FIRST NATIONAL

FINANCIAL CORPORATION

Report to Shareholders

Period Ended June 30, 2014

100 University Avenue, Suite 700, North Tower, Toronto, ON M5J 1V6
www.firstnational.ca

Fellow Shareholders:

With the seasonal strength in the Canadian housing market and the execution of its service strategy, First National performed well in the 2014 second quarter. New mortgage originations were $500 million or 12% higher than a year ago at $4.7 billion. Mortgages under administration reached a record $79.9 billion at June 30th, up 12% from a year earlier and we expanded our portfolio of mortgages pledged under securitization.

The Company also delivered solid profitability, despite a large swing in gains and losses on financial instruments, which is not indicative of business performance. The change in gains and losses affected various performance metrics including revenue, which stood at $201.6 million in the second quarter, 12% lower than a year ago. The 2013 quarter included a $42.8 million gain on financial instruments as a result of rising in bond yields while the second quarter of 2014 included an $8.2 million loss as bond yields fell. Excluding these items, revenue increased 12%.

Also impacted was net income, which stood at $28.2 million ($0.44 cents per common share) compared to $67.8 million ($1.10 per common share) a year ago and income before income taxes ($38.2 million compared to $91.9 million last year).

Pre-FMV EBITDA, which excludes these gains and losses, was $48.4 million in the second quarter, compared to $51.2 million last year. The 5% decrease reflected the Company's decision to securitize more of its originations, which will create future income from net interest margin, forgoing net placement and mortgage servicing fees in the current quarter.

Consistent with the announcement in February 2014, the Company's common share dividend is now higher at $1.50 per share annualized, reflecting our positive outlook. During the quarter, dividends of $0.37 per common share were paid, resulting in a payout ratio from adjusted cash flow of 135%. This primarily reflected the Company's decision to make a net investment of $24.1 million in new securitization transactions in the second quarter, compared to $7.4 million a year ago. Excluding cash used for securitizations, the payout ratio this quarter was 56%.

Subsequent to quarter end, First National was delighted to announce an agreement under which it will provide mortgage underwriting and fulfillment processing services to a major Canadian bank. This agreement is part of a long-term strategy to leverage the Company's expertise in underwriting mortgages and our industry-leading MERLIN technology.

Looking ahead, the Company anticipates continuing strength through the third quarter due to seasonally strong real estate market activity. We expect the low interest rate environment will continue to keep mortgage affordability at favourable levels. By realizing on significant renewal opportunities available in upcoming quarters and managing partnerships with our institutional customers, the Company will continue to focus on sustainable profitability. Despite modest new origination targets, we expect to continue to capitalize on mortgage renewals and to generate cash flow from our now $20 billion portfolio of mortgages pledged under securitization in order to maximize financial performance.

Sincerely,

Stephen Smith
Chairman, President and Chief Executive Officer
FNFC

Moray Tawse
Executive Vice President
FNFC

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following management's discussion and analysis of financial condition and results of operations is prepared as of July 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 June 30, 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 almost $80 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 $59 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.

Second Quarter 2014 Results Summary

The Company was very pleased with its results for the second quarter of 2014. The Canadian real estate market showed its strength after a slow start to the year. This was evidenced in the single-family segment where First National's origination was up more than 8% when compared to the second quarter of 2013. Together with higher originations in the commercial segment, the Company increased overall origination in the quarter by almost 12%. 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 $79.9 billion at June 30, 2014 from $71.2 billion at June 30, 2013, an increase of 12%; the growth from March 31, 2014, when MUA was $77.0 billion, was approximately 4%, an annualized increase of 15%;
- The Canadian single-family real estate market, which was markedly slow in the first quarter of 2014, turned more favourable in the second quarter of 2014. Single-family mortgage originations for the Company increased by over 8% to $3.8 billion in the second quarter of 2014 from $3.5 billion in 2013. The commercial segment had a strong quarter as volumes increased by 30%, from $677 million in 2013 second quarter to $878 million in the 2014 second quarter. Together, overall origination increased by 12% year over year;
- The Company took advantage of its renewal opportunities in the quarter, renewing $999 million of single-family mortgages. Although retention rates were similar in each quarter, in the 2013 comparative quarter the Company renewed $1.4 billion of single-family mortgages on more renewal opportunities. For the commercial segment in the second quarter, 2014 renewals decreased to $378 million from $418 million in 2013;
- During the second quarter of 2014, the Company used the Canada Mortgage Bonds ("CMB") program to successfully securitize about $121 million of multi-unit mortgages in the 10-year program and $190 million mortgages in the five-year term program. First National also securitized $37 million of mortgages for CMB replacement purposes in the quarter;
- Revenue for the second quarter of 2014 decreased to $201.6 million from $229.8 million in the 2013 comparative quarter. The 12% decrease is attributable to the large change in gains and losses on financial instruments between the quarters. In 2013 bond yields rose significantly and the Company recorded a gain of $42.8 million. In contrast, bond yields declined in the 2014 quarter, and losses of $8.2 million were incurred. Excluding the impact of the change of $51 million related to financial instruments, revenue grew 12% year over year. The growth 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 $34 million or about 34% year over year;
- Income before income taxes in the quarter decreased by 58% from $91.9 million to $38.2 million. Like revenue, net income was significantly affected by gains and losses on financial instruments which accounted for a change in net income of $51 million;
- Without the impact of gains and losses on financial instruments, the Company's earnings before income taxes, depreciation and amortization ("Pre-FMV EBITDA") for the second quarter decreased by 5%, from $51.2 million in 2013 to $48.4 million in 2014. This decrease is due to the Company's decision to securitize more of its origination. By securitizing about $600 million more of its origination than in the prior year's quarter, the Company has foregone about $2.9 million of net placement fees and mortgage servicing income in favour of future net interest margin.

Outstanding Securities of the Corporation

At June 30, 2014 and July 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					
Second Quarter	$201,596	$28,217	$48,392	$0.44	$23,902,513
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

(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 June 30, 2014, MUA totalled $79.9 billion, up from $71.2 billion at June 30, 2013, an increase of 12%. This compares to $77.0 billion at March 31, 2014, representing a quarter-over-quarter increase of 4% and an annualized increase of about 15%.

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%
Second quarter 2014	1.46%

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, funding spreads have also narrowed in recent periods such that the spread between insured 5 year mortgages and the NHA-MBS related costs of funds is approximately 1% which is still profitable for the Company to securitize. In the second quarter of 2014, the Company originated and renewed for securitization purposes approximately $2.5 billion of single-family mortgages and $0.5 billion of multi-unit residential mortgages in order to take advantage of these spreads. In the second quarter of 2014, the Company securitized through NHA-MBS approximately $641 million of floating rate single-family mortgages, $912 million of fixed rate single-family mortgages and $243 million of fixed rate multi-unit residential mortgages.

Mortgage Underwriting and Fulfillment Processing Services

Subsequent to the end of the second quarter, the Company entered into an agreement with a large Canadian schedule 1 bank ("Bank") to provide underwriting and fulfillment processing services for mortgages originated by the Bank through the single-family residential mortgage broker channel. Under the strategic agreement, First National will employ a customized software solution based on its industry leading MERLIN technology to accept mortgage applications from the Bank in the mortgage broker channel and underwrite these mortgages in accordance with the Bank's underwriting guidelines. The Bank will fund all the mortgages underwritten under the agreement and retain full responsibility for mortgage servicing and the client relationship. The Company believes it can operate this distinct division profitably after the start up period and expects to launch the new business in Ontario in early 2015 with a full national roll out by the middle of 2015. Management considers the agreement a way to leverage the capabilities and strengths of First National in the mortgage broker channel and add some diversity to the Company's service offerings.

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 $1 billion revolving line of credit with a syndicate of banks. 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. 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 some rights to convert into a floating rate dividend upon reset, 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. This capital has given 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 issue almost $1.8 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		Six months ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
For the Period		($ 000's)		
Revenue	201,596	229,830	374,301	375,058
Income before income taxes	38,217	91,945	69,478	123,181
Pre-FMV EBITDA [(1)]	48,392	51,193	89,780	88,057
At Period end				
Total assets	23,902,513	18,793,683	23,902,513	18,793,683
Mortgages under administration	79,914,694	71,228,677	79,914,694	71,228,677

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		Six months ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
For the Period		($ 000's)		
Cash provided by (used in) operating activities	(468,136)	(353,329)	(517,822)	(544,832)
Add (deduct):				
Change in mortgages accumulated for sale or securitization between periods	485,784	396,905	545,620	604,307
Additions to property, plant and equipment	(988)	(541)	(3,482)	(1,840)
Adjusted Cash Flow [1]	16,660	43,035	24,316	57,635
Less: cash dividends on preference shares	(1,162)	(1,162)	(2,325)	(2,325)
Adjusted Cash Flow available for common shareholders	15,498	41,873	21,991	55,310
Adjusted Cash Flow per Common Share ($/share) [1]	0.26	0.70	0.37	0.92
Dividends declared on Common Shares	22,487	20,989	43,975	40,978
Dividends declared per Common Share ($/share)	0.37	0.35	0.73	0.68
Payout Ratio	145%	50%	200%	74%

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 June 30, 2014, the payout ratio was 145%, much higher than the 50% ratio reported in the second quarter of 2013. While Adjusted Cash Flow increased from that recorded in the first quarter of 2014, this measure was reduced by $24.1 million which the Company invested in new securitization transactions. 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 2013 second quarter, the Company's net investment in securitizations was just $7.4 million and cash flow from existing securitizations was enough to offset the investment in new transactions. By excluding the cash related to the investment of $24.1 million in the 2014 second quarter, the payout ratio would have been 56%. Cash flow in the 2014 quarter was also negatively affected by more than $3 million of cash losses on financial instruments which compares to some small positive cash flows in the 2013 quarter related to the large gains on financial instruments recorded then.

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 June 30, 2014, new origination volume increased from $4.2 billion to $4.7 billion, or about 12%, compared to second 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 $6.0 billion of new originations and renewals for the quarter ended June 30, 2014, $3.0 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 $6.0 billion of new originations and renewals in the second quarter of 2014, $2.9 billion was placed with institutional investors.

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

Mortgage Servicing and Administration

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

	Quarter ended		Six months ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Mortgage Originations by Segment	($ millions)			
New Single-family residential	3,773	3,485	5,580	5,074
New Multi-unit and commercial	878	677	1,595	1,486
Sub-total	4,651	4,162	7,175	6,560
Single-family residential renewals	999	1,434	1,440	2,201
Multi-unit and commercial renewals	378	418	652	571
Total origination and renewals	6,028	6,014	9,267	9,332
Mortgage Originations by Funding Source				
Institutional investors – new residential	1,690	2,262	2,376	3,090
Institutional investors – renew residential	531	448	769	589
Institutional investors – multi/commercial	720	804	1,479	1,348
NHA-MBS/ CMB/ ABCP securitization	2,971	2,391	4,457	4,118
Internal Company resources	116	109	186	187
Total	6,028	6,014	9,267	9,332
Mortgages under Administration				
Single-family residential	61,830	53,441	61,830	53,441
Multi-unit residential and commercial	18,085	17,788	18,085	17,788
Total	79,915	71,229	79,915	71,229

Total new mortgage origination volumes increased in the second quarter of 2014 compared to the same period in 2013 by more than 11% as the single-family housing market did better in comparison to the slow start in 2013. Single-family volumes increased by over 8% year over year as demand for housing continued. New commercial segment originations increased in the second quarter of 2014, increasing by almost 30% compared to the 2013 quarter. When combined with renewals in the segment, total production increased from $1.1 billion in the 2013 quarter to $1.25 billion in 2014, or by almost 15%. 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 with volumes increasing from $2.4 billion in the 2013 quarter to almost $3.0 billion in the 2014 quarter.

Total revenues for the quarter ended June 30, 2014 decreased by about 12% compared to the quarter ended June 30, 2013, from $229.8 million to $201.6 million. This measure decreased mainly because of large changes in gains and losses on financial instruments.

Net Interest - Securitized Mortgages

Comparing the quarter ended June 30, 2014 to the quarter ended June 30, 2013, “net interest – securitized mortgages” increased by 15% to $29.0 million from $25.3 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 $15.0 billion as at June 30, 2013 to $20.2 billion as at June 30, 2014; however, the market for prime mortgages became more competitive as the Company grew this portfolio. At June 30, 2013, the Company’s securitized mortgage portfolio earned gross spreads of approximately 1.01%. By June 30, 2014, as higher-spread securitizations

amortized down and new securitizations were entered into at tighter spreads, the weighted-average gross spread decreased to 0.95%. The 2014 second 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 second quarter of 2014 was to reduce the Company's net interest margin by approximately $2.0 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 19% to $36.1 million from $44.8 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 25% from the 2013 second quarter to the 2014 second quarter. The Company also earned about $1.8 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 13% to $2.6 million from $2.3 million. The gains relate to multi-unit residential mortgages originated and sold to institutional NHA-MBS issuers. Although volumes for these transactions increased by 46% from the 2013 second quarter to the 2014 second quarter, generally, spreads on these transactions tightened in 2014 so that the Company realized lower per unit gains.

Mortgage Servicing Income

Mortgage servicing income decreased 5% to $22.8 million from $24.0 million. This decrease was due to increased securitization by the Company and lower administration fees. The growth in the amount of MUA, which grew by 12% year over year, reflects the growth of MUA for the Company's securitization programs of 37% and third-party MUA growth of 5% between the second quarters of 2013 and 2014. At June 30, 2014, there were approximately $21.7 billion of mortgages in MUA on which the Company earned net interest spread as opposed to servicing revenue. This has grown from $15.9 billion in 2013. As the securitized portfolio has grown and become a larger part of MUA, mortgage servicing income 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 were reached in late 2013.

Mortgage Investment Income

Mortgage investment income decreased 12% to $13.5 million from $15.4 million. The change is largely due to a one-time gain of $1.1 million in 2013 on the sale of a commercial property which it had acquired under foreclosure in 2008 and written down to market value. Income was also reduced due to lower mortgage rates on mortgages accumulated for securitization. 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. The remaining change is a combination of factors, including about $0.2 million of additional mortgage interest earned on consolidation of the $59 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**		**Six months ended**	
	June 30, 2014	**June 30, 2013**	**June 30, 2014**	**June 30, 2013**
		($ 000's)		
Gains (losses) on short bonds used for the economic hedging program	(9,330)	29,664	(24,233)	23,235
Gains related to the mortgages designated at fair value net of interest rate swaps	1,037	13,307	7,784	16,250
Gains (losses) on deferred placement fees receivable	104	(279)	131	(263)
Other gains (losses)	(28)	108	(68)	169
Total gains (losses) on financial instruments	(8,217)	42,800	(16,386)	39,391

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% in the first quarter. In the second quarter of 2014, bond yields continued to fall, this time by about 0.18% in the period. 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 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 second quarter of 2014, the Company recorded losses on these hedges of $9.3 million (2013 – gain of $29.7 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 $1.3 billion of bonds sold short at the end of the second 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 $1.0 million net gain for the quarter.

Brokerage Fees Expense

Brokerage fees expense decreased 25% to $21.4 million from $28.4 million. This decrease is almost entirely explained by lower origination of single-family mortgages for institutional investors, which also fell by 25%.

Salaries and Benefits Expense

Salaries and benefits expense increased 5% to $16.2 million from $15.5 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. Although commercial origination including renewals increased by 15% from second quarter in 2013, sales compensation decreased by $0.2 million year over year. As at June 30, 2014, the Company had 716 employees, compared to 674 as at June 30, 2013. The 6% 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 16% to $8.9 million from $7.7 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.

Other Operating and Amortization of Intangibles Expenses

Other operating and amortization of intangibles expenses increased 2% to $11.2 million from $11.0 million. The amortization of intangible assets recognized on the IPO was $1.3 million in the 2014 second quarter compared to $1.4 million in the 2013 comparative quarter, as some of these assets became fully amortized in 2013. Other operating expenses increased by $0.4 million as the Company incurred higher costs related to its growth including costs related to the launch of its new mortgage underwriting and fulfillment processing services business.

Income before Income Taxes and Pre-FMV EBITDA

Income before income taxes decreased 58% to $38.2 million from $91.9 million. The decrease was almost entirely the result of a falling interest rate environment, which negatively affected the Company's interest rate hedges in the 2014 quarter. The decrease was magnified in comparison to the 2013 quarter, when the Company earned $42.8 million of gains on financial instruments. Together the change accounted for a decrease in income before income taxes of $51 million. Pre-FMV EBITDA, which eliminates the impact of the gains and losses on financial instruments, decreased 5% to $48.4 million from $51.2 million. The decrease was largely due to the lower mortgage servicing income and placement fees net of broker fees. Together these decreased the Company's pre-tax profit by $2.9 million.

Provision for Income Taxes

The provision for taxes decreased by 59% to $10.0 million from $24.1 million. The provision is lower due to the decreased earnings recorded in the 2014 quarter compared to those in the 2013 quarter.

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	**June 30, 2014**	**June 30, 2013**	**June 30, 2014**	**June 30, 2013**
Originations and renewals	4,771,718	4,919,917	1,255,838	1,094,851
Percentage change	*(3.0%)*		*14.7%*	
Revenue	153,884	180,739	47,712	49,091
Percentage change	*(14.9%)*		*(2.8%)*	
Income before income taxes	27,009	74,185	11,208	17,760
Percentage change	*(63.6%)*		*(36.9%)*	
Period ended	**June 30, 2014**	**December 31, 2013**	**June 30, 2014**	**December 31, 2013**
Identifiable assets	19,269,291	16,282,131	4,603,446	4,257,310
Mortgages under administration	61,829,706	57,652,258	18,084,988	17,966,745

Residential Segment

Overall residential origination including renewals decreased by 3% between the second quarters of 2014 and 2013 while residential revenues decreased by about 15%. Part of the decrease in revenue is due to the change in gains and losses on financial instruments. Excluding these changes, revenue increased by 12% as the securitized mortgage portfolio grew and produced higher interest revenue. The net change in gains and losses on financial instruments of $44.4 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 decreased by 8% year over year, indicative of lower mortgage servicing and net placement fee revenue as the Company has elected to securitize a greater portion of its origination. Identifiable assets have increased since December 31, 2013, as the Company added about $2.2 billion of net single-family mortgages to mortgages pledged under securitization, $500 million of mortgages accumulated for securitization and more than $300 million of government bonds purchased for hedging purposes.

Commercial Segment

Commercial revenues decreased by almost 3% from the prior year's quarter, but increased by 12% if the impact of changes in gains and losses on the fair value of financial instruments are excluded. This growth is due to higher overall origination and to higher interest revenue on the Company's commercial segment securitized mortgage portfolio and higher deferred placement fees as the multi-unit residential mortgage market has become more competitive. Without fair value amounts, net income before tax increased by a small amount, or an increase of less than 1% year over year, 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 $350 million.

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 June 30, 2014, the Company has entered into repurchase transactions with financial institutions to borrow $720 million related to $734 million of mortgages held in "mortgages accumulated for sale or securitization" on the balance sheet.

At June 30, 2014, outstanding bank indebtedness (excluding bank indebtedness at the Fund level) was $749.6 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 $886.1 million (December 31, 2013 - $454.8 million) of mortgages accumulated for sale or securitization. At June 30, 2014, the Company's other interest-yielding assets included: (1) deferred placement fees receivable of $33.6 million (December 31, 2013 – $33.6 million) and (2) mortgage and loan investments of $205.0 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 increased between December 31, 2013 and June 30, 2014, and now stands at $38.5 million (December 31, 2013 – $Nil). This represents a debt-to-equity ratio of approximately 0.1 to 1, which the Company believes is at a very conservative level. This ratio has increased from December 31, 2013 when there was no "true leverage" as the Company has invested $35 million in new mortgage securitizations and $20 million in new mortgage and loan investments.

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 June 30, 2014, $7.0 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 June 30, 2014, the investment in cash collateral was $18.1 million (December 31, 2013 - $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 second quarter of 2014, the Company will receive approximately $75 million of cash, on an annualized basis, from its servicing operations and $126 million of annualized cash flow from securitization transaction spread and deferred placement fees receivables. Together, on an after-tax basis, this $148 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 June 30, 2014, the Company had $999 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 June 30, 2014, the Company had entered into $101 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 April 1, 2014 to June 30, 2014 was a $9.3 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 $2.8 million as at June 30, 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 $2.8 million on the swap has been excluded from earnings and been applied to increase the carrying value of the debenture note payable. The Company is also a party to 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 June 30, 2014, the aggregate notional value of

these swaps was $30.1 million. During the quarter the value of these swaps decreased by about $28. 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 June 30, 2014, the Company has various exposures to changing credit spreads. In particular, in mortgages accumulated for sale or securitization, there are over $1.6 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 June 30, 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; however, in the next year, there will be greater expenditures as required to support the new third party underwriting business.

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 June 30, 2014 continue to be consistent with those used for the year ended December 31, 2013 and the quarter ended March 31, 2014.

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 June 30, 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 July 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 was pleased with the results of second quarter of 2014 particularly with its very strong origination volumes as the Company took advantage of what is typically the strongest seasonal quarter of the year. The Company anticipates continuing strength through the third quarter in what is another seasonally strong quarter for the real estate market. Management is also delighted with the mortgage underwriting and fulfillment processing services agreement which was entered into subsequent to the quarter end. Management hopes this will be a long term strategy to leverage the Company's expertise in underwriting mortgages and its industry-leading MERLIN technology.

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 $20 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]

Second Quarter 2014

First National Financial Corporation

INTERIM CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

[Unaudited - in thousands of Canadian dollars]

As at

	Notes	June 30, 2014 $	December 31, 2013 $
ASSETS			
Restricted cash	3	**448,945**	431,111
Accounts receivable and sundry		**64,867**	60,110
Securities purchased under resale agreements and owned		**1,290,340**	1,055,443
Mortgages accumulated for sale or securitization	5	**1,620,445**	1,074,825
Mortgages pledged under securitization	3	**20,156,223**	17,651,644
Deferred placement fees receivable	4	**33,636**	33,580
Cash held as collateral for securitization	3	**25,075**	24,804
Purchased mortgage servicing rights		**2,678**	3,079
Mortgage and loan investments	6	**204,978**	184,584
Income taxes recoverable		**5,723**	—
Other assets		**49,603**	50,037
Total assets		**23,902,513**	20,569,217
LIABILITIES AND EQUITY			
Liabilities			
Bank indebtedness	8	**754,022**	274,484
Obligations related to securities and mortgages sold under repurchase agreements		**720,385**	609,292
Accounts payable and accrued liabilities		**79,865**	66,426
Securities sold under repurchase agreements and sold short		**1,292,051**	1,050,199
Debt related to securitized and participation mortgages	9	**20,371,356**	17,884,303
Debenture loan payable		**177,812**	179,195
Income taxes payable		—	4,207
Deferred tax liabilities		**53,600**	51,200
Total liabilities		**23,449,091**	20,119,306
Equity attributable to shareholders			
Common shares	10	**122,671**	122,671
Preferred shares	10	**97,394**	97,394
Retained earnings		**188,100**	184,561
		408,165	404,626
Non-controlling interests		**45,257**	45,285
Total equity		**453,422**	449,911
Total liabilities and equity		**23,902,513**	20,569,217

On behalf of the board

John Brough

Robert Mitchell

First National Financial Corporation

INTERIM CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

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

		Three months ended		Six months ended	
		June 30, 2014	**June 30, 2013**	**June 30, 2014**	**June 30, 2013**
	Notes	$	$	$	$
REVENUE					
Interest revenue - securitized mortgages		**134,783**	100,550	**259,836**	195,064
Interest expense - securitized mortgages		**(105,757)**	(75,249)	**(203,394)**	(145,509)
Net interest - securitized mortgages	3	**29,026**	25,301	**56,442**	49,555
Placement fees		**36,101**	44,781	**53,873**	63,908
Gains on deferred placement fees	4	**2,620**	2,254	**5,325**	4,469
Mortgage investment income		**13,487**	15,409	**25,837**	25,769
Mortgage servicing income		**22,822**	24,036	**45,816**	46,457
Realized and unrealized gains (losses) on financial instruments		**(8,217)**	42,800	**(16,386)**	39,391
		95,839	154,581	**170,907**	229,549
EXPENSES					
Brokerage fees		**21,372**	28,389	**31,205**	40,388
Salaries and benefits		**16,184**	15,530	**32,405**	31,385
Interest		**8,853**	7,705	**15,602**	13,405
Other operating		**9,963**	9,566	**19,717**	18,127
Amortization of intangible assets		**1,250**	1,446	**2,500**	3,063
		57,622	62,636	**101,429**	106,368
Income before income taxes		**38,217**	91,945	**69,478**	123,181
Income tax expense		**10,000**	24,100	**18,200**	32,300
Net income and comprehensive income for the period		**28,217**	67,845	**51,278**	90,881
Net income attributable to:					
Shareholders		**27,510**	67,193	**49,839**	89,942
Non-controlling interests		**707**	652	**1,439**	939
		28,217	67,845	**51,278**	90,881
Earnings per share					
Basic	10	**0.44**	1.10	**0.79**	1.46

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	**—**	**—**	**49,839**	**1,439**	**51,278**
Dividends paid or declared	**—**	**—**	**(46,300)**	**(1,467)**	**(47,767)**
Balance at June 30, 2014	**122,671**	**97,394**	**188,100**	**45,257**	**453,422**

	Common shares	Preferred shares	Retained earnings	Non-controlling interests	Total equity
	$	$	$	$	$
Balance at January 1, 2013	122,671	97,394	102,440	—	322,505
Comprehensive income	—	—	89,942	939	90,881
Dividends paid or declared	—	—	(43,303)	(1,222)	(44,525)
Initial recognition of non-controlling interests	—	—	—	45,599	45,599
Balance at June 30, 2013	122,671	97,394	149,079	45,316	414,460

See accompanying notes

First National Financial Corporation

INTERIM CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

[Unaudited - in thousands of Canadian dollars]

	Three months ended		Six months ended	
	June 30, 2014	**June 30, 2013**	**June 30, 2014**	**June 30, 2013**
	$	$	$	$
OPERATING ACTIVITIES				
Net income for the period	**28,217**	67,845	**51,278**	90,881
Add (deduct) items not affecting cash				
Deferred income taxes	**1,300**	12,800	**2,400**	12,200
Non-cash portion of gains on deferred placement fees	**(2,337)**	(1,985)	**(4,922)**	(4,244)
Decrease (increase) in restricted cash	**(145,230)**	77,012	**(17,834)**	(56,631)
Net investment in mortgages pledged under securitization	**(1,486,769)**	(1,059,280)	**(2,488,764)**	(1,982,875)
Net increase in debt related to securitized mortgages	**1,607,883**	974,825	**2,481,933**	2,022,863
Amortization of deferred placement fees receivable	**2,561**	4,819	**4,997**	10,072
Amortization of purchased mortgage servicing rights	**208**	196	**401**	402
Amortization of property, plant and equipment	**708**	602	**1,416**	1,204
Amortization of intangible assets	**1,250**	1,446	**2,500**	3,063
Unrealized (gains) losses on financial instruments	**5,066**	(43,506)	**5,622**	(37,929)
	12,857	34,774	**39,027**	59,006
Net change in non-cash working capital balances related to operations	**(480,993)**	(388,103)	**(556,849)**	(603,838)
Cash used in operating activities	**(468,136)**	(353,329)	**(517,822)**	(544,832)
INVESTING ACTIVITIES				
Additions to property, plant and equipment	**(988)**	(541)	**(3,482)**	(1,840)
Investment of cash held as collateral under securitization	**(9,227)**	7,831	**(271)**	40,146
Investment in mortgage and loan investments	**(36,774)**	(39,260)	**(62,377)**	(70,935)
Repayment of mortgage and loan investments	**9,794**	20,231	**41,984**	35,651
Cash provided by (used in) investing activities	**(37,195)**	(11,739)	**(24,146)**	3,022
FINANCING ACTIVITIES				
Dividends paid	**(23,650)**	(22,151)	**(45,801)**	(42,803)
Obligations related to securities and mortgages sold under repurchase agreements	**207,698**	333,578	**111,093**	420,697
Debt related to participation mortgages	**1,217**	(8,600)	**5,120**	(11,260)
Securities purchased under resale agreements and owned, net	**(60,963)**	(235,543)	**(234,897)**	(1,131,661)
Securities sold under repurchase agreements and sold short, net	**60,065**	260,799	**228,382**	1,148,908
Non-controlling interest	**(733)**	(732)	**(1,467)**	44,378
Cash provided by financing activities	**183,634**	327,351	**62,430**	428,259
Net increase in bank indebtedness during the period	**(321,697)**	(37,717)	**(479,538)**	(113,551)
Bank indebtedness, beginning of period	**(432,325)**	(260,878)	**(274,484)**	(185,044)
Bank indebtedness, end of period	**(754,022)**	(298,595)	**(754,022)**	(298,595)
Supplemental cash flow information				
Interest received	**159,257**	122,404	**306,182**	258,744
Interest paid	**108,101**	79,973	**208,000**	152,702
Income taxes paid	**10,770**	9,626	**25,730**	21,299

See accompanying notes

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

June 30, 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 approximately $80 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 July 29, 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 June 30, 2014, the cash held as collateral for securitization was $25,075 [December 31, 2013 - $24,804].

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

	June 30, 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	**20,009,415**	**20,405,337**	17,532,693	17,919,788
Mark to market adjustment	**45,256**	—	37,956	—
Capitalized origination costs	**101,552**	—	80,995	—
Debt discounts	—	**(50,777)**	—	(47,161)
	20,156,223	**20,354,560**	17,651,644	17,872,627
Add:				
Principal portion of payments held in restricted cash	**410,710**	—	398,285	—
Participation debt	—	**16,796**	—	11,676
	20,566,933	**20,371,356**	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 June 30 are as follows:

	2014 $	**2013** $
Opening balance, April 1	**87,793**	60,194
Add: new origination costs in the period	**23,825**	13,166
Less: amortization in the period	**(10,066)**	(7,205)
Ending balance, June 30	**101,552**	66,155

The mortgages securitized through NHA-MBS and CMB programs have been classified as loans and receivables, except for approximately $1.2 billion [2013 - $1.0 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:

	June 30, 2014	
	Commercial mortgages	**Residential mortgages**
HFT mortgages	**$147,615**	**$3,277,978**
Average life [in months] [1]	**31**	**24**
Prepayment speed assumption [annual rate]	**3.3%**	**11.6%**
Impact on fair value of 10% adverse change	**$111**	**$559**
Impact on fair value of 20% adverse change	**$122**	**$1,114**
Discount rate [annual rate]	**2.2%**	**2.0%**
Impact on fair value of 10% adverse change	**$845**	**$10,711**
Impact on fair value of 20% adverse change	**$1,676**	**$21,360**

[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.

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 June 30, 2014, $499,485 [2013 - $357,377] of mortgages were placed with institutional investors which created gains on deferred placement fees of $2,620 [2013 - $2,254]. Cash receipts on deferred placement fees receivable for the three months ended June 30, 2014 were $2,786 [2013 - $5,226].

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. As at June 30, 2014, the fair value of deferred placement fees receivable is $33,636 [2013 - $33,580]. 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:

	June 30, 2014	
	Commercial mortgages	**Residential mortgages**
Average life [in months] [1]	**57**	**16**
Prepayment speed assumption [annual rate]	—	**15%**
Impact on fair value of 10% adverse change	—	**$3**
Impact on fair value of 20% adverse change	—	**$7**
Residual cash flows discount rate [annual rate]	**4.6%**	**4.1%**
Impact on fair value of 10% adverse change	**$387**	**$1**
Impact on fair value of 20% adverse change	**$765**	**$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.

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:

	June 30, 2014	**December 31, 2013**
	$	$
Mortgages accumulated for securitization	**1,568,693**	1,063,068
Mortgages accumulated for sale	**51,752**	11,757
	1,620,445	1,074,825

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:

	June 30, 2014	**December 31, 2013**
	$	$
Mortgage loans, classified as loans and receivables	**145,822**	115,630
Mortgage loans, designated as fair value through profit or loss	**59,156**	68,954
	204,978	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 June 30, 2014, the Company had mortgages under administration of $79,914,694 [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 June 30, 2014, the Company administered 259,600 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].

Mortgages under administration are serviced as follows:

	June 30, 2014 $	December 31, 2013 $
Institutional investors	**49,886,013**	48,245,957
Mortgages accumulated for sale or securitization and mortgage and loan investments	**1,816,775**	1,255,267
Securitization vehicles, deferred placement investors	**4,985,757**	5,075,254
Mortgages pledged under securitization	**20,009,415**	17,532,693
CMBS conduits	**3,216,734**	3,509,832
	79,914,694	75,619,003

The Company's exposure to credit loss is limited to mortgages under administration totaling $206,406 [December 31, 2013 - $201,271], of which $3,876 of mortgages have principal and interest payments in arrears as at June 30, 2014 [December 31, 2013 - $4,971]. The Company incurred actual credit losses, net of recoveries, of $8 during the three months ended June 30, 2014 [2013 - $2,203]. As at June 30, 2014, the Company has $6,541 [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 June 30, 2014 was $518,589 [December 31, 2013 - $405,426].

8. BANK INDEBTEDNESS

Bank indebtedness includes a revolving credit facility of $1,000,000 [December 31, 2013 - $570,000] maturing in January 2018, of which $748,341 [December 31, 2013 - $258,421] was drawn as at June 30, 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 June 30, 2014, debt related to securitized mortgages was $20,354,560 [December 31, 2013 - $17,872,627], net of unamortized discounts of $50,777 [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 June 30, 2014, debt related to participation mortgages was $16,796 [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.

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 June 30, 2014	**59,967,429**	**122,671**	**4,000,000**	**97,394**

[c] Earnings per share

	Three months ended June 30,		Six months ended June 30,	
	2014	**2013**	**2014**	**2013**
Net income attributable to shareholders	**$27,510**	$67,193	**$49,839**	$89,942
Less: dividends declared on preferred shares	**(1,162)**	(1,162)	**(2,325)**	(2,325)
Net earnings attributable to common shareholders	**$26,348**	$66,031	**$47,514**	$87,617
Number of common shares outstanding	**59,967,429**	59,967,429	**59,967,429**	59,967,429
Basic earnings per common share	**$0.44**	$1.10	**$0.79**	$1.46

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.

[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.

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:

	June 30, 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	—	—	448,945	448,945	448,945
Accounts receivable and sundry	—	3,082	61,785	64,867	64,867
Securities purchased under resale agreements and owned	—	—	1,290,340	1,290,340	1,290,340
Mortgages accumulated for sale or securitization	51,752	—	1,568,693	1,620,445	1,620,445
Mortgages pledged under securitization	—	4,140,639	16,015,584	20,156,223	20,464,375
Deferred placement fees receivable	—	33,636	—	33,636	33,636
Cash held as collateral for securitization	—	—	25,075	25,075	25,075
Mortgage and loan investments	—	59,156	145,822	204,978	204,978
Total financial assets	51,752	4,236,513	19,556,244	23,844,509	24,152,661
Financial liabilities					
Bank indebtedness	—	—	754,022	754,022	754,022
Obligations related to securities and mortgages sold under repurchase agreements	—	—	720,385	720,385	720,385
Accounts payable and accrued liabilities	—	6,179	73,686	79,865	79,865
Securities sold under repurchase agreements and sold short	—	1,292,051	—	1,292,051	1,292,051
Debt related to securitized and participation mortgages	—	—	20,371,356	20,371,356	20,566,317
Debenture loan payable	—	177,812	—	177,812	177,812
Total financial liabilities	—	1,476,042	21,919,449	23,395,491	23,590,452

	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

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

	June 30, 2014			
	Level 1	**Level 2**	**Level 3**	**Total**
	$	$	$	$
Financial assets				
Mortgages accumulated for sale	**—**	**51,752**	**—**	**51,752**
HFT mortgages	**—**	**—**	**4,140,639**	**4,140,639**
Deferred placement fees receivable	**—**	**—**	**33,636**	**33,636**
Mortgage and loan investments	**—**	**—**	**59,156**	**59,156**
Interest rate swaps	**—**	**3,082**	**—**	**3,082**
Total financial assets	**—**	**54,834**	**4,233,431**	**4,288,265**
Financial liabilities				
Securities sold under repurchase agreements and sold short	**1,292,051**	**—**	**—**	**1,292,051**
Interest rate swaps	**—**	**6,179**	**—**	**6,179**
Debenture loan payable	**—**	**177,812**	**—**	**177,812**
Total financial liabilities	**1,292,051**	**183,991**	**—**	**1,476,042**

	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
Debenture loan payable	—	179,195	—	179,195
Total financial liabilities	1,050,199	182,834	—	1,233,033

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 June 30, 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 $2,422 [2013 - loss of $7,416]. 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 $3,151 [2013 - $176] of the Company's financial assets and financial liabilities for the quarters ended June 30, 2014 and 2013, all of which have been classified as fair value through profit or loss:

	Three months ended June 30,		Six months ended June 30,	
	2014	**2013**	**2014**	**2013**
	$	$	$	$
HFT mortgages	**1,038**	11,774	**7,785**	16,960
Deferred placement fees receivable	**104**	(279)	**131**	(263)
Securities owned and sold short	**(9,331)**	31,197	**(24,234)**	22,525
Interest rate swaps	**(28)**	108	**(68)**	169
	(8,217)	42,800	**(16,386)**	39,391

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 June 30, 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.

	Fair value as at April 1, 2014 $	Investments $	Unrealized gains recorded in income $	Payments and amortization $	Fair value as at June 30, 2014 $
Financial assets					
HFT mortgages	**4,035,578**	**723,142**	**2,318**	**(620,399)**	**4,140,639**
Deferred placement fees receivable	**33,756**	**2,337**	**104**	**(2,561)**	**33,636**
Mortgage and loan investments	**65,847**	**—**	**—**	**(6,691)**	**59,156**
Total financial assets	**4,135,181**	**725,479**	**2,422**	**(629,651)**	**4,233,431**

	Fair value as at April 1, 2013 $	Investments $	Unrealized losses recorded in income $	Payments and amortization $	Fair value as at June 30, 2013 $
Financial assets					
HFT mortgages	2,791,868	879,077	(7,137)	(859,057)	2,804,751
Deferred placement fees receivable	38,941	1,985	(279)	(4,818)	35,829
Mortgage and loan investments	41,791	11,871	—	(5,156)	48,506
Total financial assets	2,872,600	892,933	(7,416)	(869,031)	2,889,086

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 June 30, 2014, accounts receivable and sundry have been increased by $2,812 [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 June 30, 2014, the ratio was 2.2:1 [December 31, 2013 - 1.1:1]. The Company was in compliance with the bank covenant throughout the period.

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 June 30, 2014			Six months ended June 30, 2014		
	Residential $	Commercial $	Total $	Residential $	Commercial $	Total $
REVENUE						
Interest revenue - securitized mortgages	**100,418**	**34,365**	**134,783**	**193,938**	**65,898**	**259,836**
Interest expense - securitized mortgages	**(78,215)**	**(27,542)**	**(105,757)**	**(148,584)**	**(54,810)**	**(203,394)**
Net interest - securitized mortgages	**22,203**	**6,823**	**29,026**	**45,354**	**11,088**	**56,442**
Placement and servicing	**45,099**	**8,227**	**53,326**	**73,032**	**15,596**	**88,628**
Mortgage investment income	**8,367**	**5,120**	**13,487**	**16,028**	**9,809**	**25,837**
	75,669	**20,170**	**95,839**	**134,414**	**36,493**	**170,907**
EXPENSES						
Amortization	**1,300**	**658**	**1,958**	**2,601**	**1,315**	**3,916**
Interest	**8,283**	**570**	**8,853**	**14,644**	**958**	**15,602**
Other operating	**39,077**	**7,734**	**46,811**	**66,526**	**15,385**	**81,911**
	48,660	**8,962**	**57,622**	**83,771**	**17,658**	**101,429**
Income before income taxes	**27,009**	**11,208**	**38,217**	**50,643**	**18,835**	**69,478**
Identifiable assets	**19,269,291**	**4,603,446**	**23,872,737**	**19,269,291**	**4,603,446**	**23,872,737**
Goodwill	—	—	**29,776**	—	—	**29,776**
Total assets	**19,269,291**	**4,603,446**	**23,902,513**	**19,269,291**	**4,603,446**	**23,902,513**
Capital expenditures	**691**	**297**	**988**	**2,437**	**1,045**	**3,482**

First National Financial Corporation

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

June 30, 2014

	Three months ended June 30, 2013			Six months ended June 30, 2013		
	Residential	**Commercial**	**Total**	**Residential**	**Commercial**	**Total**
	$	$	$	$	$	**$**
REVENUE						
Interest revenue - securitized mortgages	72,107	28,443	100,550	139,704	55,360	195,064
Interest expense - securitized mortgages	(52,731)	(22,518)	(75,249)	(102,411)	(43,098)	(145,509)
Net interest - securitized mortgages	19,376	5,925	25,301	37,293	12,262	49,555
Placement and servicing	99,099	14,772	113,871	130,650	23,575	154,225
Mortgage investment income	9,533	5,876	15,409	15,510	10,259	25,769
	128,008	26,573	154,581	183,453	46,096	229,549
EXPENSES						
Amortization	1,343	705	2,048	2,788	1,479	4,267
Interest	7,180	525	7,705	12,287	1,118	13,405
Other operating	45,300	7,583	52,883	73,036	15,660	88,696
	53,823	8,813	62,636	88,111	18,257	106,368
Income before income taxes	74,185	17,760	91,945	95,342	27,839	123,181
Identifiable assets	14,870,349	3,893,558	18,763,907	14,870,349	3,893,558	18,763,907
Goodwill	—	—	29,776	—	—	29,776
Total assets	14,870,349	3,893,558	18,793,683	14,870,349	3,893,558	18,793,683
Capital expenditures	380	161	541	1,289	551	1,840

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 has serviced these mortgages during their terms at market commercial servicing rates. The mortgages which are administered by the Company have a balance of $21,246 as at June 30, 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 has also provided the Company with portfolio insurance at market premiums. The total bulk insurance purchased during the second quarter of 2014 was $691 [2013 - $806], 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 June 30, 2014, the portfolio had a balance of $8.8 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 June 30, 2014, no part of the line was drawn and 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 retirement home company at market rates. In the second quarter of 2014, the Company funded a new mortgage for $9.0 million and consulted on a $59.6 million real estate purchase and mortgage assumption transaction to the related party, earning $113 of placement fees. As at June 30, 2014, the portfolio administered by the Company totalled $87.1 million [December 31, 2013 - $19.2 million].

15. SUBSEQUENT EVENT

Subsequent to the end of the second quarter, the Company entered into an agreement with a large Canadian schedule 1 bank ["Bank"] to provide underwriting and fulfillment processing services for mortgages originated by the Bank through the residential mortgage broker channel. Under the agreement, The Company will employ a customized software solution to accept mortgage applications from the Bank in the mortgage broker channel and underwrite these mortgages in accordance with the Bank's underwriting guidelines. The Bank will fund all the mortgages underwritten under the agreement and retain full responsibility for mortgage servicing and the client relationship. The Company will create a separate division to provide these services which are scheduled to commence in early 2015.

First National Financial Corporation

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