
| For the Period | (\$ 000's) | |
| Revenue | 172,705 | 145,228 |
| Income before income taxes | 31,261 | 31,236 |
| Pre-FMV EBITDA ⁽¹⁾ | 41,388 | 36,864 |
| At Period end | | |
| Total assets | 21,683,307 | 17,163,697 |
| Mortgages under administration | 76,974,628 | 68,462,517 |

Note:

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

Adjusted Cash Flow is not a defined term under IFRS. Management believes that net cash generated by the Company prior to investing and financing activities is an important measure for investors to monitor. Management cautions investors that, due to the Company's nature as a mortgage seller and securitizer, there will be significant variations in this measure from quarter to quarter as the Company collects and invests cash from mortgage transactions. Adjusted Cash Flow is determined by the Company as cash provided from operating activities increased/decreased by the change in mortgages accumulated for sale or securitization in the period. These mortgages consist primarily of mortgages that the Company funds ahead of securitization transactions. Normally, during the three months after funding, the Company aggregates all relevant mortgages "warehoused" to date and creates a pool to sell to the NHA-MBS market or CMB. As the Company typically raises term debt through the securitization markets on these mortgages in the months subsequent to the month of funding, there are large amounts of cash invested at quarter ends. The Company's credit facilities provide full financing for the majority of these mortgage loans. Accordingly, management believes the measure of Adjusted Cash Flow is meaningful only if the change in mortgages accumulated for sale between reporting periods is adjusted. The calculation also adjusts for the cash needed for investment in capital assets.

Determination of Adjusted Cash Flow and Payout Ratio

| | Quarter ended | |
|--|-------------------|-------------------|
| | March 31, 2014 | March 31, 2013 |
| For the Period | (\$ 000's) | |
| Cash provided by (used in) operating activities | (49,686) | (191,503) |
| Add (deduct): | | |
| Change in mortgages accumulated for sale or securitization between periods | 59,836 | 207,402 |
| Additions to property, plant and equipment | (2,494) | (1,299) |
| Adjusted Cash Flow ⁽¹⁾ | 7,656 | 14,600 |
| Less: cash dividends on preference shares | (1,163) | (1,163) |
| Adjusted Cash Flow available for common shareholders | 6,493 | 13,437 |
| Adjusted Cash Flow per Common Share (\$/share) ⁽¹⁾ | 0.11 | 0.22 |
| Dividends declared on Common Shares | 21,488 | 19,989 |
| Dividends declared per Common Share (\$/share) | 0.36 | 0.33 |
| Payout Ratio | 331% | 149% |

Note:

- (1) These non-IFRS measures adjust cash provided by (used in) operating activities by accounting for changes between periods in mortgages accumulated for sale or securitization and mortgage securitization activity. 2013 figures have been restated to conform to the current calculation.

For the quarter ended March 31, 2014, the payout ratio was 331%, much higher than the 149% ratio reported in the first quarter of 2013. Typically the first quarter of the Company's fiscal year has shown payout ratios in excess of 100% as the first quarter requires the payment of certain accrued expenses from the previous year end. These include payments related to the single-family broker volume bonus program, and the payout of employee commissions and bonuses. In 2014 this was particularly apparent as the Company invested \$16.0 million (or about \$0.26 per common share) in working capital including: \$9.2 million for employee bonus payments and \$7.9 million for instalments relate to corporate tax payments for fiscal 2013 as well as 2014. Without this investment in working capital, the payout ratio would have been about 96% for the first quarter of 2014. Generally new securitizations reduce cash provided from operations as the Company invests in broker fees to originate the mortgages and incurs the related costs required to raise the securitization debt. In the 2014, cash flow from existing securitizations was enough to offset the investment in new transactions. In the 2013 comparative quarter, the Company invested about \$9 million in new securitizations. Cash flow in both quarters was also negatively affected by the losses on financial instruments which for the 2014 quarter were primarily realized losses which required cash settlement.

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 provides the Company with servicing fees to complement revenue earned through originations. For the quarter ended March 31, 2014, new origination volume increased from \$2.4 billion to \$2.5 billion, or about 5%, compared to first quarter 2013.

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 revenue 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 \$3.2 billion of new originations and renewals for the quarter ended March 31, 2014, \$1.5 billion was originated for securitization purposes.

Placement Fees and Gain on Deferred Placement Fees

The Company recognizes revenue at the time that a mortgage is placed with an institutional investor. Cash amounts received in excess of the mortgage principal at the time of placement are recognized in revenue as "placement fees". The present value of additional amounts expected to be received over the remaining life of the mortgage sold (excluding normal market-based servicing fees) is recorded as a "deferred placement fee". A deferred placement fee arises when mortgages with spreads in excess of a base spread are sold. Normally the Company would earn an upfront cash placement fee, but investors prefer paying the Company over time as they earn net interest margin on such transactions. Upon the recognition of a deferred placement fee, the Company establishes a "deferred placement fee receivable" that is amortized as the fees are received by the Company. Of the Company's \$3.2 billion of originations in the first quarter of 2014, \$1.7 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

The Company services virtually all mortgages generated through its mortgage origination activities on behalf of a wide range of institutional investors. Mortgage servicing and administration is a key component of the Company’s overall business strategy and a significant source of continuing income and cash flow. In addition to pure servicing revenues, fees related to mortgage administration are earned by the Company throughout the mortgage term. Another aspect of servicing is the administration of funds held in trust, including borrowers’ property tax escrow, reserve escrow 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.

Results of Operations

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

| Mortgage Originations by Segment | Quarter ended | |
|--|-----------------------|-----------------------|
| | March 31, 2014 | March 31, 2013 |
| | (\$ millions) | |
| New Single-family residential | 1,807 | 1,589 |
| New Multi-unit and commercial | 717 | 809 |
| Sub-total | 2,524 | 2,398 |
| Single-family residential renewals | 441 | 767 |
| Multi-unit and commercial renewals | 274 | 153 |
| Total origination and renewals | 3,239 | 3,318 |
| Mortgage Originations by Funding Source | | |
| Institutional investors – residential | 924 | 969 |
| Institutional investors – multi/commercial | 759 | 544 |
| NHA-MBS/ CMB/ ABCP securitization | 1,486 | 1,727 |
| Internal Company resources | 70 | 78 |
| Total | 3,239 | 3,318 |
| Mortgages under Administration | | |
| Single-family residential | 58,929 | 50,584 |
| Multi-unit residential and commercial | 18,046 | 17,879 |
| Total | 76,975 | 68,463 |

Total new mortgage origination volumes increased in the first quarter of 2014 compared to the same period in 2013 by more than 5% as the single-family housing market did better in comparison to the slow start in 2013. Single-family volumes increased by over 13% year over year as demand for housing continued. Management had hoped for a larger increase in this segment; however an unseasonably long winter in central Canada and increased competition on mortgage rates mitigated this growth. New commercial segment originations decreased in the first quarter of 2014, falling by 11% compared to the 2013 quarter; however, when combined with renewals in the segment, total production increased from \$962 million in the 2013 quarter to \$991 million in 2014, or by 3%. The low interest rate environment which existed for most of 2013 has continued into 2014, stimulating increased real estate transactions. Together with the Company's expertise in underwriting CMHC mortgages, these rates drove origination volumes. Origination for direct securitization into NHA-MBS, CMB and ABCP programs remained a large part of the Company's strategy although volumes decreased from \$1.7 billion in the 2013 quarter to almost \$1.5 billion in the 2014 quarter.

Total revenues for the quarter ended March 31, 2014 increased by about 19% compared to the quarter ended March 31, 2013, from \$145.2 million to \$172.7 million. This measure increased largely because of higher interest revenue on the larger portfolio of mortgages pledged under securitization and mortgage investment income.

Net Interest - Securitized Mortgages

Comparing the quarter ended March 31, 2014 to the quarter ended March 31, 2013, "net interest - securitized mortgages" increased by 13% to \$27.4 million from \$24.3 million. The increase was due to a larger portfolio of securitized mortgages offset by tighter weighted-average spreads on the portfolio year over year. The portfolio of mortgages funded through securitization increased from \$14.0 billion as at March 31, 2013 to \$18.7 billion as at March 31, 2014; however, the market for prime mortgages became more competitive as the Company grew this portfolio. At March 31, 2013, the Company's securitized mortgage portfolio earned gross spreads of approximately 1.03%. By March 31, 2014, as higher-spread securitizations amortized down and new securitizations were entered into at tighter spreads, the weighted-average gross spread decreased to 0.97%. The 2014 first quarter has also been affected by the ongoing impact of the large gains on financial instruments recorded in 2013. As described in 2013, these gains will be reflected in narrower spreads on the mortgages in the future and lower net interest margins over the terms of the securitized mortgages. The impact in the first quarter of 2014 was to reduce the Company's net interest margin by approximately \$1.8 million. Net interest is also affected by the amortization of deferred origination costs and fair value adjustments that are capitalized on securitized mortgages.

Placement Fees

Placement fee revenue decreased 7% to \$17.8 million from \$19.1 million. This decrease is due to lower volumes originated for residential institutional investors offset by higher per unit pricing on a portion of the Company's residential origination. This portion of new single-family origination volume, excluding single-family renewal volume, decreased by 17% from the 2013 first quarter to the 2014 first quarter. The Company also earned about \$1 million of additional fees from mortgage renewals as it negotiated higher placement fees on renewal with its institutional investors and placed more renewal origination in 2014 as opposed to 2013.

Gains on Deferred Placement Fees

Gains on deferred placement fees revenue increased 23% to \$2.7 million from \$2.2 million. The gains relate to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Although volumes for these transactions increased by 54% from the 2013 first quarter to the 2014 first quarter, generally, spreads on these transactions tightened in 2014 so that the Company realized lower per unit gains.

Mortgage Servicing Income

Mortgage servicing income increased 3% to \$23.0 million from \$22.4 million. This increase was primarily due to the growth in the amount of MUA, which grew by 12% year over year. This growth rate reflects the growth of MUA for the Company's securitization programs of 42% and third-party MUA growth of 5% between 2013 and 2014. At March 31, 2014, there were approximately \$19.8 billion of mortgages in MUA on which the Company earned net interest spread as opposed to servicing revenue. This has grown from \$13.9 billion in 2013. As the securitized portfolio has grown and become a larger part of MUA, mortgage servicing has been sacrificed for interest spread as recorded in "net interest - securitized mortgages" revenue. The Company's average rate of servicing has also dropped as volume discount thresholds for some residential investors have been reached.

Mortgage Investment Income

Mortgage investment income increased 19% to \$12.4 million from \$10.4 million. The change is largely due to the Company's larger securitization program. As the Company elects to securitize more of its origination, mortgages accumulated for securitization increase and earn the Company higher interest income in the warehousing period prior to securitization. This is particularly true for the CMB program, for which the warehousing period is as long as four months. The remaining change is a combination of offsetting factors, including about \$1.3 million of mortgage interest earned on consolidation of the \$66 million of mortgages held through the Fund.

Realized and Unrealized Gains (Losses) on Financial Instruments

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

| Summary of realized and unrealized gains (losses) on financial instruments | Quarter ended | |
|---|---------------------------|---------------------------|
| | March 31, 2014 | March 31, 2013 |
| | (\$ 000's) | |
| Losses on short bonds used for the economic hedging program | (14,903) | (6,429) |
| Gains related to the mortgages designated at fair value net of interest rate swaps | 6,747 | 2,943 |
| Gains on deferred placement fees receivable | 27 | 16 |
| Other gains (losses) | (40) | 61 |
| Total losses on financial instruments | (8,169) | (3,409) |

For most of 2013, Canadian capital markets were relatively upbeat. The impact of an improving global economy and recovery in Canada meant that bond yields increased and prices fell. This momentum faltered in early 2014 and bond yields dropped by 0.25% from December 31, 2013 to March 31, 2014. For the Company, this meant the value of holding short bond positions as a hedge against its mortgages pending securitization decreased and the Company recorded significant losses related to the valuation of these financial instruments.

The Company uses short Government of Canada bonds (including CHT-issued bonds) together with repurchase agreements to create forward interest rate contracts to hedge the interest rate risk associated with fixed rate mortgages originated for its own securitization programs. For accounting purposes, these do not qualify as interest rate hedges as the bonds used are not derivatives but simple cash-based financial instruments. These gains or losses are recorded in the period in which the bond yields change; however, the offsetting economic gains or losses are not recorded in the same period. Instead, the resulting economic gain (or loss) will be reflected in wider or narrower spreads on the mortgages pledged for securitization and will be realized in net interest margin over the terms of the mortgages and the related debts. In the first quarter of 2014, the Company recorded losses on these hedges of \$14.9 million (2013 - \$6.4 million). While these losses decreased the current quarter's net income, the gross spread on the related portfolio of securitized mortgages going forward will be proportionally wider as the Company has issued securitization-related debt at lower interest rates than it would have prior to the movement in bond yields. In order to adequately hedge its interest rate exposure, the Company had almost \$1 billion of bonds sold short at the end of the first quarter of 2014.

The portion of the Company's mortgages which is held at fair value (primarily those funded through ABCP), was affected positively by the change in yields; however, these gains were offset by losses on the value of the interest rate swaps, which were used to hedge all fixed rate mortgages in this portfolio. The mortgages were favourably affected by lower rates of prepayment and the tightening of mortgage funding spreads experienced within the quarter, which made existing mortgages comparatively more valuable. The Company also profited from the renewed mortgages which have been measured at fair value. These renewals created immediate gains for the Company, as renewed mortgages typically do not require the payment of an upfront brokerage fee. The net fair value of the gains and losses on all mortgages held at fair value was a \$6.7 million net gain for the quarter.

Brokerage Fees Expense

Brokerage fees expense decreased 18% to \$9.8 million from \$12.0 million. This decrease is largely explained by lower origination of single-family mortgages for institutional investors, which fell by 17%. Commercial broker fees also decreased to account for the additional 1% decrease in these expenses.

Salaries and Benefits Expense

Salaries and benefits expense increased 2% to \$16.2 million from \$15.9 million. The increase is due primarily to an increase in headcount offset by lower employee costs associated with commercial segment origination. The Company compensates its commercial sales staff with commissions based on the profitability of originated mortgages. Commercial origination decreased by 11% from first quarter 2013 to 2014, and sales compensation decreased by \$0.7 million year over year. As at March 31, 2014, the Company had 676 employees, compared to 643 as at March 31, 2013. The 5% increase in headcount is largely needed to meet the administrative demand associated with the increased MUA, which grew by 12% year over year. Management salaries were paid to the two senior executives (Co-founders) who together control about 77% of the Company's common shares. The current period expense is a result of the compensation arrangement executed on the closing of the initial public offering ("IPO").

Interest Expense

Interest expense increased 18% to \$6.7 million from \$5.7 million. As discussed in the “Liquidity and Capital Resources” section of this analysis, the Company warehouses a portion of the mortgages it originates prior to settlement with the ultimate investor or funding with a securitization vehicle. The Company uses the debenture together with a \$1 billion credit facility with a syndicate of banks and 30-day repurchase facilities to fund the mortgages during this period. The overall interest expense has increased from the prior period due to increased use of these facilities to warehouse the larger amounts of mortgages originated for the Company’s securitization programs. As at March 31, 2014, the Company had borrowed \$1.1 billion using these facilities, compared to \$1.0 billion as at March 31, 2013. Generally, interest expense would have been higher but for the increased use of 30-day repurchase facilities.

Other Operating and Amortization of Intangibles Expenses

Other operating and amortization of intangibles expenses increased 8% to \$11.0 million from \$10.2 million. The amortization of intangible assets recognized on the IPO was \$1.3 million in the 2014 first quarter compared to \$1.6 million in the 2013 comparative quarter, as some of these assets became fully amortized in 2013. Other operating expenses increased by \$1.2 million as the Company incurred higher costs related to its growth and the increased size of its securitization program, including costs for rent and mortgage servicing, which together increased \$0.7 million year over year.

Non-Controlling Interests

This amount relates to the amount of the net income earned from the First National Mortgage Investment Fund that pertains to interests other than the Company. The amount has increased during 2014 as the Fund’s operations became more profitable as it levered up its operations to maximize capital efficiency.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes increased less than 1% to \$31.3 million from \$31.2 million. The small increase was partially the result of a falling interest rate environment, which negatively affected the Company’s interest rate hedges in both quarters. Pre-FMV EBITDA, which eliminates the impact of the gains and losses on financial instruments, increased 12% to \$41.4 million from \$36.9 million. The increase was largely due to the combination of higher net interest on securitized mortgages and increased placement fees net of broker fees. Together these provided the Company with \$4.0 million of additional pre-tax profit.

Provision for Income Taxes

The provision for taxes was the \$8.2 million in each of the comparative quarters as net income was very similar year to year and the effective tax rate of 26.3% did not change significantly.

Operating Segment Review

The Company aggregates its business from two segments for financial reporting purposes: (i) Residential (which includes single-family residential mortgages); and (ii) Commercial (which includes multi-unit residential and commercial mortgages), as summarized below:

| Operating Business Segments | | | | |
|------------------------------------|----------------------------------|------------------------------|---------------------------|------------------------------|
| | Residential | | Commercial | |
| | (\$000's except percent amounts) | | | |
| Quarter ended | March 31, 2014 | March 31, 2013 | March 31, 2014 | March 31, 2013 |
| Originations and renewals | 2,247,417 | 2,355,389 | 990,387 | 961,174 |
| <i>Percentage change</i> | <i>(4.6%)</i> | | <i>3.0%</i> | |
| Revenue | 129,114 | 105,125 | 43,591 | 40,103 |
| <i>Percentage change</i> | <i>22.8%</i> | | <i>8.7%</i> | |
| Income before income taxes | 23,634 | 21,157 | 7,627 | 10,079 |
| <i>Percentage change</i> | <i>11.7%</i> | | <i>(24.3%)</i> | |
| Period ended | March 31, 2014 | December 31, 2013 | March 31, 2014 | December 31, 2013 |
| Identifiable assets | 17,309,595 | 16,282,131 | 4,343,936 | 4,257,310 |
| Mortgages under administration | 58,929,145 | 57,652,258 | 18,045,483 | 17,966,745 |

Residential Segment

Overall residential origination including renewals decreased by 5% between the first quarters of 2014 and 2013 while residential revenues increased by about 23%. Part of the increase in revenue is due to the change in gains and losses on financial instruments. Excluding these changes, revenue increased by 24% as the securitized mortgage portfolio grew and produced higher interest revenue. The net change in losses on financial instruments of \$2.1 million also affected net income before income taxes. Without the impact of such fair value changes, net income before income taxes for the residential segment would have grown by 19% year over year, indicative of MUA growth of 9% and higher net margins on placement fees and securitized mortgages. Identifiable assets have increased since December 31, 2013, as the Company added more than \$750 million of net single-family mortgages to mortgages pledged under securitization, and almost \$250 million of government bonds purchased for hedging purposes.

Commercial Segment

Commercial revenues increased by almost 9% from the prior year's quarter, 15% if the impact of changes in losses on the fair value of financial instruments is excluded. This growth is due to higher overall origination and to higher interest revenue on the Company's commercial segment securitized mortgage portfolio offset by tighter margins on placement and deferred placement as the multi-unit residential mortgage market has become more competitive. Without fair value amounts, net income before tax increased by about \$0.2 million year over year, or an increase of just 2%, as tighter mortgage spreads and the amortization of the large fair value gains from 2013 reduced operating efficiency. Identifiable assets have increased from those at December 31, 2013, as the Company increased its securitized portfolio of multi-unit residential mortgages through NHA-MBS by almost \$250 million. This growth was offset by the reduction of almost \$100 million in the amount of government bonds purchased for hedging purposes and the amount of mortgages accumulated for securitization at period end.

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 will always be well bid and highly liquid. This strategy proved effective during the turmoil experienced in 2007 through 2009, when capital markets retreated and only the highest-quality assets were bid. As the Company's results in those years have shown, First National had little, if any, 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 debenture loan and the Company's revolving bank credit facility. This aggregate indebtedness is typically used to fund: (1) mortgages accumulated for sale or securitization, (2) deferred placement fees receivable, (3) the origination costs associated with securitization, and (4) mortgage and loan investments. The Company has a credit facility with a syndicate of eight financial institutions for a total credit of \$1 billion. This facility was closed in January 2014 for a four-year term. Bank indebtedness may also include borrowings obtained through overdraft facilities. At March 31, 2014, the Company has entered into repurchase transactions with financial institutions to borrow \$513 million related to \$519 million of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At March 31, 2014, outstanding bank indebtedness (excluding bank indebtedness at the Fund level) was \$421.3 million (December 31, 2013 - \$260.3 million). Together with the debenture financing of \$175 million (December 31, 2013 - \$175 million), this "combined debt" was used to fund \$609.5 million (December 31, 2013 - \$454.8 million) of mortgages accumulated for sale or securitization. At March 31, 2014, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of \$33.8 million (December 31, 2013 - \$33.6 million) and (2) mortgage and loan investments of \$178.0 million (December 31, 2013 - \$184.6 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 remained at \$nil as at December 31, 2013 and March 31, 2014. Effectively the Company's bank, debenture and repo debt have been used entirely to fund mortgages accumulated for sale or securitization such that there is no debt needed to fund any other part of the Company's operations.

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

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

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. In June 2011, CMHC issued new regulations regarding the timing of mortgage title transfer to its custodian. The notice requires that cash collateral be posted immediately on pool settlement with the custodian on a dollar-for-dollar basis for all mortgages not registered with the custodian. Due to the difficulty in obtaining evidence from land registry offices on a timely basis, the Company has been required to post cash collateral for the pending

title transfers. At March 31, 2014, \$0.4 million (December 31, 2013 - \$4.8 million) of this collateral was held by the custodian. The collateral will be repaid to the Company as registration is subsequently evidenced to the custodian on these mortgages. The other significant portion of cash collateral is the investment made on behalf of the Company's ABCP programs. As at March 31, 2014, the investment in cash collateral was \$15.4 million (December 31, 2012 - \$20.0 million).

As demonstrated previously, the Company continues to see strong demand for its mortgage product from institutional investors and liquidity from bank-sponsored commercial paper conduits. By focusing on the prime mortgage market, the Company believes it will continue to attract bids for mortgages as its institutional customers seek government-insured assets for investment purposes. The Company also believes it can manage any liquidity issues that would arise from a year-long slowdown in origination volumes. Based on cash flow received in the first quarter of 2014, the Company will receive approximately \$78 million of cash, on an annualized basis, from its servicing operations and \$120 million of annualized cash flow from securitization transaction spread and deferred placement fees receivables. Together, on an after-tax basis, this \$146 million of annual cash flow would be more than sufficient to support the annual dividends of \$90 million on the common shares and the \$4.65 million on the preference shares. Although this is a simplified analysis, it does highlight the sustainability of the Company's business model and dividend policy through periods of economic weakness.

As described earlier, the Company issued 4,000,000 Class A preference shares, Series 1 at a price of \$25.00 per share for gross proceeds of \$100 million, before issue expenses. The net proceeds of \$96.7 million were invested in FNFLP as partners' capital. The issuance gives the Company additional capital, which will allow it to undertake greater volumes of securitization transactions directly and reduce reliance on institutional investors as a funding source.

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

Financial Instruments and Risk Management

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

The Company believes its hedging policies are suitably designed such that the interest rate risk of holding mortgages prior to securitization is mitigated. From an accounting perspective, any gains or losses on these instruments are recorded in the current period, as the Company’s economic hedging strategy does not qualify as hedging for accounting purposes. The Company uses bond forwards (consisting of bonds sold short and bonds purchased under resale agreements) to manage interest rate exposure between the time a mortgage rate is committed to the borrower and the time the mortgage is transferred to the securitization vehicle and the matched term debt is arranged. As interest rates change, the value of these short bonds will vary inversely with the value of the related mortgages. As interest rates increase, a gain will be recorded on the bonds, which should be offset by a tighter interest rate spread between the interest rates on mortgages and the securitization debt. This spread will be earned over the term of the related mortgages. For single-family mortgages, primarily mortgages for the Company’s own securitization programs, only some of the mortgage commitments issued by the Company eventually fund. The Company must assign a probability of funding to each mortgage in the pipeline and estimate how that probability changes as mortgages move through the various stages of the pipeline. The amount that is actually hedged is the expected value of mortgages funding within the next 120 days (120 days being the standard maximum rate hold period available for the mortgages). As at March 31, 2014, the Company had \$955 million of notional forward bond positions related to its single-family programs. For multi-unit residential and commercial mortgages, the Company assumes all mortgages committed will fund and hedges each mortgage individually. This includes mortgages committed for the CMB program as well as mortgages for transfer to the Company’s other securitization vehicles. As at March 31, 2014, the Company had entered into \$40 million of notional value forward bond sales for this segment. The total net value of realized and unrealized gains and losses on account of all notional hedges pertaining to the period January 1, 2014 to March 31, 2014 was a \$14.9 million loss. This amount has been included in revenue in the statement of comprehensive income.

Upon settlement of the debenture issuance, the Company entered into a float-for-fix swap. The swap requires the Company to pay CDOR+2.134% on a notional amount of \$175 million and to receive the debenture interest coupon (5.07%) semi-annually. This effectively converts the fixed rate semi-annual debenture-based loan payable into a floating rate monthly resetting note payable. Since the date when this swap was entered into, five-year interest rates have decreased pursuant to global economic issues and the value of this swap has increased to \$4.2 million as at March 31, 2014. The Company has documented this swap as a hedge for accounting purposes, as the fixed leg of the swap exactly matches the cash flow obligations under the debenture. Effectively, the unrealized gain of \$4.2 million on the swap has been excluded from earnings and been applied to increase the carrying value of the debenture note payable. The Company is also a party to three amortizing fix-for-float rate swaps that economically hedge the interest rate exposure related to certain mortgages held on the balance sheet that the Company has originated as replacement assets for its CMB activities. As at March 31, 2014, the aggregate notional value

of these swaps was \$37.6 million. During the quarter the value of these swaps decreased by about \$40. The amortizing swaps mature between July 2015 and June 2021.

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

The same exposure to risk is inherent in the Company's securitization through ABCP. The Company is exposed to the risk that 30-day ABCP rates are greater than 30-day BA rates. Prior to the financial crisis, the Company considered this a low risk given the quality of the assets securitized, the amount of credit enhancements provided by the Company and the strong covenant of the bank-sponsored conduits with which the Company transacted. In 2008, 30-day ABCP traded at approximately 1.10 percentage points over BAs; but by the end of March 2011, 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 March 31, 2014, the Company has various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there are over \$1.1 billion of mortgages that are susceptible to some degree of changing credit spreads.

Capital Expenditures

A significant portion of First National's business model consists of the origination and placement or securitization of financial assets. Generally, placement activities do not require much capital investment as the Company acts primarily in the capacity of a broker. On the other hand, the undertaking of securitization transactions may require significant amounts of the Company's own capital. This capital is provided in the form of cash collateral, credit enhancements, and the upfront funding of broker fees and other origination costs. These are described more fully in the "Liquidity and Capital Resources" section above. For fixed assets, the business requires capital expenditures on technology (both software and hardware), leasehold improvements and office furniture. During the quarter ended March 31, 2014, the Company equipped a new floor at its head office for growth of its administration department and purchased new computers and office and communications equipment primarily to support its single-family residential business. Going forward, the Company expects capital expenditures on fixed assets will be approximately \$3.5 million annually.

Summary of Contractual Obligations

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

Critical Accounting Policies and Estimates

The Company prepares its financial statements in accordance with IFRS, which requires management to make estimates, judgments and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management bases its estimates on historical experience and other assumptions that it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. The significant accounting policies of First National are described in Note 2 to the Company's audited financial statements as at December 31, 2013. 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 requires the use of estimates to determine the fair value of the retained interest (derived from the present value of expected future cash flows) in the mortgages. These retained interests are reflected on the Company's balance sheet as deferred placement fees receivable. The key assumptions used in the valuation of gains on deferred placement fees are prepayment rates and the discount rate used to present value future expected cash flows. The annual rate of unscheduled principal payments is determined by reviewing portfolio prepayment experience on a monthly basis. The Company uses different rates for its various programs, which average approximately 15% for single-family mortgages. The Company assumes there is virtually no prepayment on multi-unit residential fixed rate mortgages.

On a quarterly basis, the Company reviews the estimates used to ensure their appropriateness and monitors the performance statistics of the relevant mortgage portfolios to adjust and improve these estimates. The estimates used reflect the expected performance of the mortgage portfolio over the lives of the mortgages. The assumptions underlying the estimates used for the quarter ended March 31, 2014 continue to be consistent with those used for the year ended December 31, 2013 and the quarter ended March 31, 2013.

The Company has elected to treat its financial assets and liabilities, including deferred placement fees receivable, specific mortgages pledged under securitization, some mortgage and loan investments and bonds sold short, at fair value through profit or loss. Essentially, this policy requires the Company to record changes in the fair value of these instruments in the current period's earnings. The Company's assets and liabilities are such that the Company must use valuation techniques based on assumptions that are not fully supported by observable market prices or rates in most cases. Much like the valuation of deferred placement fees receivable described above, the Company's method of determining the fair value of its securitized mortgages has a significant impact on earnings. The Company uses different prepayment rates for its various programs, which average approximately 10% for single-family mortgages. The Company assumes there is virtually no prepayment on multi-unit residential fixed rate mortgages. Actual prepayment experience has been consistent with these assumptions. The Company has also assumed discount rates based on Government of Canada bond yields plus a spread that the Company believes would enable a third party to purchase the mortgages and make a normal profit margin for the risk involved.

Future Accounting Changes

The Company will be required to adopt IFRS 9, Financial Instruments (IFRS 9), which is the first phase of the IASB's project to replace IAS 39. On November 19, 2013, the IASB decided that the previously set mandatory effective date of January 1, 2015 would not allow sufficient time for entities to prepare to apply IFRS 9 and recently determined that the mandatory effective date will be January 1, 2018. IFRS 9 will provide new requirements for the way in which an entity should classify and measure financial assets and liabilities that are in the scope of IAS 39, with a final standard targeted in the first half of 2014. The standard requires all financial assets to be classified on the basis of the entity's business model for managing such financial assets and the contractual cash flow characteristics of the financial assets. On November 19, 2013, the IASB introduced a new hedge accounting model. The general hedge accounting standard is intended to provide better links between an entity's risk management activities, the rationale for hedging and the impact of hedging on the financial statements. The impairment phase of the IASB's financial instruments project is currently under development, with a review draft of the standard issued in March 2013 and a final standard targeted in the first half of 2014. Management is currently evaluating the potential impact that the adoption of IFRS 9 will have on the Company's consolidated financial statements.

Disclosure Controls and Internal Controls over Financial Reporting

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

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

No changes were made in the Company's internal controls over financial reporting during the quarter ended March 31, 2014 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 the policies set for mortgage default insurance companies), competition, reliance on mortgage insurers, reliance on key personnel and the ability to attract and retain employees and executives, conduct and compensation of independent mortgage brokers, failure or unavailability of computer and data processing systems and software, insufficient insurance coverage, change in or loss of ratings, impact of natural disasters and other events, and environmental liability. In addition, risks associated with the structure of the Company include those related to the dependence on FNFLP, leverage and restrictive covenants, dividends which are not guaranteed and could fluctuate with FNFLP's performance, restrictions on potential growth, the market price of the Company's shares,

statutory remedies, control of the Company and contractual restrictions, and income tax matters. Risk and risk exposure are managed through a combination of insurance, a system of internal controls and sound operating practices. The Company's key business model is to originate primarily prime mortgages and find funding through various channels to earn ongoing servicing or spread income. For the single-family residential segment, the Company relies on independent mortgage brokers for origination and several large institutional investors for sources of funding. These relationships are critical to the Company's success. For a more complete discussion of the risks affecting the Company, reference should be made to the Company's Annual Information Form.

Forward-Looking Information

Forward-looking information is included in this MD&A. In some cases, forward-looking information can be identified by the use of terms such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "intend", "estimate", "predict", "potential", "continue" or other similar expressions concerning matters that are not historical facts. Forward-looking information may relate to management's future outlook and anticipated events or results, and may include statements or information regarding the future financial position, business strategy and strategic goals, product development activities, projected costs and capital expenditures, financial results, risk management strategies, hedging activities, geographic expansion, licensing plans, taxes and other plans and objectives of or involving the Company. Particularly, information regarding growth objectives, any increase in mortgages under administration, future use of securitization vehicles, industry trends and future revenues is forward-looking information. Forward-looking information is based on certain factors and assumptions regarding, among other things, interest rate changes and responses to such changes, the demand for institutionally placed and securitized mortgages, the status of the applicable regulatory regime, and the use of mortgage brokers for single-family residential mortgages. This forward-looking information should not be read as providing guarantees of future performance or results, and will not necessarily be an accurate indication of whether or not, or the times by which, those results will be achieved. While management considers these assumptions to be reasonable based on information currently available to it, they may prove to be incorrect. Forward-looking information is subject to certain factors, including risks and uncertainties, which could cause actual results to differ materially from what management currently expects. These factors include reliance on sources of funding, concentration of institutional investors, reliance on independent mortgage brokers, and changes in interest rates as outlined under "Risk and Uncertainties Affecting the Business". In evaluating this information, the reader should specifically consider various factors, including the risks outlined under "Risk and Uncertainties Affecting the Business", which may cause actual events or results to differ materially from any forward-looking information. The forward-looking information contained in this discussion represents management's expectations as of April 29, 2014, and is subject to change after such date. However, management and the Company disclaim any intention or obligation to update or revise any forward-looking information, whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Outlook

Management considers the first quarter to be a solid start to 2014 reflecting the strong market in the fourth quarter of 2013. The Company anticipates higher origination volumes in the second and third quarter, compared to the first quarter as the spring and summer seasons typically lead to more favorable buying conditions. This growth will be moderated by a weaker real estate market and continuing price competition in the single-family sector. Spreads earned on securitizations are narrower than they have been in the past several quarters.

The Company anticipates the low interest rate environment will continue to keep mortgage affordability at favourable levels. By realizing on the significant renewal opportunities available in upcoming quarters and managing its partnerships with institutional customers, the Company will continue to focus on sustainable profitability. Despite modest new origination targets, management expects to continue to capitalize on mortgage renewals and to generate cash flow from its almost \$18 billion portfolio of mortgages pledged under securitization in order to maximize the Company's financial performance.

Interim Condensed Consolidated Financial Statements

First National Financial Corporation

[Unaudited]

First Quarter 2014

First National Financial Corporation

**INTERIM CONDENSED CONSOLIDATED STATEMENT OF
FINANCIAL POSITION**

[Unaudited - in thousands of Canadian dollars]

As at

| | | March 31, 2014 | December 31, 2013 |
|---|-------|---------------------------|------------------------------|
| | Notes | \$ | \$ |
| ASSETS | | | |
| Restricted cash | 3 | 303,715 | 431,111 |
| Accounts receivable and sundry | | 63,705 | 60,110 |
| Securities purchased under resale agreements and owned | | 1,229,377 | 1,055,443 |
| Mortgages accumulated for sale or securitization | 5 | 1,134,661 | 1,074,825 |
| Mortgages pledged under securitization | 3 | 18,667,136 | 17,651,644 |
| Deferred placement fees receivable | 4 | 33,756 | 33,580 |
| Cash held as collateral for securitization | 3 | 15,848 | 24,804 |
| Purchased mortgage servicing rights | | 2,886 | 3,079 |
| Mortgage and loan investments | 6 | 177,997 | 184,584 |
| Income taxes recoverable | | 3,653 | — |
| Other assets | | 50,573 | 50,037 |
| Total assets | | 21,683,307 | 20,569,217 |
| LIABILITIES AND EQUITY | | | |
| Liabilities | | | |
| Bank indebtedness | 8 | 432,325 | 274,484 |
| Obligations related to securities and mortgages sold under repurchase agreements | | 512,687 | 609,292 |
| Accounts payable and accrued liabilities | | 69,110 | 66,426 |
| Securities sold under repurchase agreements and sold short | | 1,225,806 | 1,050,199 |
| Debt related to securitized and participation mortgages | 9 | 18,762,256 | 17,884,303 |
| Debenture loan payable | | 179,236 | 179,195 |
| Income taxes payable | | — | 4,207 |
| Deferred tax liabilities | | 52,300 | 51,200 |
| Total liabilities | | 21,233,720 | 20,119,306 |
| Equity attributable to shareholders | | | |
| Common shares | 10 | 122,671 | 122,671 |
| Preferred shares | 10 | 97,394 | 97,394 |
| Retained earnings | | 184,239 | 184,561 |
| | | 404,304 | 404,626 |
| Non-controlling interests | | 45,283 | 45,285 |
| Total equity | | 449,587 | 449,911 |
| Total liabilities and equity | | 21,683,307 | 20,569,217 |

See accompanying notes



John Brough



Robert Mitchell

First National Financial Corporation

**INTERIM CONDENSED CONSOLIDATED STATEMENT OF
COMPREHENSIVE INCOME**

[Unaudited - in thousands of Canadian dollars, except earnings per unit]

| | | Three months ended | |
|------------------------------------|---|---------------------------|---------------------|
| | | March 31, | December 31, |
| | | 2014 | 2013 |
| Notes | | \$ | \$ |
| REVENUE | | | |
| | Interest revenue - securitized mortgages | 125,053 | 94,514 |
| | Interest expense - securitized mortgages | <u>(97,637)</u> | <u>(70,260)</u> |
| 3 | Net interest - securitized mortgages | 27,416 | 24,254 |
| | Placement fees | 17,772 | 19,127 |
| 4 | Gains on deferred placement fees | 2,705 | 2,215 |
| | Mortgage investment income | 12,350 | 10,360 |
| | Mortgage servicing income | 22,994 | 22,421 |
| | Realized and unrealized losses on financial instruments | <u>(8,169)</u> | <u>(3,409)</u> |
| | | 75,068 | 74,968 |
| EXPENSES | | | |
| | Brokerage fees | 9,833 | 11,999 |
| | Salaries and benefits | 16,221 | 15,855 |
| | Interest | 6,749 | 5,700 |
| | Other operating | 9,754 | 8,561 |
| | Amortization of intangible assets | <u>1,250</u> | <u>1,617</u> |
| | | 43,807 | 43,732 |
| | Income before income taxes | 31,261 | 31,236 |
| | Income tax expense | <u>8,200</u> | <u>8,200</u> |
| | Net income and comprehensive income for the period | 23,061 | 23,036 |
| Net income attributable to: | | | |
| | Shareholders | 22,329 | 22,749 |
| | Non-controlling interests | <u>732</u> | <u>287</u> |
| | | 23,061 | 23,036 |
| Earnings per share | | | |
| | Basic | 10 0.35 | 0.36 |

See accompanying notes

First National Financial Corporation

**INTERIM CONDENSED CONSOLIDATED STATEMENT OF
CHANGES IN EQUITY**

[Unaudited - in thousands of Canadian dollars]

| | Common shares | Preferred shares | Retained earnings | Non- controlling interests | Total equity |
|----------------------------------|--------------------------|-----------------------------|------------------------------|---|-------------------------|
| | \$ | \$ | \$ | \$ | \$ |
| Balance at January 1, 2014 | 122,671 | 97,394 | 184,561 | 45,285 | 449,911 |
| Comprehensive income | — | — | 22,329 | 732 | 23,061 |
| Dividends paid or declared | — | — | (22,651) | (734) | (23,385) |
| Balance at March 31, 2014 | 122,671 | 97,394 | 184,239 | 45,283 | 449,587 |

| | Common shares | Preferred shares | Retained earnings | Non- controlling interests | Total equity |
|---|--------------------------|-----------------------------|------------------------------|---|-------------------------|
| | \$ | \$ | \$ | \$ | \$ |
| Balance at January 1, 2013 | 122,671 | 97,394 | 102,440 | 42,895 | 365,400 |
| Comprehensive income | — | — | 22,749 | 287 | 23,036 |
| Dividends paid or declared | — | — | (21,152) | (489) | (21,641) |
| Initial recognition of non-controlling interests | — | — | — | 2,704 | 2,704 |
| Balance at March 31, 2013 | 122,671 | 97,394 | 104,037 | 45,397 | 369,499 |

See accompanying notes

First National Financial Corporation

**INTERIM CONDENSED CONSOLIDATED STATEMENT OF
CASH FLOWS**

[Unaudited - in thousands of Canadian dollars]

| | Three months ended | |
|---|---------------------------|------------------------------|
| | March 31, 2014 | December 31, 2013 |
| | \$ | \$ |
| OPERATING ACTIVITIES | | |
| Net income for the period | 23,061 | 23,036 |
| Add (deduct) items not affecting cash | | |
| Deferred income tax expense (recovery) | 1,100 | (600) |
| Non-cash portion of gains on deferred placement fees | (2,585) | (2,259) |
| Increase (decrease) in restricted cash | 127,396 | (133,643) |
| Net investment in mortgages pledged under securitization | (1,001,995) | (923,595) |
| Net increase in debt related to securitized mortgages | 874,050 | 1,048,038 |
| Amortization of deferred placement fees receivable | 2,436 | 5,253 |
| Amortization of purchased mortgage servicing rights | 193 | 206 |
| Amortization of property, plant and equipment | 708 | 602 |
| Amortization of intangible assets | 1,250 | 1,617 |
| Unrealized losses on financial instruments | 556 | 5,577 |
| | 26,170 | 24,232 |
| Net change in non-cash working capital balances related to operations | (75,856) | (215,735) |
| Cash used in operating activities | (49,686) | (191,503) |
| INVESTING ACTIVITIES | | |
| Additions to property, plant and equipment | (2,494) | (1,299) |
| Repayment of cash held as collateral for securitization | 8,956 | 32,315 |
| Investment in mortgage and loan investments | (25,603) | (31,675) |
| Repayment of mortgage and loan investments | 32,190 | 15,420 |
| Cash provided by investing activities | 13,049 | 14,761 |
| FINANCING ACTIVITIES | | |
| Dividends paid | (22,151) | (20,652) |
| Obligations related to securities and mortgages sold under repurchase agreements | (96,605) | 87,119 |
| Debt related to participation mortgages | 3,903 | (2,660) |
| Securities purchased under resale agreements and owned, net | (173,934) | (896,118) |
| Securities sold under repurchase agreements and sold short, net | 168,317 | 888,109 |
| Non-controlling interest | (734) | 45,110 |
| Cash provided by (used in) financing activities | (121,204) | 100,908 |
| Net increase in bank indebtedness during the period | (157,841) | (75,834) |
| Bank indebtedness, beginning of period | (274,484) | (185,044) |
| Bank indebtedness, end of period | (432,325) | (260,878) |
| Supplemental cash flow information | | |
| Interest received | 146,925 | 136,340 |
| Interest paid | 99,899 | 72,729 |
| Income taxes paid | 14,960 | 11,673 |

See accompanying notes

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2014

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 \$77 billion in mortgages under administration, FNFLP is an originator and underwriter of mortgages and a significant participant in the mortgage broker distribution channel.

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

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of preparation

The interim condensed consolidated financial statements have been prepared in accordance with IAS 34 - Interim Financial Reporting under International Financial Reporting Standards ["IFRS"], as issued by the International Accounting Standards Board [the "IASB"]. The interim condensed consolidated financial statements have been prepared using the same accounting policies used in the preparation of the audited annual consolidated financial statements for the year ended December 31, 2013 except that on January 1, 2014, the Company adopted IFRIC 21- Levies. The standard requires an entity to recognize a liability for a levy when the activity that triggers payment occurs. There is no material impact on the Company's interim condensed consolidated financial statements from adopting IFRIC 21.

These interim condensed consolidated financial statements should be read in conjunction with the audited annual consolidated financial statements and are presented in Canadian dollars with all values rounded to the nearest thousands, except when otherwise indicated. The interim condensed consolidated financial statements were authorized for issue by the Board of Directors on April 29, 2014.

First National Financial Corporation

**NOTES TO INTERIM CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS**

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

March 31, 2014

3. MORTGAGES PLEDGED UNDER SECURITIZATION

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

As part of the ABCP transactions, the Company provides cash collateral for credit enhancement purposes as required by the rating agencies. Credit exposure to securitized mortgages is generally limited to this cash collateral. The principal and interest payments on the securitized mortgages are paid to the Company by the structured entities monthly over the term of the mortgages. The full amount of the cash collateral is recorded as an asset and the Company anticipates full recovery of these amounts. NHA-MBS securitizations may also require cash collateral in some circumstances. As at March 31, 2014, the cash held as collateral for securitization was \$15,848 [December 31, 2013 - \$24,804].

First National Financial Corporation

**NOTES TO INTERIM CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS**

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

March 31, 2014

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

| | March 31, 2014 | | December 31, 2013 | |
|---|---|--|---|--|
| | Carrying amount of securitized mortgages | Carrying amount of associated liabilities | Carrying amount of securitized mortgages | Carrying amount of associated liabilities |
| | \$ | \$ | \$ | \$ |
| Securitized mortgages at face value | 18,531,089 | 18,794,210 | 17,532,693 | 17,919,788 |
| Mark to market adjustment | 48,254 | — | 37,956 | — |
| Capitalized origination costs | 87,793 | — | 80,995 | — |
| Debt discounts | — | (47,533) | — | (47,161) |
| | 18,667,136 | 18,746,677 | 17,651,644 | 17,872,627 |
| Add: | | | | |
| Principal portion of payments held in restricted cash | 269,655 | — | 398,285 | — |
| Participation debt | — | 15,579 | — | 11,676 |
| | 18,936,791 | 18,762,256 | 18,049,929 | 17,884,303 |

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

The changes in capitalized origination costs for the three months ended March 31 are as follows:

| | 2014 | 2013 |
|--|----------------|-------------|
| | \$ | \$ |
| Opening balance, January 1 | 80,995 | 55,130 |
| Add: new origination costs in the period | 16,128 | 11,300 |
| Less: amortization in the period | (9,330) | (6,237) |
| Ending balance, March 31 | 87,793 | 60,193 |

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2014

The mortgages securitized through NHA-MBS and CMB programs have been classified as loans and receivables, except for approximately \$1.3 billion [2013 - \$1.1 billion] of securitized mortgages included in held for trading ["HFT"] mortgages. These mortgages are carried at par plus adjustment for unamortized origination costs. Most mortgages in bank-sponsored ABCP programs have been classified as fair value through profit or loss.

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

| | March 31, 2014 | |
|--|---------------------------------|----------------------------------|
| | Commercial mortgages | Residential mortgages |
| HFT mortgages | \$220,496 | \$3,147,859 |
| Average life [in months] ⁽¹⁾ | 23 | 25 |
| Prepayment speed assumption [annual rate] | 5.9% | 11.7% |
| Impact on fair value of 10% adverse change | \$3 | \$622 |
| Impact on fair value of 20% adverse change | \$5 | \$1,238 |
| Discount rate [annual rate] | 2.4% | 2.5% |
| Impact on fair value of 10% adverse change | \$937 | \$10,498 |
| Impact on fair value of 20% adverse change | \$1,857 | \$20,935 |

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

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

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2014

4. DEFERRED PLACEMENT FEES RECEIVABLE

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

During the three months ended March 31, 2014, \$529,690 [2013 - \$382,854] of mortgages were placed with institutional investors which created gains on deferred placement fees of \$2,705 [2013 - \$2,215]. Cash receipts on deferred placement fees receivable for the three months ended March 31, 2014 were \$2,649 [2013 - \$5,699].

The Company uses various assumptions to value the deferred placement fees receivable, which are set out in the table below, including the rate of unscheduled prepayments. Accordingly, the deferred placement fees receivable are subject to measurement uncertainty. An assumption of no credit losses was used, commensurate with the credit quality of the investors. The effect of variations between actual experience and assumptions will be recorded in future statements of comprehensive income. Key economic weighted average assumptions and the sensitivity of the current carrying value of residual cash flows to immediate 10% and 20% adverse changes in those assumptions are summarized as follows:

| | March 31, 2014 | |
|--|---------------------------------|----------------------------------|
| | Commercial mortgages | Residential mortgages |
| Fair value of deferred placement fees receivable | \$33,756 | \$1 |
| Average life [in months] ^[1] | 55 | 25 |
| Prepayment speed assumption [annual rate] | — | 15% |
| Impact on fair value of 10% adverse change | — | \$4 |
| Impact on fair value of 20% adverse change | — | \$7 |
| Residual cash flows discount rate [annual rate] | 4.7% | 4.0% |
| Impact on fair value of 10% adverse change | \$397 | \$1 |
| Impact on fair value of 20% adverse change | \$785 | \$2 |

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

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2014

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

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 for placement with institutional investors.

Mortgages originated for the Company's own securitization programs are classified as loans and receivables and are recorded at amortized cost. Mortgages funded for placement with other investors are designated as held for trading and recorded at fair value. The fair values of mortgages held for trading approximate their carrying value due to their short-term nature. The following table summarizes the components of mortgages according to their classification:

| | March 31, 2014 | December 31, 2013 |
|--|---------------------------|------------------------------|
| | \$ | \$ |
| Mortgages accumulated for securitization | 1,102,321 | 1,063,068 |
| Mortgages accumulated for sale | 32,340 | 11,757 |
| | <u>1,134,661</u> | <u>1,074,825</u> |

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2014

6. MORTGAGE AND LOAN INVESTMENTS

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

Mortgage and loan investments consist of the following:

| | March 31, 2014 | December 31, 2013 |
|---|---------------------------|------------------------------|
| | \$ | \$ |
| Mortgage loans, classified as loans and receivables | 112,150 | 115,630 |
| Mortgage loans, designated as fair value through profit or loss | 65,847 | 68,954 |
| | 177,997 | 184,584 |

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

7. MORTGAGES UNDER ADMINISTRATION

As at March 31, 2014, the Company had mortgages under administration of \$76,974,629 [December 31, 2013 - \$75,619,003], including mortgages held on the Company's interim condensed consolidated statement 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 March 31, 2014, the Company administered 249,885 mortgages [December 31, 2013 - 245,291] for 91 institutional investors [December 31, 2013 - 91] with an average remaining term to maturity of 41 months [December 31, 2013 - 42 months].

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

March 31, 2014

Mortgages under administration are serviced as follows:

| | March 31, 2014 | December 31, 2013 |
|--|---------------------------|------------------------------|
| | \$ | \$ |
| Institutional investors | 48,694,006 | 48,245,957 |
| Mortgages accumulated for sale or securitization and mortgage and loan investments | 1,307,053 | 1,255,267 |
| Securitization vehicles, deferred placement investors | 5,087,098 | 5,075,254 |
| Mortgages pledged under securitization | 18,531,089 | 17,532,693 |
| CMBS conduits | 3,355,383 | 3,509,832 |
| | <u>76,974,629</u> | <u>75,619,003</u> |

The Company's exposure to credit loss is limited to mortgages under administration totaling \$136,414 [December 31, 2013 - \$201,271], of which \$2,928 of mortgages have principal and interest payments outstanding as at March 31, 2014 [December 31, 2013 - \$4,971]. The Company incurred actual credit losses, net of recoveries, of \$370 during the three months ended March 31, 2014 [2013 - \$996]. As at March 31, 2014, the Company has \$4,897 [December 31, 2013 - \$7,687] of uninsured non-performing mortgages [net of provisions for credit losses] included in accounts receivable and sundry.

The Company maintains trust accounts on behalf of the investors it represents. The Company also holds municipal tax funds in escrow for mortgagors. Since the Company does not hold a beneficial interest in these funds, they are not presented on the interim condensed consolidated statement of financial position. The aggregate of these accounts as at March 31, 2014 was \$432,294 [December 31, 2013 - \$405,426].

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8. BANK INDEBTEDNESS

Bank indebtedness includes a revolving credit facility of \$1,000,000 [December 31, 2013 - \$570,000] maturing in December 2016, of which \$417,506 [December 31, 2013 - \$258,421] was drawn as at March 31, 2014 and against which the following have been pledged as collateral:

- [a] a general security agreement over all assets, other than real property, of the Company; and
- [b] a general assignment of all mortgages owned by the Company.

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

**9. DEBT RELATED TO SECURITIZED AND PARTICIPATION
MORTGAGES**

Debt related to securitized mortgages represents the funding for mortgages pledged under the NHA-MBS, CMB and ABCP programs. As at March 31, 2014, debt related to securitized mortgages was \$18,746,677 [December 31, 2013 - \$17,872,627], net of unamortized discounts of \$47,533 [December 31, 2013 - \$47,161]. A comparison of the carrying amounts of the pledged mortgages and the related debt is summarized in note 3.

As at March 31, 2014, debt related to participation mortgages was \$15,579 [December 31, 2013 - \$11,676].

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.

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10. SHAREHOLDERS' EQUITY

[a] Authorized

Unlimited number of common shares

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

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

[b] Capital stock activities

| | Common shares | | Preferred shares | |
|--|-------------------|----------------|------------------|---------------|
| | # | \$ | # | \$ |
| Balance, December 31, 2013 and March 31, 2014 | 59,967,429 | 122,671 | 4,000,000 | 97,394 |

[c] Earnings per share

| | Three months ended March 31, 2014 | Three months ended March 31, 2013 |
|--|--|--|
| Net income and comprehensive income for the period | \$23,061 | \$23,036 |
| Less dividends declared on preferred shares | (1,163) | (1,163) |
| Less earnings related to non-controlling interests | (732) | (287) |
| Net income attributable to common shareholders | \$21,166 | \$21,586 |
| Number of common shares outstanding | 59,967,429 | 59,967,429 |
| Basic earnings per common share | \$0.35 | \$0.36 |

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11. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Fair value measurement

The Company uses the following hierarchy for determining and disclosing fair value of financial instruments recorded at fair value in the interim condensed consolidated statement 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] HFT mortgages in mortgages under securitization and certain mortgage and loan investments

The fair value of these mortgages is determined by discounting projected cash flows using market industry pricing practices. Discount rates used are determined by comparison to similar term loans made to borrowers with similar credit. This methodology will reflect changes in interest rates which have occurred since the mortgages were originated. Impaired mortgages are recorded at net realizable value. Refer to note 3 "Mortgages pledged under securitization" for the key assumptions used.

- [b] Deferred placement fees receivable

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

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[c] Securities owned and sold short

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

[d] Other financial assets and financial liabilities

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

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Carrying value and fair value of selected financial instruments

The following tables provide a comparison of the carrying and fair values for each classification of financial instruments:

| | March 31, 2014 | | | | |
|--|--|--|---|----------------------------------|---------------------------|
| | Financial instruments classified as FVTPL \$ | Financial instruments designated as FVTPL \$ | Loans & receivables /financial liabilities at amortized cost \$ | Total carrying value \$ | Total fair value \$ |
| Financial assets | | | | | |
| Restricted cash | — | — | 303,715 | 303,715 | 303,715 |
| Accounts receivable and sundry | — | 4,525 | 59,180 | 63,705 | 63,705 |
| Securities purchased under resale agreements and owned | — | — | 1,229,377 | 1,229,377 | 1,229,377 |
| Mortgages accumulated for sale or securitization | 32,340 | — | 1,102,321 | 1,134,661 | 1,134,661 |
| Mortgages pledged under securitization | — | 4,035,578 | 14,631,558 | 18,667,136 | 18,922,179 |
| Deferred placement fees receivable | — | 33,756 | — | 33,756 | 33,756 |
| Cash held as collateral for securitization | — | — | 15,848 | 15,848 | 15,848 |
| Mortgage and loan investments | — | 65,847 | 112,150 | 177,997 | 177,997 |
| Total financial assets | 32,340 | 4,139,706 | 17,454,149 | 21,626,195 | 21,881,238 |
| Financial liabilities | | | | | |
| Bank indebtedness | — | — | 432,325 | 432,325 | 432,325 |
| Obligations related to securities and mortgages sold under repurchase agreements | — | — | 512,687 | 512,687 | 512,687 |
| Accounts payable and accrued liabilities | — | 6,477 | 62,633 | 69,110 | 69,110 |
| Securities sold under repurchase agreements and sold short | — | 1,225,806 | — | 1,225,806 | 1,225,806 |
| Debt related to securitized and participation mortgages | — | — | 18,762,256 | 18,762,256 | 18,963,993 |
| Debenture loan payable | — | 179,236 | — | 179,236 | 179,236 |
| Total financial liabilities | — | 1,411,519 | 19,769,901 | 21,181,420 | 21,383,157 |

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| | December 31, 2013 | | | | |
|--|--|--|---|-------------------------------------|-----------------------------|
| | Financial instruments classified as FVTPL | Financial instruments designated as FVTPL | Loans & receivables /financial liabilities at amortized cost | Total carrying value | Total fair value |
| | \$ | \$ | \$ | \$ | \$ |
| Financial assets | | | | | |
| Restricted cash | — | — | 431,111 | 431,111 | 431,111 |
| Accounts receivable and sundry | — | 6,976 | 53,134 | 60,110 | 60,110 |
| Securities purchased under resale agreements and owned | — | — | 1,055,443 | 1,055,443 | 1,055,443 |
| Mortgages accumulated for sale or securitization | 11,757 | — | 1,063,068 | 1,074,825 | 1,074,825 |
| Mortgages pledged under securitization | — | 3,969,524 | 13,682,120 | 17,651,644 | 17,729,958 |
| Deferred placement fees receivable | — | 33,580 | — | 33,580 | 33,580 |
| Cash held as collateral for securitization | — | — | 24,804 | 24,804 | 24,804 |
| Mortgage and loan investments | — | 68,954 | 115,630 | 184,584 | 184,584 |
| Total financial assets | 11,757 | 4,079,034 | 16,425,310 | 20,516,101 | 20,594,415 |
| Financial liabilities | | | | | |
| Bank indebtedness | — | — | 274,484 | 274,484 | 274,484 |
| Obligations related to securities and mortgages sold under repurchase agreements | — | — | 609,292 | 609,292 | 609,292 |
| Accounts payable and accrued liabilities | — | 3,639 | 62,787 | 66,426 | 66,426 |
| Securities sold under repurchase agreements and sold short | — | 1,050,199 | — | 1,050,199 | 1,050,199 |
| Debt related to securitized and participation mortgages | — | — | 17,884,303 | 17,884,303 | 17,911,851 |
| Debenture loan payable | — | 179,195 | — | 179,195 | 179,195 |
| Total financial liabilities | — | 1,233,033 | 18,830,866 | 20,063,899 | 20,091,447 |

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

| | March 31, 2014 | | | |
|--|--------------------------|----------------|------------------|------------------|
| | Level 1 | Level 2 | Level 3 | Total |
| | \$ | \$ | \$ | \$ |
| Financial assets | | | | |
| Mortgages accumulated for sale | — | 32,340 | — | 32,340 |
| HFT mortgages | — | — | 4,035,578 | 4,035,578 |
| Deferred placement fees receivable | — | — | 33,756 | 33,756 |
| Mortgage and loan investments | — | — | 65,847 | 65,847 |
| Interest rate swaps | — | 4,525 | — | 4,525 |
| Total financial assets | — | 36,865 | 4,135,181 | 4,172,046 |
| Financial liabilities | | | | |
| Securities sold under repurchase agreements and sold short | 1,225,806 | — | — | 1,225,806 |
| Interest rate swaps | — | 6,477 | — | 6,477 |
| Total financial liabilities | 1,225,806 | 6,477 | — | 1,232,283 |
| | December 31, 2013 | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| | \$ | \$ | \$ | \$ |
| Financial assets | | | | |
| Mortgages accumulated for sale | — | 11,757 | — | 11,757 |
| HFT mortgages | — | — | 3,969,524 | 3,969,524 |
| Deferred placement fees receivable | — | — | 33,580 | 33,580 |
| Mortgage and loan investments | — | — | 68,954 | 68,954 |
| Interest rate swaps | — | 6,976 | — | 6,976 |
| Total financial assets | — | 18,733 | 4,072,058 | 4,090,791 |
| Financial liabilities | | | | |
| Securities sold under repurchase agreements and sold short | 1,050,199 | — | — | 1,050,199 |
| Interest rate swaps | — | 3,639 | — | 3,639 |
| Total financial liabilities | 1,050,199 | 3,639 | — | 1,053,838 |

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In estimating the fair value of financial assets and financial liabilities using valuation techniques or pricing models, certain assumptions are used including those that are not fully supported by observable market prices or rates [Level 3]. The amount of the change in fair value recognized by the Company in net income for the three months ended March 31, 2014 that was estimated using a valuation technique based on assumptions that are not fully supported by observable market prices or rates was a gain of \$13,524 [2013 – \$9,044]. Although the Company's management believes that the estimated fair values are appropriate as at the date of the interim condensed consolidated statement of financial position, those fair values may differ if other reasonably possible alternative assumptions are used.

The following table presents changes in the fair values (including realized loss of \$7,613 [2013 - gain of \$2,168]) of the Company's financial assets and financial liabilities for the quarters ended March 31, 2014 and 2013, all of which have been classified as fair value through profit or loss:

| | March 31, 2014 | March 31, 2013 |
|------------------------------------|---------------------------|---------------------------|
| | \$ | \$ |
| HFT mortgages | 6,747 | 5,186 |
| Deferred placement fees receivable | 27 | 16 |
| Securities owned and sold short | (14,903) | (8,672) |
| Interest rate swaps | (40) | 61 |
| | (8,169) | (3,409) |

Movement in Level 3 financial instruments measured at fair value

The following tables show the movement in Level 3 financial instruments in the fair value hierarchy for the three months ended March 31, 2014 and 2013. The Company classifies financial instruments to Level 3 when there is reliance on at least one significant unobservable input in the valuation models.

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| | Fair value as at January 1, 2014 \$ | Investments \$ | Unrealized gain recorded in income \$ | Payment and amortization \$ | Fair value as at March 31, 2014 \$ |
|---------------------------------------|---|-------------------|---|-----------------------------------|--|
| Financial assets | | | | | |
| HFT mortgages | 3,969,524 | 606,995 | 13,497 | (554,438) | 4,035,578 |
| Deferred placement fees receivable | 33,580 | 2,585 | 27 | (2,436) | 33,756 |
| Mortgage and loan investments | 68,954 | — | — | (3,107) | 65,847 |
| Total financial assets | 4,072,058 | 609,580 | 13,524 | (559,981) | 4,135,181 |
| | Fair value as at January 1, 2013 \$ | Investments \$ | Unrealized gain recorded in income \$ | Payment and amortization \$ | Fair value as at March 31, 2013 \$ |
| Financial assets | | | | | |
| HFT mortgages | 2,776,551 | 787,515 | 9,028 | (781,226) | 2,791,868 |
| Deferred placement fees receivable | 41,919 | 2,259 | 16 | (5,253) | 38,941 |
| Mortgage and loan investments | 11,385 | — | — | (5,984) | 5,401 |
| Total financial assets | 2,829,855 | 789,774 | 9,044 | (792,463) | 2,836,210 |

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Derivative financial instrument and hedge accounting

The Company entered into a swap agreement to hedge the debenture loan payable against changes in fair value by converting the fixed rate debt into a variable rate debt. The swap agreement has been designated as a fair value hedge and the hedging relationship is formally documented, including the risk management objective and measurement of effectiveness. The swap agreement is recorded at fair value with the changes in fair value recognized in income. Changes in fair value attributed to the hedged risk are accounted for as basis adjustments to the debenture loan payable and are recognized in income. Accordingly, as at March 31, 2014, accounts receivable and sundry have been increased by \$4,236 [December 31, 2013 - \$4,195] to account for the swap derivative, and the debenture loan payable has been increased by the same amount.

12. CAPITAL MANAGEMENT

The Company's objective is to maintain a strong capital base so as to maintain investor, creditor and market confidence and sustain future development of the business. Management defines capital as the Company's equity, long-term debt and retained earnings. The Company has a minimum capital requirement as stipulated by its bank credit facility. The agreement limits the debt under bank indebtedness together with the debentures to four times FNFLP's equity. As at March 31, 2014, the ratio was 1.5:1 [December 31, 2013 - 1.1:1]. The Company was in compliance with the bank covenant throughout the period.

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13. EARNINGS BY BUSINESS SEGMENT

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

| | Three months ended March 31, 2014 | | |
|--|--|-------------------|-------------------|
| | Residential | Commercial | Total |
| | \$ | \$ | \$ |
| REVENUE | | | |
| Interest revenue - securitized mortgages | 93,520 | 31,533 | 125,053 |
| Interest expense - securitized mortgages | (70,369) | (27,268) | (97,637) |
| Net interest - securitized mortgages | 23,151 | 4,265 | 27,416 |
| Placement and servicing | 27,933 | 7,369 | 35,302 |
| Mortgage investment income | 7,661 | 4,689 | 12,350 |
| | 58,745 | 16,323 | 75,068 |
| EXPENSES | | | |
| Amortization | 1,301 | 657 | 1,958 |
| Interest | 6,361 | 388 | 6,749 |
| Other operating | 27,449 | 7,651 | 35,100 |
| | 35,111 | 8,696 | 43,807 |
| Income before income taxes | 23,634 | 7,627 | 31,261 |
| Identifiable assets | 17,309,595 | 4,343,936 | 21,653,531 |
| Goodwill | — | — | 29,776 |
| Total assets | 17,309,595 | 4,343,936 | 21,683,307 |
| Capital expenditures | 1,746 | 748 | 2,494 |

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| | Three months ended March 31, 2013 | | |
|--|--|-------------------|--------------|
| | Residential | Commercial | Total |
| | \$ | \$ | \$ |
| REVENUE | | | |
| Interest revenue - securitized mortgages | 67,597 | 26,917 | 94,514 |
| Interest expense - securitized mortgages | (49,680) | (20,580) | (70,260) |
| Net interest - securitized mortgages | 17,917 | 6,337 | 24,254 |
| Placement and servicing | 31,551 | 8,803 | 40,354 |
| Mortgage investment income | 5,977 | 4,383 | 10,360 |
| | 55,445 | 19,523 | 74,968 |
| EXPENSES | | | |
| Amortization | 1,445 | 774 | 2,219 |
| Interest | 5,107 | 593 | 5,700 |
| Other operating | 27,736 | 8,077 | 35,813 |
| | 34,288 | 9,444 | 43,732 |
| Income before income taxes | 21,157 | 10,079 | 31,236 |
| Identifiable assets | 13,252,196 | 3,881,725 | 17,133,921 |
| Goodwill | — | — | 29,776 |
| Total assets | 13,252,196 | 3,881,725 | 17,163,697 |
| Capital expenditures | 909 | 390 | 1,299 |

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14. RELATED PARTY TRANSACTIONS

Over the past several years, various commercial borrowers of the Company applied to the Company for mezzanine mortgage financing. The amounts of the mortgages requested were in excess of the Company's internal investment policies for investments of that nature; however, a business controlled by a senior executive and shareholder of the Company entered into agreements with the borrowers to fund the mortgages. The Company serviced these mortgages during their terms at market commercial servicing rates. The mortgages which are administered by the Company have a balance of \$21,562 as at March 31, 2014 [December 31, 2013 - \$31,245].

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 also provided the Company with portfolio insurance at market premiums. The total bulk insurance purchased during the first quarter of 2014 was \$737, 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 March 31, 2014, the portfolio had a balance of \$8.9 million [December 31, 2013 - \$9.0 million].

A senior executive and shareholder of the Company is a director on the board of a retirement home company. The Company has provided a commitment to fund up to \$10 million through a secured revolving line of credit until January 2015 to the retirement home company. The Company earns a standby fee at market rate on any undrawn portion to the end of the commitment period. For the quarter ended March 31, 2014, the Company earned \$6 of standby fees from the related party. The Company also provides mezzanine mortgage funding, mortgage servicing and placement services to the real estate company at market rates. As at March 31, 2014, the portfolio administered by the Company totalled \$18.9 million [December 31, 2013 - \$19.2 million].

First National Financial Corporation

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M5K 1J7

TSX Symbol

Common shares: (TSX) FN
Preferred shares: (TSX) FN.PR.A

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