



**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**EGI FINANCIAL HOLDINGS INC.****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS****For the three and 12 month periods ending December 31, 2009**

*References to "EGI" or "the Company" in this Management's Discussion and Analysis of Financial Condition and Results of Operations refer to EGI Financial Holdings Inc. on a consolidated basis, both now and in its predecessor forms.*

The following discussion should be read in conjunction with EGI's audited consolidated financial statements and the related notes. The following commentary is current as of March 15, 2010. Additional information relating to EGI is available on SEDAR at [www.sedar.com](http://www.sedar.com). Certain totals, subtotals and percentages may not reconcile due to rounding.

EGI uses both Canadian generally accepted accounting principles (GAAP) and certain non-GAAP measures to assess performance. Securities regulators require that companies caution readers about non-GAAP measures that do not have a standardized meaning under GAAP and are unlikely to be comparable to similar measures used by other companies. EGI analyzes performance based on operating income and underwriting ratios such as combined, expense and loss ratios.

The following discussion contains forward-looking information that involves risk and uncertainties based on current expectations. This information includes, but is not limited to, statements about the operations, business, financial condition, priorities, targets, ongoing objectives, strategies and outlook for EGI in 2010 and subsequent periods.

This information is based upon certain material factors or assumptions that were applied in drawing a conclusion or making a projection as reflected in the forward-looking information. By its nature, this information is subject to inherent risks and uncertainties that may be general or specific. A variety of material factors, many of which are beyond EGI's control, affect the operations, performance and results of EGI and its business and could cause actual results to differ materially from the expectations expressed in any of this forward-looking information (see "Risk Factors").

EGI's actual results could differ materially from those anticipated in this forward-looking information as a result of various factors, including those discussed in this Management's Discussion and Analysis. Forward-looking information is provided for the purpose of providing information about management's current expectations and plans relating to the future. Readers are cautioned that such information may not be appropriate for other purposes. Additional information about the risks and uncertainties about EGI's business is provided in its disclosure materials, including its annual information form, filed with the securities regulatory authorities in Canada, available at [www.sedar.com](http://www.sedar.com). EGI does not undertake to update any forward-looking information.

Underwriting income and interest expense for 2007 in the following table has been restated to reflect the re-allocation of interest expense, related to corporate indebtedness, as a separate line item after investment income in 2008. The restatement was made for comparative purposes only and does not affect net income after taxes.

**Financial Highlights**

	Year ended December 31				
(\$ THOUSANDS EXCEPT PER SHARE AMOUNTS)	2009	2008	2007	2006	2005
<b>Revenue</b>					
Direct written and assumed premiums					
Personal Lines/Auto	\$117,291	\$121,410	\$109,870	\$ 97,932	\$105,567
Niche Products	46,571	49,320	48,065	19,902	11,439
<b>Total direct written premiums</b>	<b>163,862</b>	<b>170,730</b>	<b>157,935</b>	<b>117,834</b>	<b>117,006</b>
Net written premiums	149,745	158,107	146,511	106,047	91,783
Net earned premiums	149,379	157,255	119,606	103,942	76,344
Other revenue	–	–	–	1	227
<b>Total underwriting revenue</b>	<b>149,379</b>	<b>157,255</b>	<b>119,606</b>	<b>103,943</b>	<b>76,571</b>
<b>Underwriting expenses</b>					
Incurred claims	108,194	105,837	71,179	59,503	45,997
Acquisition costs	34,429	37,026	26,143	19,499	12,073
Operating expenses	16,095	14,229	12,043	10,431	9,083
<b>Total underwriting expense</b>	<b>158,718</b>	<b>157,092</b>	<b>109,365</b>	<b>89,433</b>	<b>67,153</b>
Underwriting income (loss)	(9,339)	163	10,241	14,510	9,418
Investment income	17,771	10,009	12,954	11,033	7,527
Interest expense	1,212	1,216	259	–	–
<b>Income before income taxes</b>	<b>7,220</b>	<b>8,956</b>	<b>22,936</b>	<b>25,543</b>	<b>16,945</b>
<b>Income tax expense (recovery)</b>					
Current	3,531	3,453	7,839	9,832	7,505
Future	(826)	(476)	32	(1,270)	(1,768)
	2,705	2,977	7,871	8,562	5,737
<b>Income from continuing operations</b>	<b>4,515</b>	<b>5,979</b>	<b>15,065</b>	<b>16,981</b>	<b>11,208</b>
Extraordinary gain	–	–	–	–	5,669
<b>Net income</b>	<b>\$ 4,515</b>	<b>\$ 5,979</b>	<b>\$ 15,065</b>	<b>\$ 16,981</b>	<b>\$ 16,877</b>
Net income per share – basic	\$0.38	\$ 0.57	\$ 1.56	\$ 1.76	\$ 2.09
– diluted	\$0.36	\$ 0.53	\$ 1.45	\$ 1.67	\$ 1.96
Book value per share	\$ 11.12	\$ 10.16	\$ 10.50	\$ 8.93	\$ 7.33
Net operating income <sup>(1)</sup>	\$ 189	\$ 9,083	\$ 12,957	\$ 15,302	\$ 10,440
Net operating income per share – diluted	\$ 0.02	\$ 0.80	\$ 1.24	\$ 1.50	\$ 1.23
(1) Net operating income is defined as net income plus or minus after-tax realized losses or gains on sale of investments as shown below:					
Net income from continuing operations	\$ 4,515	\$ 5,979	\$15,065	\$16,981	\$11,208
Add losses (deduct gains) from sales of investments	(6,860)	4,833	(3,350)	(2,623)	(1,221)
Tax impact	2,534	(1,729)	1,242	944	453
<b>Net operating income</b>	<b>\$ 189</b>	<b>\$ 9,083</b>	<b>\$12,957</b>	<b>\$15,302</b>	<b>\$10,440</b>

As at December 31					
(\$ THOUSANDS)	2009	2008	2007	2006	2005
<b>Balance Sheet Data</b>					
Cash and short-term deposits	\$ 46,885	\$ 29,111	\$ 22,785	\$ 17,153	\$ 15,899
Investments	294,365	259,774	238,310	179,383	152,736
Total assets	446,465	402,780	370,084	288,439	260,731
Provision for unpaid claims	207,220	185,255	169,091	146,101	129,173
Unearned premiums	72,643	71,154	69,190	43,154	39,973
Bank indebtedness	19,550	19,550	19,550	–	–
Total shareholders' equity	133,431	118,604	101,671	86,041	72,585

The following table shows the Company's selected financial ratios and return on equity (ROE) data. These ratios are defined in the "Glossary of Selected Insurance Terms".

Selected Financial Ratios <sup>(1)</sup> and ROE Data (%)	2009	2008	2007	2006	2005
Loss ratio	72.4	67.3	59.5	57.2	60.3
Expense ratio	33.9	32.6	31.9	28.8	27.7
Combined ratio	106.3	99.9	91.4	86.0	88.0
ROE	3.6	5.4	16.1	21.4	30.1
Adjusted ROE <sup>(2)</sup>	3.6	5.4	16.1	21.4	25.9

- (1) The underwriting ratios (the loss and expense ratios and the combined ratio) are all non-GAAP measures which are common insurance industry measures of performance.
- (2) Excludes the after-tax effects resulting from acquisitions and divestitures including the corresponding adjustments to shareholders' equity (see "Significant Transactions").

## 2009 Financial Overview

Net income after taxes for 2009 was \$4.5 million, a decrease of \$1.5 million, or 25%, compared to net income of \$6.0 million in 2008. An underwriting loss of \$9.3 million in 2009 compares to underwriting income of \$0.2 million in 2008 and investment income including realized gains (losses) increased to \$17.8 million from \$10.0 million in 2008.

Investment income in 2009 includes net realized gains on the disposal of investments of \$6.9 million compared to net realized losses, including impairments of \$4.8 million in 2008. No impairment provisions were recorded in 2009.

Net operating income, defined as net income excluding after-tax realized gains/losses, including impairments on the sale of investments, was \$0.2 million for the year ended December 31, 2009, compared to \$9.1 million in 2008. The decrease of \$8.9 million reflects a significant increase in the combined ratio in 2009 to 106.3% compared to 99.9% in 2008.

## Overview of EGI

EGI operates in the property and casualty (P&C) insurance industry in Canada and the United States, primarily focusing on non-standard automobile insurance and other niche and specialty general insurance products. Founded in 1997 as an insurance and reinsurance broker and marketer, EGI has since developed its business to focus on underwriting opportunities not served by many of the larger, standard insurers.

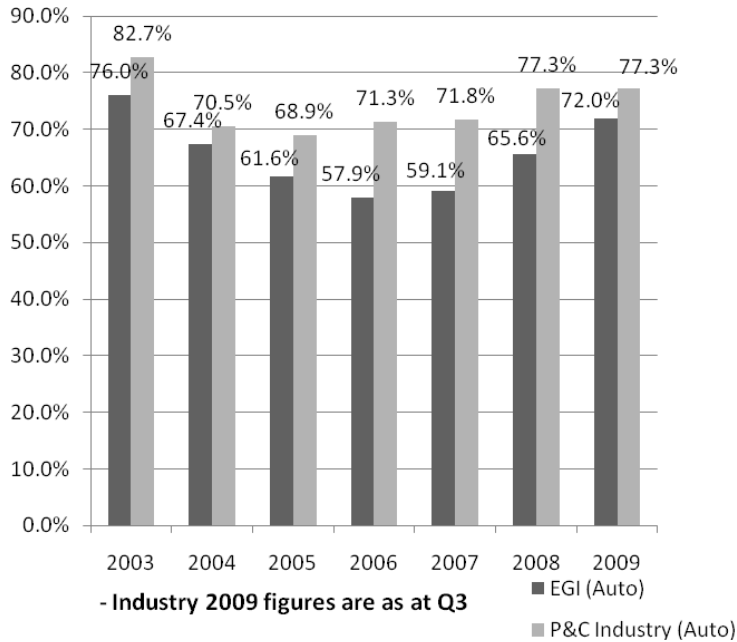
EGI operates through two Strategic Business Units (SBUs) in Canada, the Personal Lines division and the Niche Products division. The Personal Lines division was created in 2006 to transition the Automobile division into a multi-product, multi-line SBU. Currently, the Personal Lines division focuses on the underwriting of non-standard automobile insurance and motorcycle business but has also expanded into other specialty lines of business such as antique and classic vehicles, trailers, motor homes and recreational vehicles. Through its Niche Products division, EGI designs and underwrites specialized insurance programs, such as higher premium property, primary and excess liability, legal expense and accident and health insurance for a variety of businesses and consumers and extended warranty coverage for homes and consumer products.

In addition to the two SBUs in Canada, EGI also formed the International division in 2008 to leverage its strategy to expand into the United States. Currently, this division is focused on personal lines business, predominantly non-standard automobile insurance. As an interim step to execute this strategy, EGI entered the U.S. non-standard auto insurance market under reinsurance agreements with three arm's-length insurance companies. These companies provide property and casualty insurance to the non-standard private passenger automobile segment of the industry and operate in several states in the southeastern U.S. Being dissatisfied with the results of these arrangements, EGI terminated the reinsurance agreements. EGI is now pursuing its U.S. expansion by incorporating and capitalizing in its own insurance company and Managing General Agents (MGA), where the Company can exercise greater underwriting control.

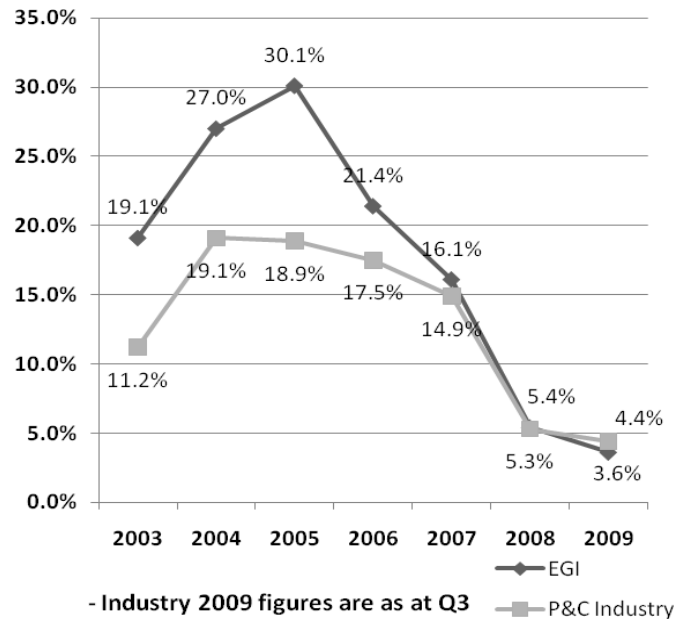
By pursuing its focused niche strategy, EGI's objective is to produce an ROE superior to the Canadian P&C insurance industry average. A key factor in achieving this objective is for EGI's loss ratio to be below the industry average.

The charts below illustrate EGI's and the P&C insurance industry's automobile loss ratios and return on equity.

**Loss Ratio (%)**



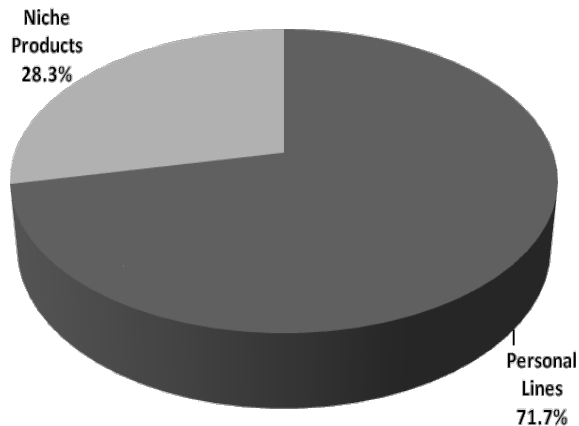
**ROE (%) <sup>(2)</sup>**



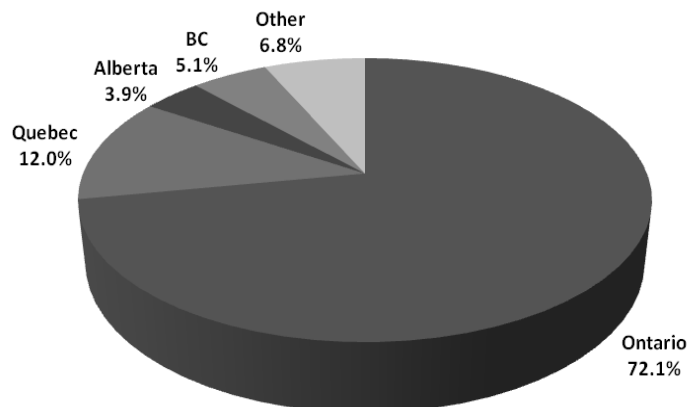
- (1) Source for P&C industry data: MSA Research Inc. (data represents over 92% of Canadian primary writers when measured on a premium volume basis).
- (2) EGI results for 2003 and 2004 include net income from discontinued operations. 2005 results include extraordinary gain.

Approximately 72% of EGI's written premium revenue in 2009 was from its Personal Lines business in Canada with approximately 72% of total premiums underwritten in Ontario. The breakdown of direct written premiums by category of business and by region during 2009 is illustrated below.

**2009 Gross Written Premiums by Category**



**2009 Gross Written Premiums by Region**



Net earned premiums from the sale of Personal Lines automobile policies (Canada and United States combined) account for 74% of net earned premiums. One of EGI's diversification strategies is the growth of the non-auto business in the Niche Products division, currently accounting for approximately 26% of net earned premiums, and the growth of the newly created International division.

The financial performance of EGI is determined by two main factors: (i) the level of premiums earned in relation to claims and operating costs incurred; and (ii) the returns generated from the investment portfolio. Premiums collected are ultimately used to pay claims and operating expenses. There is, however, a time lapse between the collection of premiums and the payment of claims and certain operating expenses. This allows EGI to invest premiums collected and earn an investment return until claims and operating expenses are paid. EGI also earns an investment return on invested capital.

EGI's results also include fees for consulting, and income from one-time gains from acquisitions and divestitures and from corporate and other activities. The impact on the statement of income from the non-operating transactions is discussed in the "Significant Transactions" section.

## Outlook

The instability of the automobile insurance market in 2009 continues to provide potential opportunities for non-standard and niche insurers such as EGI. The economy is precarious, industry pricing practices are inadequate, competitors are in disarray and the extended soft market of the past number of years is showing signs of hardening. Through the long contracting market phase, EGI has preserved its capital and focused where possible on profitable lines of business. EGI is well positioned to take advantage of the opportunities that the changing market cycle may offer. The objective is to ensure that EGI's core non-standard automobile insurance, remains strong and profitable while the Company prepares for the gradual hardening of the market.

In 2009, the automobile insurance industry continued to suffer from escalating loss ratios because of inadequate pricing. This was further compounded by a poor economy and more generous judicial awards, which resulted in increased claims for Accident Benefits, particularly in Ontario. A low interest rate environment has limited the investment income of all insurance companies, which has created a greater emphasis on underwriting results. However, EGI's investment income has remained strong, increasing by 77.6% in 2009, compared to the previous year. The impact of past actions taken by standard insurers seems to have reversed somewhat with signs of tighter underwriting by those insurers towards the end of the year. Because auto insurance rate increases are regulated, standard companies are limited in the amount of rate increase that can be taken at one time in order to achieve their desired underwriting margin. Tighter underwriting is their only option to fully restore profitability. This market hardening has compounding effects that tend to benefit EGI. As standard insurers tighten their underwriting, EGI's sales tend to increase as marginal risks naturally flow to non-standard insurers. Second, these "grey market" risks tend to be more profitable, as EGI collects non-standard premiums on risks that formerly qualified as standard. Third, EGI should retain the best risks in its renewal book of business, since tighter industry underwriting will restrict EGI's policyholders' options to find alternative coverage with EGI's competitors. The erosion of underwriting margins experienced in the auto insurance sector in 2009 is expected to continue at least through the first half of 2010 when the new automobile insurance reform will take effect in Ontario. It is not known with certainty at this time what the combined impact of these reforms will be on claims costs but the reforms are designed and expected to have some positive effect, with the goal of curtailing large premium rate increases to consumers. Overall, EGI is uniquely positioned to capitalize on its strong capital base,

the state of the auto insurance market and the instability of certain of its competitors. This is a rare opportunity to shape industry rates and rules, explore profitable new segments and emerge from 2010 as the pre-eminent provider of non-standard automobile insurance in Canada.

EGI also sees opportunities to grow its Niche Products business and to continue to pursue its diversification strategy. Similar to auto insurance, the other P&C lines of business also experienced escalating loss ratios during 2009. Again, the economic environment and a soft market cycle were contributing factors to the increase in the industry loss ratio. This soft market for the majority of non-auto lines of business persisted throughout 2009 and is expected to continue to exist during 2010. The focus of EGI's Niche Products business during 2010 will be to invest aggressively in product lines with proven performance and revive or cancel underperforming programs. During 2009, EGI took the initiative to substantially reduce the Emergency Travel Health (ETH) business, an underperforming program, to a minimal volume. The same action will be taken with other similar underperforming programs and the emphasis will be on pursuing new and innovative growth opportunities. EGI has laid the groundwork in the past few years to aggressively expand the Niche Products line of business, including the hiring of experienced staff and qualifying new sources of production.

In 2009, the Company refocused its strategy to enter the U.S. non-standard automobile insurance market and should start to see the results of this initiative in 2010. It has terminated all of its third-party reinsurance agreements and has redirected the attention and efforts of its U.S. staff to establishing itself as an insurance carrier, distributing its products through independent producers. EGI has established an MGA and will be launching programs in Florida and Texas as soon as regulatory approval is obtained. A seasoned management team has been established and an operational underwriting, claims and administration infrastructure is in place.

EGI will continue to focus on profitable organic growth opportunities by expanding on its existing business but will also seek out and consider selected acquisition opportunities in Canada and the United States to foster its growth and diversification strategy.

## Strategy

EGI's business strategies and actions are guided by its vision: "to be the pre-eminent Canadian writer of specialized, niche insurance". EGI's objective is to deliver an ROE superior to the average of the Canadian P&C insurance industry through a comprehensive specialized insurance offering. EGI's focus is on non-standard auto and targeted niches that are currently underserved by the market and which require the high level of underwriting and claims expertise of EGI's management team and staff.

For 2010, EGI's strategic goals remain focused on driving profitable business growth by leveraging and building on its strengths.

In order to achieve this objective, EGI intends to:

*Protect the core.* EGI concentrates on what it considers to be the best segments of the non-standard automobile insurance market, which has resulted in above-average underwriting margins over the long term. The Company will continue to provide the optimum level of service to its producers in order to support and expand its offering in this market segment. In addition, focusing primarily on return on equity, EGI will consider returning to markets from which the Company previously exited if long-term profitable opportunities arise.

*Grow Niche Products.* As many brokers need specialty insurers to cover all of their customers' insurance requirements, EGI's Niche Products division is well positioned to respond to this market opportunity.

Working closely with producers, EGI will continue to pursue new and innovative growth opportunities that are not offered by traditional insurers. EGI will also invest aggressively in product lines with proven performance in order to grow these lines. It will also focus on reviving or cancelling underperforming programs so that it can improve the underwriting margin in this division

*Diversify Geographically.* With the termination of the assumed reinsurance business from selected third party U.S. insurers, EGI is now focused on establishing its presence as an insurer in the U.S. to write non-standard automobile business. EGI's new insurance company, Echelon Insurance Company of America (EICA), is domiciled in Florida and will be licensed in certain selected states, which EGI believes constitute attractive markets, to contribute to EGI's goal of earning superior returns. EGI announced on March 1, 2010, that EICA has acquired American Colonial Insurance Company, Inc., a Florida-domiciled property and casualty insurance company. EGI's management team has extensive past experience with the acquisition and operation of U.S. non-standard auto carriers. The U.S. expansion initiative is a major step by the Company in pursuing its diversification and expansion strategies. The Company will also be exploring opportunities in underdeveloped and underserved Canadian jurisdictions.

*Expertly service producers.* EGI strives to provide optimum level service at the right cost to its policyholders and producers. EGI has created and implemented written service standards in all departments interfacing with policyholders or producers. Staff members in these departments are thoroughly trained in the delivery of quality service to achieve these standards at a minimum. This service commitment ensures its policyholders and producers continue to be served by knowledgeable employees in a responsive manner. In order to maintain this standard of service, EGI continuously invests in the development of processes, tools and technology to facilitate easier pathways to transact business, which encourages producers to do more business with us.

*Be Opportunistic.* EGI intends to continue to grow its business by seeking attractively priced acquisitions of insurers or books of business in markets and business lines that are compatible with EGI's strategic objectives. With the current financial crisis, EGI anticipates that there will be further consolidation of insurance companies on both sides of the border and there will be continued downward pressure on the asking price of companies that become available for sale.

*Develop Employees.* The most valuable asset of the organization is its human resources which are the key to executing on its strategies. Therefore EGI continuously invests in the development of its employees and nurtures an interesting and challenging work environment. EGI strongly believes in the personal success of its employees and therefore provides the opportunity for them to achieve this goal which is supported by a succession planning process. EGI also fosters a culture of continuous improvement.

## **Competitive Strengths**

EGI believes that it is uniquely positioned to be the market leader in the specialty P&C insurance industry for the following reasons:

*Comprehensive specialized insurance offering.* EGI offers its producers, both agents and brokers and through MGAs, a comprehensive line of insurance products comprised of non-standard and specialty vehicle automobile insurance and specialized non-auto insurance products and programs. Responding to a market need, EGI thoroughly researches a product opportunity and develops underwriting procedures and ratings that will both meet the customers' requirements and earn an attractive ROE for EGI. The Company then arranges for distribution through its distribution channels.

*Entrepreneurial culture.* EGI fosters a responsive, entrepreneurial environment which encourages innovation in the development of new niche programs and the flexibility to allow for unique, tailor-made solutions to meet market demand.

*Strong customer service focus.* EGI believes that its strong reputation for customer service with its producers and policyholders is a differentiating factor from both an underwriting and a claims standpoint. Automobile policies are typically issued in five business days or less from receipt of the completed application. In the last published Automobile Claims Satisfaction Survey (2005) of insurers, EGI ranked highest among its non-standard auto competitors. Also in a recent survey of brokers by the Insurance Brokers Association of Ontario, EGI ranked the highest among non-standard auto writers. Because of limited competition in niche markets, EGI believes that its strong customer service focus provides stability to the existing business and future growth opportunities with existing and new producers.

*Financial strength.* EGI has a strong capital base relative to its current underwriting commitments, as evidenced by the strong Minimum Capital Test ratio of its main insurance subsidiary. Echelon General's Minimum Capital Test ratio as at December 31, 2009, was 308.3% compared to the P&C insurance industry average Minimum Capital Test ratio of 224% (as per Office of the Superintendent of Financial Institutions' (OSFI) third-quarter 2009 information). Its Premiums-to-Capital ratio is a conservative 1.2:1. EGI intends to preserve and grow its underwriting capital through appropriate pricing, underwriting discipline and conservative loss reserving practices.

*Experienced management team.* EGI has a seasoned group of owner-managers who have worked together successfully for years. With an average of over 20 years of experience in senior positions within the insurance industry, the executive management team has extensive knowledge in non-standard and niche insurance products together with an entrepreneurial thrust and a decisive, collegial management style.

## **Personal Lines Division**

As part of its strategic planning and analysis process, EGI has moved to diversify its writings, both geographically and by product line, including the creation, development, marketing and processing of new personal lines product offerings. The new product lines include motorcycles, antique autos, trailers, all terrain vehicles, recreational vehicles and snowmobiles.

These new offerings, in conjunction with the Company's core, non-standard automobile product, will provide distributors with a wider array of personal lines products (which have historically been underserved by the standard market). This will be accomplished by utilizing the same niche underwriting philosophy and discipline that has been the hallmark of EGI's activities.

Although the non-standard automobile segment remains the largest, single component of EGI's activities, the additional personal lines products will facilitate additional production and diversification, making the Company an even more important partner for its distributors. In this manner, the non-standard automobile segment will continue to form the critical, though not the sole, component of the Personal Lines division.

The non-standard automobile segment currently targeted by EGI's Personal Lines division is high premium insurance for drivers who, because of inexperience or a poor driving record, are not able to obtain insurance from standard insurers. EGI provides coverage for private passenger vehicles as well as single commercial vehicles and small commercial (class 36) and farm fleets. Management believes that EGI's underwriting discipline and claims expertise, strict controls and an experienced management team (who are well versed in the nuances of non-

standard auto) enable the Company to select those drivers in the higher premium categories who have a proportionally lower potential claims risk.

For applicants paying the higher premiums for non-standard automobile insurance, price is an important consideration. EGI provides selected drivers with a lower premium option than the higher premium coverage offered by the Facility Association (or the Groupement in Quebec), the industry-operated pools that serve as the "market of last resort." EGI targets drivers most likely to be "reformers" not "repeaters". These non-standard auto risks fall between Facility and the applicants normally targeted by standard market insurers. The likely reformer expresses concern with respect to his or her poor driving record and exhibits a sincere desire to improve (so as to re-enter the standard market at standard rates) at the earliest opportunity. EGI trains its brokers and agents to select qualifying risks. EGI then employs the experience of its underwriting personnel to ensure that complete and accurate underwriting and rating information has been developed.

In recent years, EGI focused on appointing brokers and agents in "rural" and "targeted urban" centres in its markets due to concerns regarding growth in the number of fraudulent claims in the densely-populated urban centres. This strategy has resulted, over time, in enhanced underwriting margins that on average exceed the industry average.

In July 2005, EGI withdrew from the Alberta personal lines automobile insurance market. The Alberta government's auto insurance reform package (introduced in October 2004) imposed a capping of insurance premiums, particularly for inexperienced and other higher risk drivers, through the implementation of a mandated rating grid and clearly defined risk selection rules. The grid subsidizes the premiums of higher-risk drivers which has resulted in the overcharging of lower-risk drivers in Alberta. The size of this subsidy remains large. Significant changes to the grid rating system will be required to make re-entry into the Alberta private passenger market a viable option. EGI continues to monitor the shifting political winds in the province. EGI presently underwrites motorcycle, commercial, small fleet and farm vehicle insurance in Alberta.

In September 2005, EGI also withdrew from the Newfoundland and Labrador private passenger automobile insurance market. This decision was made as a result of the introduction of Bill 26, which eliminated an insurer's ability to use statistically valid rating factors (such as number of years licensed) which are essential to the proper underwriting of non-standard risks. The regulatory changes made it, in the opinion of management, uneconomical for a non-standard automobile insurer to underwrite the higher risk, private-passenger business for its own account in Newfoundland and Labrador.

As part of the strategy to develop business in other vehicle types, in the first quarter of 2006 EGI entered into an exclusive arrangement with a specialist broker to write motorcycle business in Ontario. Direct written premiums from this arrangement, along with producers of motorcycle business in other jurisdictions, totaled \$15.3 million in 2009. The Company implemented rate increases in 2008 and 2009 and, as a result, 2009 sales were lower than EGI's total direct written premium of \$16.7 million in 2008, due to a reduction in policy count.

EGI will maintain and grow its personal lines business by employing the following strategies:

- Continue to expand non-standard auto writings in jurisdictions where EGI earlier withdrew or restricted its premium writing – such as Nova Scotia, Prince Edward Island, and New Brunswick. Using this strategy, EGI has had significant growth in Nova Scotia where the Company has found market opportunities in some segments within the non-standard market. Direct written premiums in Nova Scotia were \$7.0 million in 2009, a positive increase over 2008 direct written premiums of \$2.4 million. From very modest beginnings, Quebec

(8.6%) and Atlantic Canada (7.7%) now generate significant shares of Personal Lines writings and are targeted for further profitable growth in 2010.

- Monitor the impact of recent government reforms in Ontario aimed at addressing the rapidly escalating costs of insurance claims caused by the infrastructure which has enveloped the claims process. If successful the government reforms may allow EGI to increase its business activities in selected urban markets. The changes are expected to be formally published, in their final form, in March 2010 and enacted in June/July 2010. The changes are intended to slow the rate of claims cost growth (particularly for accident benefits). Historically, a first set of reforms are followed up by additional, regulatory fine-tuning so as to achieve the intended result.
- The Company continues to analyze the Ontario market to determine if there are driver segments or geographic regions within the province where opportunities exist to profitably increase EGI's share of the market.
- Continue to build the Company's profitable personal and commercial auto lines of business in the province of Quebec. In 2009 personal lines production in Quebec totaled \$11.1 million (a 5% increase compared to 2008). Quebec remains an important territory in EGI's efforts to diversify geographically. The benefits of such diversification can be seen in Atlantic Canada, particularly in Nova Scotia, where production more than doubled in 2009.
- Use EGI's non-standard underwriting and marketing expertise to increase other lines of specialty auto insurance products such as coverage for motorcycles, snowmobiles, all terrain vehicles, antique autos and recreational vehicles in existing and new territories.
- Continue to monitor and participate in the ongoing review of Alberta's grid rating system by the Alberta Automobile Insurance Rate Board, with a view to reactivating distribution of EGI's private passenger automobile insurance coverages in that province (should a viable opportunity be proven).

### **Niche Products Division**

EGI's Niche Products division, established in 2003, provides specialized commercial and personal insurance products and programs covering areas of the market that are considered underserved. This division works with P&C insurance brokers, MGAs, benefit consultants, warranty-product distributors and third party administrators (TPAs) to design insurance and warranty product solutions that respond to gaps in the insurance market created by traditional insurers' focus on standardized coverage. The division is focused on satisfying its distributors' need for customized, consumer-oriented solutions that differentiate them from the product offerings provided by standard market insurers. Staffed with highly knowledgeable and experienced insurance professionals, the division researches and designs specialty insurance programs in response to market demand. These programs are then distributed and administered by the initiating broker, MGA, TPA or other intermediary who has worked closely with the division to design the insurance solution. EGI believes that the direct written premiums for its target specialized niche product insurance segment were approximately 10% to 12% of the non-auto Canadian P&C insurance market and 8% to 10% of the accident and health insurance market in 2009.

EGI has identified niche market segments within five product areas that offer opportunities for profitable growth: property insurance; commercial general liability and professional liability insurance; casualty insurance; accident and health insurance; and warranty products. Within each of these areas, EGI concentrates its underwriting within the sub-segments where the risk characteristics of the business offer an opportunity to obtain a higher rate relative to the specific exposure than would be available within the broader segment of that niche market. This focus allows EGI to seek a per-risk margin that exceeds what is available in the standard market.

An important component of the niche products market is the degree to which significant expertise often resides at the broker and distributor level. The distribution partners EGI selects have highly specialized knowledge of the product and the market as well as administration systems to service the customer before and after the sale. They provide highly effective distribution capability for EGI's programs. Their market knowledge and technical design capability are used in product design and, combined with EGI's expertise in pricing, underwriting structures and financial management, create a sustainable product offering. Many of EGI's distribution partners are interested in sharing in future underwriting profits through retention of risk. Accordingly, in certain circumstances, EGI will enter into a risk-sharing agreement with a distribution partner.

In response to the growth experienced in the Niche Products division, the ADAPT® system was developed to enable the administrator of each program to provide customer information to EGI in an electronic format on contracts and policies sold by the distributor. The ADAPT® system software uploads customer data provided by the administrator of the program in preset formats supplied by EGI. The ability to export data avoids costly duplication and allows the distributors to use their own internal systems to supply the required information to EGI rather than being forced to re-enter data on EGI's systems. Once the data transfer is received, EGI is able to immediately create customer policy records on the ADAPT® system and can use the claims portion of the ADAPT® system to manage claims and provide customer service.

EGI intends to maintain and grow the niche programs business by employing the following strategies:

- Continue to broaden market awareness of the existence and capabilities of EGI's Niche Products division (including EGI's risk retention structuring capabilities) by directly contacting and making presentations to qualified brokers and other insurance and warranty product distributors.
- Ensure that the Niche Products division grows organically by continuing to provide unique expertise and superior service in response to all business inquiries.
- Seek opportunities for the Niche Products division to grow through select acquisitions of books of business, distributors, administrators or an insurance company.
- Attract high quality profitable program business by offering a unique opportunity for distribution partners to enter into risk-sharing arrangements with EGI.

### **International Division**

In January 2008, EGI formed the International division to focus on its strategy to expand into the U.S. As an interim step to execute this strategy, EGI entered the U.S. non-standard auto market under reinsurance agreements with three arm's-length insurance companies. EGI has terminated the reinsurance agreements, being dissatisfied with the results.

With the termination of the assumption of business from selected U.S. insurers, the Company has refocused its efforts to being a direct insurer of non-standard automobile insurance. EGI established its new insurance company EICA in Florida and on March 1, 2010, acquired another Florida-domiciled insurer, American Colonial Insurance Company, Inc. EGI has established an MGA in Florida to transact and manage on behalf of the insurance company. It will be launching programs in Florida and Texas as soon as regulatory approval is obtained. The Company will focus on a few states which EGI believes constitute attractive markets, to contribute to EGI's goal of earning superior returns. EGI's management team has past experience with the acquisition and operation of U.S., non-standard auto carriers.

## Segmented Financial Information

The segmented information for the final quarter of 2009 and full year show significant growth in underwriting revenue for the Personal Lines division and revenue declines in the Niche Products and International divisions. The growth in Personal Lines premiums resulted primarily from an increase in premiums in the non-standard automobile line of business. The decline in the Niche Products revenue was primarily due to the significant decline in the ETH of business premium, due to the implementation of rate increases along with more restrictive underwriting criteria and initiatives taken to improve the financial performance of this line of business. The International division recorded limited earned premiums relating to the run-off of assumed reinsurance treaties with U.S. non-standard auto insurers, the largest of which was cancelled effective December 31, 2008. The remaining contract was cancelled effective March 31, 2009. As this business runs off, management expects that these contracts will have a significantly reduced impact on EGI's financial results.

(\$THOUSANDS)	For the three months ended December 31, 2009				For the three months ended December 31, 2008			
	Canada		International		Canada		International	
	Personal Lines	Niche Products	Total		Personal Lines	Niche Products	Total	
Underwriting revenue	27,757	8,385	36,142	296	25,500	10,235	35,735	3,811
Underwriting income (loss)	(4,516)	(3,525)	(8,041)	(1,069)	466	186	652	(999)
Loss ratio	88.1%	96.2%	90.0%	344.3%	70.4%	56.5%	66.4%	90.3%
Expense ratio	28.2%	45.8%	32.2%	116.2%	27.8%	41.7%	31.8%	35.9%
Combined ratio	116.3%	142.0%	122.2%	460.5%	98.2%	98.2%	98.2%	126.2%

The segmented information for the fourth quarter of 2009 shows that both the Personal Lines and Niche Products divisions recorded an underwriting loss of \$4.5 million and \$3.5 million, respectively. The International division recorded an underwriting loss of \$1.1 million in the period.

The fourth quarter 2009 Personal Lines result represents a decrease in underwriting income of \$5.0 million compared to the underwriting income of \$0.5 million in the fourth quarter of 2008. This was primarily due to an increase in the loss ratio to 88.1% in the 2009 period compared to 70.4% for the final quarter of 2008. Personal Lines experienced adverse claims experience in the quarter and, in addition, the quarter was negatively impacted by an increase in reserves of \$1.9 million, to reflect an estimate of additional HST costs, to be effective July 1, 2010, related to open claims as at December 31, 2009.

The underwriting loss in the quarter of \$3.5 million for the Niche Products division compares to an underwriting income of \$0.2 million recorded in the final quarter of 2008. A significant increase in the loss ratio to 96.2% in 2009, compared to 56.5% for the same period in 2008, was the primary factor in the result. Negative development of prior year claims in the liability line of business and an increase in Incurred But Not Reported (IBNR) reserve of \$2.0 million were the main factors in the deterioration of the loss ratio in the quarter.

The underwriting loss of \$1.1 million recorded in the International division was the result of adverse claims experience during the quarter, resulting in a loss ratio of 344% for the period compared to 90.3% in the final quarter of 2008. As noted above, this result pertains to claims experience related to the run-off of cancelled assumed reinsurance contracts effective December 31, 2008, and March 31, 2009.

(DOLLARS)	2009				2008			
	Canada		International		Canada		International	
	Personal Lines	Niche Products	Total		Personal Lines	Niche Products	Total	
Underwriting revenue	104,978	39,104	144,082	5,296	98,665	46,009	144,674	12,581
Underwriting income (loss)	(717)	(3,366)	(4,083)	(3,930)	7,058	(3,183)	3,875	(2,404)
Loss ratio	72.0%	66.3%	70.5%	126.0%	65.6%	66.0%	65.7%	85.7%
Expense ratio	28.7%	42.4%	32.4%	48.2%	27.3%	40.9%	31.6%	33.4%
Combined ratio	100.7%	108.7%	102.9%	174.2%	92.9%	106.9%	97.3%	119.1%

The segmented information on a year-to-date basis shows that the Personal Lines division recorded an underwriting loss of \$0.7 million, the Niche Products division an underwriting loss of \$3.4 million, and the International division recorded an underwriting loss of \$3.9 million.

The Personal Lines business segment recorded an increase in its loss ratio to 72.0% compared to 65.6% in 2008. Favourable claims development related to prior year claims continued for Personal Lines products in 2009, with total net positive development of \$3.7 million in 2009. This positive development however was lower than the positive development of \$5.1 million in 2008. Also contributing to the higher loss ratio in 2009 was an increase in current year loss experience to 76.4% compared to 67.8% in 2008. The Personal Lines division expense ratio increased to 28.7% compared to 27.3% in 2008 primarily as a result of the write-down of \$0.6 million of previously capitalized software costs related to the termination of the development of a policy administration system.

The Niche Products loss ratio increased to 66.3% in 2009 compared to 66.0% in 2008. The result for both years is higher than management expectations. In 2009, adverse prior year loss development of \$2.0 million, particularly in the liability line of business, and higher than expected current year liability losses, were the primary factors contributing to the result. In 2008, a higher-than-expected loss ratio incurred in the ETH insurance business was the reason for the disappointing result. The Niche Products division expense ratio increased to 42.4% in 2009, compared to 40.9% in 2008, primarily due to the decrease in earned premiums year over year due to the decline in the ETH line of business premium.

The International division incurred adverse claims experience in 2009 resulting in an increase in the loss ratio to 126.0% compared to 85.7% in 2008. As noted above, this result pertains to claims experience related to the run-off of cancelled assumed reinsurance contracts effective December 31, 2008, and March 31, 2009.

## Revenue

Revenue reflected in the consolidated financial statements includes net earned premiums, investment income, realized gains and losses on the sale of investments, and other revenue.

(\$ THOUSANDS)	2009	2008
Gross premiums written	163,862	170,730
Net premiums written	149,745	158,107
Net premiums earned	149,379	157,255
Net interest and dividends	12,027	12,136
Net realized gains (losses) on investments	6,860	(4,833)
Foreign exchange gains (losses)	(1,116)	2,706
<b>Total revenue</b>	<b>167,150</b>	<b>167,264</b>

The main source of revenue was earned premiums from the sale of insurance policies. Gross written premiums totaled \$163.8 million, 4% below the \$170.7 million level last year. While revenue fluctuated between divisions, the decrease was primarily the result of the previously noted termination of U.S. reinsurance arrangements from the International division, now in run-off. This resulted in a decrease in premiums written of \$14.6 million from the International division compared to 2008. The Niche Products division also experienced a decline in gross written premiums of \$2.7 million in 2009 compared to 2008 which, as previously noted, was due to the planned decline in premiums from the ETH line of business. Partially offsetting these decreases in premium was an increase in Personal Lines premiums written of \$10.5 million, or 9.8%, to \$118.0 million in 2009 compared to \$107.5 million in 2008. This increase is attributable to the non-standard auto line of business and the improving competitive conditions in this market, particularly for EGI as a non-standard, niche insurer.

Net earned premiums declined \$7.8 million, or 5% in 2009, to \$149.4 million from \$157.2 million last year. This decrease was in line with the percentage decrease in written premiums.

The second largest source of revenue was investment income, which constituted approximately 11% of EGI's total revenue in 2009. EGI recognizes revenue from interest, dividends, realized gains and losses on the invested assets and foreign exchange gains and losses. Market fluctuations in interest rates affect EGI's returns on, and the market value of, fixed income and short-term investments. The fair market value of EGI's exposure to preferred and common shares and other equity investments fluctuates as a result of changes in the overall level of the equity markets. Net realized gains on invested assets totaled \$6.9 million compared to losses of \$4.8 million last year. The losses in 2008 included an investment impairment of \$4.7 million recorded in the last quarter of last year due to evidence of other-than-temporary fair value deficiencies on specific investments. No impairment provisions were recorded in 2009. Foreign exchange losses of \$1.1 million recorded in 2009, due to the strengthening Canadian dollar, compared to the U.S. dollar, arose primarily from cash balances held in U.S. dollars used to fund claims liabilities and other operating requirements.

## Expenses

EGI's expenses consist of incurred claims, acquisition costs and operating expenses, including interest on borrowed funds.

(\$ THOUSANDS)	2009	2008
<b>Expenses</b>		
Incurring claims	108,194	105,837
Acquisition expense	34,429	37,026
Operating expense	16,095	14,229
	158,718	157,092
<b>Selected Underwriting Ratios</b>		
Incurring claims ratio	72.4%	67.3%
Acquisition expense ratio	23.0%	23.5%
Operating expense ratio	10.8%	9.1%
Combined ratio	106.3%	99.9%

The combined ratio for EGI increased in 2009 to 106.3% from 99.9% in 2008. As noted in the table above, the primary reason for the increase was the higher loss ratio of 72.4% in 2009 compared to 67.3% in 2008. Both Canadian divisions and the International division recorded increased loss ratios in 2009. In Personal Lines, the auto line of business loss ratio increased to 71.4% in 2009 from 63.0% in 2008, primarily due to increasing claims costs experienced by the industry. The Niche Products division also experienced adverse loss development leading to a loss ratio of 66.3% compared to 66.0% in 2008. Note that the loss ratios for both years were well above management expectations of 50-55%, due to adverse loss experience in the liability and ETH lines of business, in 2009 and 2008 respectively. The International division, due to the adverse development of claims related to U.S. reinsurance treaties, now in run-off, recorded an incurred loss ratio of 126% compared to 85.7% in 2008.

Incurring claims, also referred to as losses, are the amounts payable under insurance policies relating to insured events. Loss adjustment expenses, also referred to as claim expenses, are the expenses of settling claims, including allocated (i.e. external) loss adjustment expenses and unallocated (i.e. internal) loss adjustment expenses (together, LAE). Achieving profitable results depends on EGI's ability to manage future claims and other costs through innovative product design, strict underwriting criteria and efficient claims management.

Acquisition costs consist mainly of commissions and premium taxes which are directly related to the acquisition of premiums. Commissions are the amounts paid to producers for selling insurance policies. The amount of commission is generally a percentage of the premium of the insurance policy sold. Contingent commissions are paid to brokers and MGAs on an annual basis if they meet certain targets. In general, these producers have to meet or exceed certain criteria, including written premium targets and profitability, on average over three years, to qualify for this compensation. Premium taxes are paid by EGI to provincial governments, calculated as a percentage of direct written premiums.

Operating expenses are the non-commission selling, underwriting, administrative and interest expenses incurred to support EGI's business. A significant portion of these expenses is related to employee compensation and benefits. The effective control and management of these expenses can enhance the underwriting results from the operation.

## **Significant Transactions**

### *Normal Course Issuer Bid*

In December 2008, EGI announced its intention to make a normal course issuer bid. Pursuant to the bid, the Company proposed to purchase, over the following 12 months, up to an aggregate of 629,030 common shares of EGI, representing approximately 10% of the public float as of December 31, 2008. However, from its low point in December 2008, EGI's share price has risen steadily during 2009, and as of December 31, 2009, the Company has purchased and cancelled only 200 Company shares, so the bid arrangement has been allowed to lapse.

### *Credit Facility to fund U.S. Expansion*

In October 2007, EGI entered into a non-revolving term credit facility with a major Canadian bank in the amount of US\$20 million, converted to CDN\$19.55 million, the equivalent Canadian dollar amount as of the closing date. The facility bears interest of 6.2% per annum which is payable monthly over the three-year term of the agreement. After three years, EGI is obligated to repay the amounts drawn as at the termination of the agreement. Pursuant to the credit facility agreement, EGI is required to comply with various financial covenants and financial information reporting requirements.

The initial drawdown of US\$20 million or CDN\$19.5 million was used to increase the capital of CIM Reinsurance Company Ltd., EGI's Barbados-based subsidiary reinsurance company, which has been used to reinsure selected niche and specialty line insurers, underwriting business in the United States and currently reinsures EGI's Canadian business.

## **Regulation**

The industry in which EGI operates is regulated for the sale of P&C insurance. Changes in these regulations may significantly affect the operations and financial results of EGI. Government reforms in Ontario aimed at addressing the rapidly escalating costs of insurance claims are expected to be formally published, in their final form, in March 2010 and enacted in June/July 2010. It is not known with certainty at this time what the combined impact of these reforms will be on claims costs.

## **Significant accounting changes**

### *Intangible Assets*

On January 1, 2009, the Company adopted Handbook Section 3064, Goodwill and Intangible Assets, issued by The Canadian Institute of Chartered Accountants (CICA). Section 3064, which replaces Section 3062, Goodwill and Other Intangible Assets, and Section 3450, Research and Development Costs, provides clarifying guidance on the criteria that must be satisfied in order for an intangible asset to be recognized, including internally developed intangible assets. The adoption of these standards did not have a material effect on the financial position of the Company.

Intangible assets are recorded at cost less accumulated amortization. Amortization is provided over the estimated useful life of the asset (2 years) using the straight line method.

#### *Financial Instruments – Disclosures and Presentation*

During 2009, CICA Handbook Section 3862, Financial Instruments – Disclosures, was amended to require additional disclosures about fair value measurements. This disclosure requires the Company to classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The three levels of the fair value hierarchy are:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities

Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly

Level 3 – Inputs that are not based on observable market data

A table providing the classification of the Company's investments within the fair value hierarchy is shown in note 4 to the annual consolidated financial statements.

#### **Critical Accounting Estimates and Assumptions**

EGI's significant accounting policies are disclosed in note 3 to the consolidated financial statements for the year ended December 31, 2009. The preparation of EGI's financial statements in accordance with Canadian GAAP requires EGI to make estimates and assumptions that affect the amounts reported in the financial statements. These estimates and assumptions principally relate to the establishment of reserves for claims and expenses, impairments of investment securities, amounts recoverable from reinsurers and certain other assets. As more information becomes known, these estimates and assumptions could change and impact future results. The most significant estimates and assumptions made in preparing the financial statements are in respect of policy liabilities, investments, reinsurance and income taxes.

#### *Policy Liabilities*

Policy liabilities consist of provisions for claim liabilities and premium liabilities.

Claim liability reserves are maintained to cover EGI's estimated ultimate liability for unpaid losses and loss adjustment expenses with respect to reported and unreported claims incurred as of the end of each accounting period. The provision for unpaid claims and adjustment expenses is first determined on a case-by-case basis as claims are reported and then reassessed as additional information becomes known. The provision also accounts for the future development of these claims, including claims incurred but not reported (IBNR). Reserves do not represent an exact calculation of liability, but instead represent estimates developed using projection techniques in accordance with Canadian accepted actuarial practice. These reserve estimates are expectations of the ultimate cost of settlement and administration of claims based on EGI's assessment of facts and circumstances then known, its review of historical settlement patterns, estimates of trends in claims severity and frequency, legal theories of liability and other factors.

Variables in the reserve estimation process can be affected by both internal and external events, such as changes in claims handling procedures, economic inflation, legal trends and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. Additionally, there may be significant reporting lags between the occurrence of the insured event and the time it is actually reported to the insurer.

Reserve estimates are refined in a systematic ongoing process as historical loss experience develops and additional claims are reported and settled. Because the establishment of reserves is an inherently uncertain process involving estimates, current reserves may not be sufficient. Adjustments to reserves, both positive and negative, are reflected in the statement of income for the period in which such estimates are updated. In 2009, positive development of prior year claims reserves of \$0.7 million is reflected in the income statement (2008 – positive development of \$5.1 million)

The provision for unpaid claims and adjustment expenses is discounted to take into account the time value of money. In 2009, the discount used was 2.56% (2008 – 2.45%). Changes in market interest rates are the primary factor influencing the discount rate. Based on the net provision for unpaid claims and adjustment expenses as at December 31, 2009, a 1% increase in the discount rate would result in a decrease in the net provision of \$4.0 million and a 1% decrease in the discount rate would increase the net provision by \$4.2 million. It also includes a provision for adverse deviation, as required by Canadian accepted actuarial practice. The appointed actuary of EGI's subsidiaries, using appropriate actuarial techniques, evaluates the adequacy of the policy liabilities.

Premium liabilities are considered adequate when the unearned premium reserve (after deducting any deferred acquisition cost assets) is at least equal to the present value, at the balance sheet date, of the cash flow of claims, expenses and taxes to be incurred after that date on account of the policies in force at that date or at an earlier date. Deferred acquisition costs are comprised of commissions, premium taxes and expenses directly related to the acquisition of premiums. These costs are deferred to the extent that they are recoverable from unearned premiums, after considering the related anticipated claims, expenses and investment income in respect of these premiums. Deferred acquisition costs are amortized on the same basis as the premiums are recognized in income.

A premium deficiency would be recognized immediately by a charge to the statement of income as a reduction of deferred acquisition costs to the extent that the unearned premium reserve, plus anticipated investment income, is not adequate to recover all deferred acquisition costs and related claims and expenses. If the premium deficiency was greater than unamortized deferred acquisition costs, a liability would be accrued for the excess deficiency.

### *Investments*

EGI obtains values for all publicly traded securities in its investment portfolio from external pricing services.

Impairment of investment securities results in a charge to earnings when a market decline in the value of an investment to below cost is considered to be other-than-temporary. EGI's methodology to identify potential impairments requires professional judgment and places particular emphasis on those securities with unrealized losses of 20% or greater of the book value where the unrealized loss has been outstanding for more than six months. Assessment factors include, but are not limited to, the financial condition and rating of the issuer of the security, any collateral held and the length of time the market value of the security has been below cost. An impairment loss is recognized when the assessment concludes that there is objective evidence of impairment and the decline in fair value is other-than-temporary. Once a security with an unrealized loss is determined to be other-than-temporarily impaired, an impairment loss is recorded in the income statement with an offset to Accumulated Other Comprehensive Income. Previously impaired securities continue to be monitored quarterly. No other-than-temporary investment impairments were recorded in the statement of income in 2009.

There are inherent risks and uncertainties involved in making these judgments. Changes in circumstances and critical assumptions such as a weak economy, a pronounced economic downturn or unforeseen events which

affect one or more companies or industry sectors could result in additional write-downs in future periods for impairments that are deemed to be other-than-temporary. See also note 4 to the consolidated annual financial statements for a description of EGI's impairment policies.

### Reinsurance

Reinsurance recoverables include amounts for expected recoveries related to claims liabilities as well as the portion of the reinsured premiums which has not yet been earned by the reinsurer. The cost of reinsurance is accounted for over the terms of the underlying reinsured policies, using assumptions consistent with those used to account for the policies. Amounts recoverable from reinsurers are estimated in a manner consistent with claim and claim adjustment expense reserves and are reported in the consolidated balance sheet. The ceding of insurance liability to a reinsurer does not discharge EGI's primary liability to the policyholders. The Company's policy is to record an estimated allowance for doubtful accounts on the basis of periodic evaluations of balances due from reinsurers, reinsurer solvency, management's experience and current economic conditions.

### Income Taxes

EGI uses the asset and liability method whereby income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of financial statement assets and liabilities compared with their respective tax bases. Accordingly, a future tax asset or liability is determined for each temporary difference, based on the income tax rates that are expected to be in effect when the underlying items of revenue and expenses are expected to be realized.

Future income taxes, accumulated as a result of temporary differences, are included in the consolidated balance sheet. In addition, the consolidated statement of income contains items that are non-taxable or non-deductible for income tax purposes, which cause the income tax provision to differ from what it would be if based on statutory rates.

## SUMMARY OF QUARTERLY RESULTS

	2009				2008			
(\$ THOUSANDS EXCEPT PER SHARE DATA)	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Direct written and assumed premiums	39,303	44,455	48,487	31,616	39,948	46,067	49,779	34,936
Total revenues (excluding investment income)	36,439	35,881	35,486	41,573	39,547	36,150	35,999	45,559
Underwriting income (loss)	(9,454)	284	1,703	(1,872)	(489)	1,514	(465)	(397)
Income (loss) before income taxes	(3,280)	3,381	7,415	(297)	(3,272)	4,394	3,947	3,888
Net income (loss)	(2,347)	2,261	4,831	(230)	(2,322)	3,026	2,690	2,586
Earnings per adjusted share								
(a) Basic	\$(0.20)	\$0.19	\$0.41	\$(0.02)	\$(0.20)	\$0.28	\$0.27	\$0.27
(b) Diluted	\$(0.19)	\$0.18	\$0.38	\$(0.02)	\$(0.19)	\$0.26	\$0.25	\$0.25
Selected financial ratios (%)								
Loss ratio	92.1	63.6	61.8	71.9	68.7	64.0	67.7	68.4
Expense ratio	33.8	35.6	33.4	32.6	32.5	31.7	33.6	32.4
Combined	125.9	99.2	95.2	104.5	101.2	95.7	101.3	100.8

**QUARTER ENDED DECEMBER 31, 2009 COMPARED TO QUARTER ENDED DECEMBER 31, 2008**

The following financial information compares the results for the fourth quarter 2009 with the fourth quarter 2008.

(\$ THOUSANDS)	Q4 2009	Q4 2008	Variance \$	Variance %
Direct written premiums	39,303	39,948	(645)	(1.6)
Net written premiums	35,813	36,644	(831)	(2.3)
Net earned premiums	36,439	39,547	(3,108)	(7.9)
Claims incurred	33,551	27,169	6,382	2.3
Acquisition costs	8,120	8,980	(861)	(9.6)
Operating expenses	4,221	3,886	335	8.6
Underwriting income (loss)	(9,454)	(489)	(8,965)	(1,833)
Investment income (loss)	6,476	(2,481)	8,957	361.0
Interest expense	302	302	-	-
Net income (loss) before income taxes	(3,280)	(3,272)	(8)	(0.2)
Income taxes	(933)	(950)	(17)	(1.8)
Net income (loss)	(2,347)	(2,322)	(25)	(1.1)
Net operating income	(4,616)	3,037	(7,653)	(252.0)

**Insurance Operation***Written Premiums*

In the fourth quarter of 2009, direct written premiums decreased \$0.7 million, or 1.6%, to \$39.3 million compared to \$40.0 million in the same period last year. The decrease was the result of decreases in premiums generated by the International and Niche Products divisions. International division premiums decreased by \$4.1 million due to the cancellation of U.S. based assumed reinsurance arrangements, the largest of which was cancelled effective December 31, 2008 and the remaining treaty cancelled effective March 31, 2009. Direct written premiums generated by the Niche Products division decreased by \$2.1 million in the quarter compared to the final quarter of 2008 as the result of the decrease in ETH premiums written in 2009 compared to the same period last year. Partially offsetting these decreases, Personal Lines division direct written and assumed premiums increased \$5.6 million or 25% to \$27.8 million compared to \$22.2 million in the fourth quarter of 2008. This increase is evidence of the hardening of the automobile insurance market during the last half of 2009 which management expects will continue in 2010.

For the three months ended December 31, 2009, net written premiums decreased \$0.8 million or 2.3% to \$35.8 million compared to \$36.6 million for the last quarter of 2008. This decrease was consistent with the decrease in direct written and assumed premiums noted above.

*Earned Premiums*

Net earned premiums for the three months ended December 31, 2009, were \$36.4 million, a decrease of \$3.1 million, or 7.9%, compared to the fourth quarter of 2008. The percentage of decline in net earned premiums is greater than the decline in net written premiums which is primarily the result of the growth in Personal Lines direct written premium in the final quarter of 2009, as noted above, which will not fully impact earned premium until 2010.

### *Incurred Claims Expense*

For the quarter ended December 31, 2009, net claims expense increased \$6.4 million or 23.5% to \$33.6 million compared to \$27.2 million for the fourth quarter of 2008. This resulted in a loss ratio of 92.1% for the three months ended December 31, 2009 compared to 68.7% for the same period in 2008. The significant increase was attributable to increases in the loss ratios in the quarter for the each operating division.

The loss ratio of the Personal Lines division was 88.1% in the three month period ended December 31, 2009 compared to 70.4% in the same period of 2008. The increase in the loss ratio, compared to 2008, was due to adverse current year claims experience in the quarter resulting from the frequency and severity of reported claims, and the quarter was also negatively impacted by an increase in reserves of \$1.9 million, to reflect an estimate of additional HST costs, to be effective July 1, 2010, related to open claims as at December 31, 2009. Unfavourable development of prior year claims reserves of \$0.2 million was recorded in the final quarter of 2009, compared to favourable development of \$0.1 million in the same period of 2008.

The Niche Products division loss ratio was 96.2% in the last three months of 2009 compared to 56.5% in the same period last year. The deterioration was the result of adverse claims experience in the liability line of business as well as a significant increase in IBNR during the quarter of \$2 million. Niche Products also recorded unfavourable development of prior year claims of \$0.7 million in the final quarter of 2009. Additional estimated HST costs, of \$0.2 million as at December 31, 2009 were also recorded for this division.

The International division had a loss ratio of 344.3% in the fourth quarter of 2009 compared to 90.3% experienced in the final quarter of 2008. The increase in 2009 was primarily due to adverse claims experience resulting from unfavourable loss development of 2008 accident year claims of \$0.6 million from assumed reinsurance business written in this division.

On a Company-wide consolidated basis, net unfavourable development of prior year claims of \$1.6 million was recorded in the fourth quarter of 2009 compared to unfavourable development of \$0.2 million in the same period in 2008.

### *Acquisition Costs*

Net acquisition costs, which consist mainly of commissions and premium taxes, decreased \$0.9 million or 9.6% to \$8.1 million in the quarter ended December 31, 2009, compared to \$9.0 million in the same period in 2008. The decrease is slightly higher than the decrease in net earned premiums of 7.9% due to changes in the mix of business in 2009 as compared to 2008.

### *Operating Expenses*

For the fourth quarter of 2009, operating expenses were \$4.2 million compared to \$3.9 million (excluding interest expense) in the same period in 2008 or an increase of 8.6%. The increase is due to start up costs incurred by the U.S. operation in the International division, as well as the write-down of \$0.6 million of previously capitalized software costs related to the termination of the development of a policy administration system for Personal Lines products.

### *Underwriting Income*

Underwriting results reflect the revenues from net earned premiums less claims, acquisition and operating expenses. The quarter ended December 31, 2009, incurred an underwriting loss of \$9.5 million, compared to underwriting loss of \$0.5 million in the same quarter of 2008. As detailed above, the decline was attributable to

the increase in the loss ratio, from each operating division.

### **Investment Income**

In the final quarter of 2009, income from investments increased to \$6.5 million compared to a net loss on investments of \$2.5 million in the final quarter of 2008. The significant increase was due to the realization of net gains, on the disposal of investments, of \$3.8 million in the quarter compared to net realized losses (including impairments) of \$8.0 million in the final quarter of 2008. The significant improvement in bond and equity markets during 2009 resulted in the net gains realized in the final quarter of the year. After review of EGI's investment portfolio throughout the year, management has concluded that no impairment provisions are required as at December 31, 2009. During the final quarter of 2008, other-than-temporary impairments of \$4.7 million were recorded.

Partially offsetting the realized gains on sale of investments recorded in the quarter were foreign exchange losses of \$0.2 million. The losses resulted from the weakening of the U.S. dollar in relation to the Canadian dollar in the period, which decreased the value of bank balances held in U.S. dollars. As at December 31, 2009, EGI held US\$2.0 million which was used to fund claims liabilities and other operating purposes.

Income from interest and dividends totaled \$2.9 million in the fourth quarter of 2009 compared to \$3.2 million in the same period in 2008, reflecting the decrease in bond yields in the quarter compared to the final quarter of 2008.

### **Interest Expense**

During the final quarter of 2009, interest expense related to bank indebtedness of \$0.3 million was incurred, the same as the fourth quarter of 2008. In October 2007, EGI entered into a non-revolving term loan facility with a major Canadian bank in the amount of \$19.55 million. During the three-year term of the facility, interest of 6.2% per annum is paid monthly. See "Liquidity and Capital Resources".

### **Net Income (Loss) before Income Taxes**

For the quarter ended December 31, 2009, the net loss before income taxes was \$3.3 million compared to a net loss of \$3.3 million for the final quarter of 2008, as the result of a higher 2009 combined ratio of 125.9%, compared to 101.2% for the same period in 2008, offset by an increase in investment income to \$6.5 million incurred in the period compared to an aggregate investment loss of \$2.5 million in the same period of 2008.

### **Income Taxes**

For the quarter ended December 31, 2009, the provision for income taxes reflected a recovery of \$0.9 million compared to a recovery of \$0.9 million for the same period last year. The recovery for both periods is the result of the net loss before income taxes incurred in each period. The approximate effective tax rate was 28% for the last quarter of 2009 and 29% for the same period last year.

### **Net Operating Income (Loss)**

Net operating income or loss, defined as net income or loss plus or minus after-tax realized losses or gains on the sale of investments, decreased \$7.7 million to a loss of \$4.6 million in the final quarter of 2009 compared to

an operating income of \$3.0 million in the same period in 2008. Net operating income, in the last three months of 2009, consisted of a net loss of \$2.3 million minus after-tax realized gains on the sale of investments of \$2.3 million, compared to net loss of \$2.3 million plus after-tax realized losses on the sale of investments of \$5.3 million in 2008.

The decline in net operating income in the fourth quarter of 2009, compared to 2008, is primarily related to the increase in loss ratio recorded in each division.

### YEAR ENDED DECEMBER 31, 2009 COMPARED TO 2008

The following financial information compares results for the full year 2009 and 2008.

(\$ THOUSANDS)	2009	2008	Variance \$	Variance %
Direct written premiums	163,852	170,730	(6,878)	(4.0)
Net written premiums	149,745	158,107	(8,362)	(5.3)
Net earned premiums	149,379	157,255	(7,876)	(5.0)
Claims incurred	108,194	105,837	2,357	2.2
Acquisition costs	34,429	37,026	(2,597)	(7.0)
Operating expenses	16,095	14,229	1,866	13.1
Underwriting income (loss)	(9,339)	163	(9,502)	
Investment income (loss)	17,771	10,009	7,762	77.6
Interest expense	1,212	1,216	(4)	-
Net income (loss) before income taxes	7,220	8,956	(1,736)	(19.4)
Income taxes	2,705	2,977	(272)	(9.1)
Net income (loss)	4,515	5,979	(1,464)	(24.5)
Net operating income	189	9,083	(8,894)	(97.9)

### Insurance Operation

#### *Written Premiums*

Direct written and assumed premiums decreased \$6.9 million or 4.0% to \$163.8 million for the year ended December 31, 2009 compared to \$170.7 million for 2008. The International and Niche Products divisions experienced declines in premiums in 2009 as compared to 2008 of \$14.6 and \$2.7 million, respectively, while the Personal Lines division recorded growth in premium volume of \$10.5 million. The increase in Personal Lines premiums written was the result of premium growth in non-standard automobile line of business, a reflection of EGI's strengthening competitive position in the non-standard market. Total Personal Lines division gross written premiums were \$118.0 million in 2009 compared to \$107.5 million in 2008, reflecting a growth rate of 9.8%. Non-standard automobile premiums in 2009 increased to \$100.4 million compared to \$88.4 million in the prior year, with motorcycle premiums decreasing to \$15.3 million in 2009 compared to \$16.7 million in 2008. The remaining premiums for the Personal Lines division are from other vehicle types.

Direct written premiums for Niche Products decreased 6% to \$46.6 million for 2009, compared to \$49.3 million in 2008. The decrease was the result of the planned decrease in ETH premiums in 2009 to \$1.5 million compared to \$11.5 million in 2008. As noted earlier, the premium decrease in the ETH line of business was the result of stricter underwriting criteria implemented for the 2009–2010 travel season designed to improve the financial performance of this line of business. All other Niche Products' lines of business recorded significant

growth in 2009 compared to 2008 and management continues to view this division as a primary source of growth for EGI.

As previously noted, International division premiums decreased by \$14.6 million due to the cancellation of U.S. based assumed reinsurance arrangements, the largest of which was cancelled effective December 31, 2008, and the remaining treaty cancelled effective March 31, 2009.

Net written premiums decreased \$8.4 million or 5.3% to \$149.7 million for the year ended December 31, 2009, compared to \$158.1 million for the same period last year. The decrease in net written premiums was consistent with the percentage increase in gross written premiums noted above.

#### *Earned Premiums*

Net earned premiums for 2009, were \$149.4 million, a decrease of \$7.9 million or 5.0% from 2008. This decrease was also in line with the percentage decrease in net written premiums.

#### *Incurred Claims Expense*

Net incurred claims expense increased \$2.4 million or 2.2% to \$108.2 million for 2009, compared to \$105.8 million for 2008. The resulting loss ratio of 72.4% for 2009 represents an increase of 5.1% over the 2008 loss ratio of 67.3%. The loss ratio for each business segment increased in 2009, compared to 2008 for several reasons.

The Personal Lines division incurred a loss ratio of 72.0% in 2009 compared to 65.6% in 2008. This increase was primarily attributable to an increase in the current accident year (2009) loss ratio to 76.4% as compared to 67.8% for the 2008 accident year loss ratio last year. The increase was the result of adverse loss experience and increased claims costs experienced by automobile insurers in 2009. Favourable development of prior year claims continued in 2009 for this division, but experienced a decline compared to 2008. Positive development of prior year claims reserves in 2009 were \$3.7 million, compared to \$4.7 million for 2008. As noted earlier, another factor impacting the increased loss ratio in 2009 was an increase in reserves of \$1.9 million, to reflect an estimate of additional HST costs, to be effective July 1, 2010, related to open claims as at December 31, 2009.

The Niche Products division's loss ratio increased slightly to 66.3% for the year compared to 66% in 2008. This result was caused primarily by adverse claims experience in the liability lines of business. Several significant losses were incurred in this line in 2009 and, in addition, IBNR related to the Niche claims was increased by \$3.5 million as at December 31, 2009, compared to December 31, 2008.

The 2009 loss ratio for the International division was 126% compared to the 2008 loss ratio of 85.7%. The 2009 result was adversely impacted by unfavourable development of 2008 and 2007 accident year claims of \$1.2 million as well as adverse loss experience for the 2009 accident year. As previously noted, the reinsurance arrangements in place in the International division have been cancelled effective December 31, 2008, and March 31, 2009.

On a Company-wide consolidated basis, net favourable development of prior year claims of \$0.7 million was recorded in 2009 compared to favourable development of \$5.1 million in 2008.

#### *Acquisition Costs*

Net acquisition costs, consisting mainly of commissions and premium taxes, decreased \$2.6 million or 7.0% to \$34.4 million for 2009, compared to \$37.0 million in 2008. This decrease, compared to 2008 and in relation to the decrease in net earned premiums of 5.0%, was primarily due to the decrease in ETH premiums which

attracted a higher commission expense.

### *Operating Expenses*

Operating expenses, excluding interest expense in 2009, increased \$1.9 million or 13.1% to \$16.1 million compared to \$14.2 million for 2008. The increase was primarily attributable to start up costs of approximately \$1.0 million, incurred by EGI's U.S. operations in the International division and as well as the write-down of \$0.6 million of previously capitalized software costs related to the termination of the development of a policy administration system for Personal Lines products.

### *Underwriting Income*

Underwriting results reflect the revenues from net earned premiums less claims, acquisition and operating expenses. The overall underwriting income decreased \$9.5 million to a loss of \$9.3 million for the year ended December 31, 2009, compared to an underwriting gain of \$0.2 million for 2008. The underwriting results for 2009 and 2008 were net of \$1.3 million of corporate and other expenses.

The Personal Lines division recorded an underwriting loss for the year ended December 31, 2009, of \$0.7 million, representing a decrease of \$7.8 million compared to an income of \$7.1 million for 2008. This result was due to an increase in the combined ratio to 100.7% in 2009 compared to 92.9% in 2008.

The underwriting loss from the Niche Products division for the year ended December 31, 2009, was \$3.4 million, compared to a loss of \$3.2 million in 2008. This result was primarily due to the increase in the loss ratio caused by adverse claims experience in the liability line of business which resulted in an increase in the combined ratio to 108.6% in 2009 compared to 106.9% in 2008.

The International division incurred an underwriting loss of \$3.9 million, which includes start up expenses from EGI Insurance Services, Inc., compared to a loss of \$2.4 million 2008. As noted earlier, this result was caused by adverse claims experience from assumed premium reinsurance contracts. The combined ratio for this business segment increased to 174.2% in 2009 compared to 119.1% in 2008.

### **Investment Income**

Investment income increased \$7.8 million, to \$17.8 million in 2009 compared to \$10.0 million in 2008.

The increase in investment income compared to 2008 resulted from net gains of \$6.9 million recorded in 2009 on the sale of investments. Net losses on investments totaled \$4.8 million in 2008, consisting of \$0.1 million in net realized losses on the sale of investments and \$4.7 million of investment impairments recorded at December 31, 2008, due to evidence of other-than-temporary fair value deficiencies on specific investments. No impairment provisions were recorded as at December 31, 2009 due to the significant improvement in bond and equity markets in 2009. Partially offsetting the net gains on investments in 2009 were foreign exchange losses of \$1.1 million derived from funds held in U.S. currency and the impact of the stronger Canadian dollar.

Income from interest and dividends was \$12.1 million in 2009 resulting in no change from the 2008 income of \$12.1 million. The result reflected the impact of lower fixed income yields in 2009 as compared to 2008. The total fair value of the investment portfolio as at December 31, 2009 (including cash and short term and premium financing receivable) was \$368.2 million compared to \$309.5 million as at December 31, 2008.

**Interest Expense**

During 2009, interest expense of \$1.2 million related to bank indebtedness was incurred compared to \$1.2 million in 2008. In October 2007, EGI entered into a non-revolving term loan facility with a major Canadian bank in the amount of \$19.5 million. During the three-year term of the facility, interest of 6.2% per annum is paid monthly.

**Net Income before Income Taxes**

Net income before income taxes decreased \$1.7 million, or 19.4%, to \$7.2 million for 2009 compared to \$9.0 million for 2008 as the result of a higher combined ratio.

For the year ended December 31, 2009, an underwriting loss of \$9.3 million plus investment income of \$17.8 million, reduced by interest expenses on bank indebtedness of \$1.2 million, comprised net income before income taxes of \$7.2 million. This is compared to an underwriting income of \$0.2 million plus investment income of \$10.0 million, reduced by interest expense of \$1.2 million in 2008.

**Income Taxes**

The provision for income taxes for the year ended December 31, 2009, was \$2.7 million compared to \$3.0 million for 2008. This reflected lower pre-tax income as a result of the declining underwriting result year over year. The approximate effective tax rate increased to 37% for 2009 compared to 33% for the previous year, the increase, primarily due to the capital treatment of investment losses recorded by the holding company.

**Net Operating Income**

Net operating income decreased \$8.9 million to \$0.2 million in 2009 from \$9.1 million in 2008. Net operating income excludes the after-tax impact of net realized gains totaling \$4.3 million from net income in 2009. In 2008, net income was increased by \$3.2 million, the after-tax realized losses and impairments recorded in the year.

**YEAR ENDED DECEMBER 31, 2008 COMPARED TO 2007**

The following financial information compares results for the full year 2008 and 2007.

(\$ THOUSANDS)	2008	2007	Variance \$	Variance %
Direct written premiums	170,730	157,935	12,795	8.1
Net written premiums	158,107	146,511	11,596	7.9
Net earned premiums	157,255	119,606	37,649	31.5
Claims incurred	105,837	71,179	34,658	48.7
Acquisition costs	37,026	26,143	10,883	41.6
Operating expenses	14,229	12,043	2,186	18.2
Underwriting income (loss)	163	10,241	(10,078)	(98.4)
Investment income (loss)	10,009	12,954	(2,945)	(22.7)
Interest expense	1,216	259	957	369.5
Net income (loss) before income taxes	8,956	22,936	(13,980)	(60.9)
Income taxes	2,977	7,871	(4,894)	(62.2)
Net income (loss)	5,979	15,065	(9,086)	(60.3)
Net operating income	9,083	12,957	(3,874)	(29.9)

**Insurance Operation***Written Premiums*

Direct written and assumed premiums increased \$12.8 million or 8.1% to \$170.7 million for the year ended December 31, 2008, compared to \$157.9 million for 2007. Premium growth was achieved in both Canadian business segments. The increase in Personal Lines premiums, despite difficult market conditions in the P&C industry, was the result of premium growth in non-standard automobile and motorcycle business. Total Personal Lines division gross written premiums were \$107.5 million in 2008 compared to \$97.4 million in 2007, reflecting a growth rate of 10.4%. Non-standard automobile premiums in 2008 totaled \$88.4 million compared to \$83.2 million in the prior year, with motorcycle premiums of \$16.7 million in 2008 compared to \$13.9 million in 2007. The remaining premiums for the Personal Lines division are from other vehicle types. Regionally, Quebec automobile insurance premiums grew 16.5% to \$10.6 million for 2008, compared to \$9.1 million in 2007.

Direct written premiums for Niche Products increased 2.5% to \$49.3 million for 2008, compared to \$48.1 million in 2007. This increase was achieved despite a significant decrease of \$7.6 million in the ETH written premiums to \$11.5 million from \$19.1 million in 2007. As noted earlier, the premium decrease in the ETH line of business was the result of stricter underwriting criteria implemented for the 2008–2009 travel season designed to improve the financial performance of this line of business. All other Niche Products lines of business recorded significant growth in 2008 compared to 2007 and management continues to view this division as a primary source of growth for EGI.

Net written premiums increased \$11.6 million or 7.9% to \$158.1 million for the year ended December 31, 2008, compared to \$146.5 million for the same period last year. The increase in net written premiums was consistent with the percentage increase in gross written premiums noted above.

### *Earned Premiums*

Net earned premiums for 2008, were \$157.3 million, an increase of \$37.7 million or 31.5% from 2007. This increase was higher than the increase in net written premiums of 7.9%, primarily due to the decline of written premiums from the ETH line of business in 2008 compared to 2007. Since ETH premiums are mainly earned during the winter months (December to March), relatively high written premiums from the 2007–2008 travel season recorded in 2007, were earned in the first quarter of 2008. The decline in written premiums from this line of business will not fully impact net earned premiums until the first half of 2009.

### *Incurred Claims Expense*

Net incurred claims expense increased \$34.6 million or 48.6% to \$105.8 million for 2008, compared to \$71.2 million for 2007. The resulting loss ratio of 67.3% for 2008, represents an increase of 7.8% over the 2007 loss ratio of 59.5%. The loss ratio for each business segment increased in 2008, compared to 2007 for several reasons.

The Niche Products division's loss ratio increased to 66% for the year compared to 56.1% in 2007. This result was caused primarily by adverse claims experience in the ETH line of business for the 2007–2008 travel season. The loss ratio reflected in the 2008 results for this travel season was 99.2% on net earned premiums of \$17.2 million. Partially offsetting this result was the loss ratio from all other Niche Products programs of 45.1% which slightly exceeded EGI's expectations

The Personal Lines division incurred a loss ratio of 65.6% in 2008 compared to 59.1% in 2007. This increase was primarily attributable to a decrease in the favourable development of prior year claims recorded for this business segment in 2008 compared to 2007. Positive development continued in 2008, resulting in the release of \$4.7 million of net reserves, compared to \$10.7 million for 2007. Excluding the decrease in favourable development in 2008, the net loss ratio of 70% compares favourably to 72.1% in 2007.

The 2008 loss ratio for the International division was 85.7% compared to the 2007 loss ratio of 73.9%. The 2008 result was adversely impacted by unfavourable development of 2007 accident year claims of \$1.0 million and a 2008 calendar year loss ratio of 77.0%. As previously noted, the reinsurance arrangements in place in the International division have either been cancelled effective December 31, 2008, and March 31, 2009.

On a Company-wide consolidated basis, net favourable development of prior year claims of \$5.1 million was recorded in 2008 compared to favourable development of \$11.8 million in 2007.

### *Acquisition Costs*

Net acquisition costs, consisting mainly of commissions and premium taxes, increased \$10.9 million or 41.8% to \$37.0 million for 2008, compared to \$26.1 million in 2007. This increase, compared to 2007 and in relation to the increase in net earned premiums of 31.5%, was due to the higher proportion of Niche business compared to Personal Lines business in 2008, attracting higher acquisition expenses.

### *Operating Expenses*

Operating expenses, excluding interest expense in 2008, increased \$2.2 million or 18.3% to \$14.2 million for 2008, compared to \$12.0 million for 2007. This increase was lower than the 31.5% increase in net earned premiums noted above, which is partially the result of an improvement in economies of scale caused by an increase in 2008 in ETH net earned premiums relative to written premiums.

### *Underwriting Income*

Underwriting results reflect the revenues from net earned premiums less claims, acquisition and operating expenses. The overall underwriting income decreased \$10 million to \$0.2 million for the year ended December 31, 2008, compared to \$10.2 million for 2007. The underwriting income for 2008 and 2007 was net of \$1.3 million and \$0.9 million of corporate and other expenses, respectively. The increase in corporate and other expenses in 2008 was due to expenses associated with potential acquisition reviews during the year.

Underwriting income from the Personal Lines division for the year ended December 31, 2008, was \$7.1 million, representing a decline of \$3.5 million compared to an income of \$10.6 million for 2007. This result was due to an increase in the combined ratio to 92.9% in 2008 compared to 87.8% in 2007.

The underwriting loss from the Niche Products division for the year ended December 31, 2008, was \$3.2 million, compared to an income of \$0.3 million in 2007. This result was primarily due to the increase in the loss ratio caused by adverse claims experience in the ETH line of business which resulted in an increase in the combined ratio to 106.9% in 2008 compared to 98.8% in 2007.

The International division incurred an underwriting loss of \$2.4 million, which includes expenses from EGI Insurance Services, Inc., compared to a breakeven in 2007. As noted earlier, this result was caused by adverse claims experience from assumed premium reinsurance contracts. The combined ratio for this business segment increased to 119.1% in 2008 compared to 100.2% in 2007.

### **Investment Income**

Investment income decreased \$3.0 million, or 23.0%, to \$10.0 million in 2008 compared to \$13.0 million in 2007.

The decrease in investment income compared to 2007 resulted from net losses recorded in 2008 on the sale of investments and recording of investment impairments as at December 31, 2008. Net losses on investments totaled \$4.8 million in 2008, consisting of \$0.1 million in net realized losses on the sale of investments and \$4.7 million of investment impairments recorded at year-end, due to evidence of other-than-temporary fair value deficiencies on specific investments. This result compares to net realized gains on disposal of investments of \$3.4 million earned in 2007. Partially offsetting the net losses on investments in 2008 were foreign exchange gains of \$2.7 million derived from funds held in U.S. currency and the impact of the weakened Canadian dollar.

Income from interest and dividends increased to \$12.1 million in 2008 compared to \$9.8 million in 2007. The increase resulted from an increase in total invested assets to \$259.8 million, on a fair value basis, as at December 31, 2008, compared to \$238.3 million as at year end 2007. A significant portion of the increase in invested assets was related to funds raised of \$20.8 million pursuant to completion of EGI's rights offering in July 2008.

### **Interest Expense**

During 2008, interest expense related to bank indebtedness of \$1.2 million was incurred compared to \$0.3 million in 2007. In October 2007, EGI entered into a non-revolving term loan facility with a major Canadian bank in the amount of \$19.5 million. During the three-year term of the facility, interest of 6.2% per annum is paid quarterly.

### **Net Income before Income Taxes**

Net income before income taxes decreased \$13.9 million, or 60.7%, to \$9.0 million for 2008 compared to \$22.9 million for 2007 as the result of a higher combined ratio and the decline in investment income.

For the year ended December 31, 2008, underwriting income of \$0.2 million plus investment income of \$10.0 million, reduced by interest expenses on bank indebtedness of \$1.2 million, comprised net income before income taxes of \$9.0 million. This is compared to an underwriting income of \$10.2 million plus investment income of \$13.0 million, reduced by interest expense of \$0.3 million in 2007.

### **Income Taxes**

The provision for income taxes for the year ended December 31, 2008, was \$3.0 million compared to \$7.9 million for 2007. This reflected lower pre-tax income as a result of lower underwriting profits and lower investment income year over year. The approximate effective tax rate decreased to 33% for 2008 compared to 34% for the previous year, primarily due to the decline in the federal corporate income tax rate to 19.5% in 2008 from 22.1% in 2007.

### **Net Operating Income**

Net operating income decreased \$3.7 million to \$9.1 million in 2008 from \$13.0 million in 2007. Net operating income excludes the after-tax impact of net realized losses and impairments on investments totaling \$3.2 million from net income in 2008. In 2007, net income was reduced by \$2.2 million, the after-tax realized gains recorded in the year.

## **BALANCE SHEET ANALYSIS**

### **Investments**

EGI has an investment policy that seeks to provide a stable income base to support EGI's liabilities without incurring an undue level of investment risk. All investment decisions are made with this risk-return trade off in mind. The two most important methods used to reduce the level of risk without reducing the rate of return in EGI's portfolio are diversification and the use of proven investment professionals.

EGI's Board of Directors has established an Investment Committee to develop and implement detailed strategies consistent with EGI's objectives and to report regularly to the Board of Directors on its activities. EGI has outsourced all buy/sell decisions on individual securities to a small number of reputable professional investment managers. Using the "prudent person" approach, the Investment Committee monitors the performance of each manager, measuring his or her performance against an appropriate market index benchmark.

Each of EGI's investment managers operates under an investment management agreement which provides the investment manager with a discretionary mandate to hold one or more types of securities and/or cash. The investment manager receives an annual fee (payable quarterly) based on a negotiated percentage of the market value of the portfolio being managed. The investment manager's engagement is subject to immediate cancellation by EGI, without penalty, upon giving written notice.

EGI's investment portfolio is invested in well-established, active and liquid markets in Canada and the United States. Fair value for most investments is determined by reference to quoted market prices. The external

investment managers invest on a total return basis, viewing realized gains and losses as important and recurring components of the return on investments and, consequently, of income. The timing of the realization of gains and losses may be unpredictable, and changes in the overall levels of fixed income or equity markets generally result in corresponding changes in realized gains and losses.

To assess impairments, the Investment Committee and management review all holdings with a fair value below their carrying values and, in consultation with the appropriate investment manager, ascertain whether the carrying amounts are expected to be recovered. EGI's investment managers provide advice as to whether the fair value of these securities is adversely affected on an other-than-temporary basis. Based on this advice, and the significantly improved bond and equity markets in 2009, EGI has recorded no impairment provisions for the year ended December 31, 2009. Impairment provisions of \$4.7 million were recorded for the year ended December 31, 2008.

### Fair value of Investments

The following table provides a comparison as at December 31, 2009, and December 31, 2008:

(\$ THOUSANDS)	As at December 31	
	2009 Fair value	2008 Fair value
Bonds		
Canadian		
Federal	\$ 83,777	\$ 82,078
Provincial	44,696	45,162
Municipal	6,254	6,935
Corporate	90,024	86,570
	224,751	220,745
United States		
Corporate	6,819	2,717
Total Bonds	231,570	223,462
Preferred shares	7,567	4,042
Common shares		
Canadian	52,210	29,049
United States	1,072	1,178
	53,282	30,227
Investment income due and accrued	1,946	2,043
	\$294,365	\$259,774

EGI's portfolio is constructed in a manner that seeks to ensure that its objectives of producing a competitive rate of return are met, while at the same time protecting and enhancing statutory underwriting capital on a long-term basis. This is achieved through diversification principles that ensure each asset class has limited exposure by region, industry, issuer and type of underlying security. Target ranges are set for each asset class and economic sector and are monitored by the Investment Committee to ensure that EGI's investment managers comply with these guidelines. Each manager is required to satisfy EGI's liquidity needs while adhering to all regulatory requirements.

### **Impaired assets and provisions for losses**

The Board of Directors has established a policy to write down or make a provision for any investment with other-than-temporary impairment.

Management has reviewed currently available information and the advice of its investment managers regarding those investments whose estimated fair values are less than carrying values. For those securities whose decline in fair value was considered to be other-than-temporary, the Company has recorded the difference between the cost of the investment and its fair value as an impairment which reduces investment income in the year recorded.

The Company considers an impairment to be other-than-temporary if it is unlikely the Company will recover an investment's amortized cost in a reasonable period of time. Factors considered by the Company include but are not limited to the impact of issuer and industry specific events, current and expected future market and economic conditions, the nature of the investment, and the severity and duration of the fair value deficiency.

No impairment provisions were recorded by EGI in 2009. During 2008, an impairment loss of \$4.7 million, comprised of \$4.3 million of common shares and \$0.4 million of Canadian corporate bonds, was recognized.

A gross unrealized loss of \$3.3 million on investments held as at December 31, 2009, is recorded, net of tax, in the amount of \$2.2 million in Accumulated Other Comprehensive Loss. The Company has concluded, based on its review that these fair value deficiencies are considered temporary in nature and they will be monitored on an ongoing basis.

### **Fixed Income Securities**

EGI holds fixed income securities to provide a steady, predictable level of income and reasonable liquidity with minimum risk of loss and a fixed sum at maturity. EGI's portfolio is diversified by selecting various types of government and corporate bonds. Constraints on types of issuers take liquidity, diversification and risk into account by limiting the portfolio mix by issuer.

EGI's portfolio maintains a high overall credit quality level as measured by Dominion Bond Rating Service (DBRS). Constraints are placed on the percentage of bonds which can be held in the rating classes as follows: Class A or better – no maximum; Class BBB or lower – maximum 10%. EGI's policy is to purchase only corporate bond issues which are rated BBB or better at the time of purchase. In the event of subsequent downgrades, the Investment Committee will consider whether to continue to hold the bonds.

The following table sets forth EGI's fixed income portfolio by credit quality according to DBRS as at December 31, 2009, and 2008.

**Fixed Income Portfolio**

<b>As at December 31</b>					
		<b>2009</b>		<b>2008</b>	
(\$ THOUSANDS)	Fair value	% of Fair value	Fair value	% of Fair value	
AAA	\$111,702	48%	\$107,830	48	
AA	64,446	28%	60,713	27	
A	48,090	21%	48,080	22	
BBB	6,882	3%	6,765	3	
B	321	-	-	-	
CCC	129	-	74	-	
<b>Total</b>	<b>\$231,570</b>	<b>100%</b>	<b>\$223,462</b>	<b>100</b>	

**Common Shares**

Common shares are a key component of EGI's portfolio to enhance the capital appreciation opportunities of EGI's invested assets. Using a conservative approach to equity selection, EGI's investment managers ensure that equities of companies with a reputation for strong management and a proven track record of success are selected for EGI's portfolio. Diversification by industry sector also reduces the overall risk level inherent in EGI's common share portfolio.

EGI generally limits its total exposure to common shares at any one time to a maximum of 16% of the total of its invested assets and premium financing receivables, which is slightly below the average exposure to equities for Canadian-owned P&C insurers.

**Canadian Common Share Portfolio**

Restrictions as to the amount of common shares held in any industry sector are also part of EGI's risk diversification methodology. The following table outlines EGI's Canadian common share exposure to industry sectors as at December 31, 2009, and 2008.

<b>As at December 31</b>					
		<b>2009</b>		<b>2008</b>	
(\$ THOUSANDS)	Fair value and carrying amount	% of fair value	Fair value and carrying amount	% of fair value	
Energy	\$13,452	26	\$5,513	19	
Financial services	10,653	20	9,173	32	
Materials	9,605	18	4,105	14	
Other	18,500	36	10,258	35	
<b>Total</b>	<b>\$52,510</b>	<b>100</b>	<b>\$29,049</b>	<b>100</b>	

**Recoverable from Reinsurers**

(\$ THOUSANDS)	As at December 31	
	2009	2008
Reinsurers' share of unpaid claims	\$38,736	\$41,901
Reinsurers' share of unearned premiums	4,972	3,712
<b>Total</b>	<b>\$43,708</b>	<b>\$45,613</b>

As at December 31, 2009, the amount recoverable from reinsurers decreased by \$1.9 million, or 4%, to \$43.7 million from \$45.6 million at December 31, 2008. The decrease was due to reduced reliance on reinsurance particularly for the 2009 and 2008 policy years. All reinsurers, with balances due, have a rating of B++ or above as determined by Standard & Poor's and A.M. Best, except for several Niche Products distributors who share a portion of the risk with EGI, for whom EGI holds deposits.

**Accounts Receivable**

(\$ THOUSANDS)	As at December 31	
	2009	2008
Premium financing receivables	\$27,007	\$20,615
Facility Association	(133)	(87)
Agents and brokers	5,994	6,949
Other	82	88
<b>Total</b>	<b>\$32,950</b>	<b>\$27,565</b>

Premium financing receivables was the largest component of this asset as at December 31, 2009, and represents approximately 82% or \$27.0 million of total receivables. Premium financing receivables increased to \$27.0 million at December 31, 2009, from \$20.6 million at December 31, 2008. The majority of the automobile business is billed directly to policyholders and remitted on a monthly basis.

**Provision for Unpaid Claims**

EGI establishes loss reserves to provide for future amounts required to pay claims related to insured events that have occurred and been reported but have not yet been settled, as well as for those related to events that have occurred but have not yet been reported to the insurer. Claims provisions (i.e. reserves for claims liability) are established at the individual file level by the "case method" as claims are reported. The provisions are subsequently adjusted as additional information affecting the estimated amount of a claim becomes known during the course of its settlement. With the assistance of EGI's consulting actuary, a reserve provision is also made for management's calculation of factors affecting the future development of claims, including a provision for IBNR claims, based on the volume of business currently in force and the historical experience on claims. Reserves are also established for the estimated internal and external loss adjustment expenses which will be incurred during the claims settlement process.

The provision for unpaid claims and adjustment expenses is discounted to take into account the time value of money as required by EGI's primary insurance regulator. It also includes a provision for adverse deviation as required by accepted Canadian actuarial practice. EGI's consulting actuary reports on the adequacy of EGI's

claims reserves on a quarterly basis. As time passes, more information about the claims becomes known and provisional estimates are appropriately adjusted upward or downward. Adjustments to reserves are reflected in the results of operations in the periods in which the estimates are changed.

The development of the provision for claims is shown by the difference between estimates of reserves as of the initial year-end and the re-estimated liability at each subsequent year-end. This is based on actual payments in full or partial settlement of claims, plus re-estimates of the reserves required for claims still open or claims still unreported. Favourable development means that the original reserve estimates were higher than subsequently indicated. Unfavourable development means that the original reserve estimates were lower than subsequently indicated.

For further discussion of EGI's reserving methods and underlying assumptions, see "Critical Accounting Estimates and Assumptions – Policy Liabilities".

Provision for unpaid claims consists of the gross amount of individual case reserves established and management's estimate of claims incurred, but not reported, based on the volume of business currently in force and historical claims experience. In order to ensure that EGI's provision for unpaid claims (often called "reserves") is adequate, management has retained the services of an independent consulting actuary. EGI strives to establish adequate provisions at each quarter-end.

EGI estimates its reserves on a quarterly basis and this is supported by quarterly assessments by the independent consulting actuary. Every quarter, for each line of business, EGI compares actual and expected claims development. To the extent that actual results differ from expected development, assumptions are re-evaluated and new estimates are derived. Although EGI believes its overall provision levels to be adequate to satisfy its obligations under existing policies, actual losses may deviate, perhaps substantially, from the amounts reflected in EGI's financial statements. To the extent provisions prove to be inadequate, EGI would have to increase such provisions and incur a charge to earnings in the future.

The table below shows the development of the provision for claims reserves including loss adjustment expenses as at December 31 in each year of the five-year period and for the year ended December 31, 2009, for Echelon (on a 100% basis).

(\$ THOUSANDS)	Year ended December 31				
	2008	2007	2006	2005	2004
Reserve carried (actuarial present value basis) <sup>(1)</sup>	178,694	168,257	145,691	129,041	107,196
Reserve at December 31, 2003					
Cumulative paid to December 31, 2003					
Cumulative redundancy (deficiency)					
Reserve at December 31, 2004					
Cumulative paid to December 31, 2004					
Cumulative redundancy (deficiency)					
Reserve at December 31, 2005					70,620
Cumulative paid to December 31, 2005					24,922
Cumulative redundancy (deficiency)					11,654
Reserve at December 31, 2006				88,029	49,557
Cumulative paid to December 31, 2006				25,817	41,158
Cumulative redundancy (deficiency)				15,195	16,481
Reserve at December 31, 2007			107,992	67,408	36,129
Cumulative paid to December 31, 2007			30,432	46,413	55,306
Cumulative redundancy (deficiency)			7,267	15,220	15,761
Reserve at December 31, 2008		117,541	81,172	50,013	25,237
Cumulative paid to December 31, 2008		44,265	53,325	62,210	66,181
Cumulative redundancy (deficiency)		6,450	11,194	16,818	15,778
Reserve at December 31, 2009	131,106	88,559	59,497	31,593	16,720
Cumulative paid to December 31, 2009	47,873	72,406	74,162	78,557	74,561
Cumulative redundancy (deficiency)	(285)	7,292	12,032	18,891	15,915

(1) Amounts include provision for adverse deviation (PFAD) of \$19,689 for 2008; \$17,401 for 2007; \$14,756 for 2006; \$12,473 for 2005; and \$8,613 for 2004.

The uncertainties regarding EGI's reserves could result in a liability exceeding the reserves by an amount that would be material to EGI's financial condition or results of operations in a future period. Future development could be significantly different from the past, due to many unknown factors (see "Risk Factors").

## Reinsurance

EGI has reinsurance treaties with several unaffiliated reinsurers, all of whom are selected on the basis of their creditworthiness. EGI purchases reinsurance to reduce its exposure to the insurance risks that it assumes in writing business. For 2009, the maximum net retention on a single risk was \$1.5 million (2008 – \$1.5 million).

In accordance with industry practice, EGI's reinsurance recoverables with licensed Canadian reinsurers are generally unsecured because Canadian regulations require these reinsurers to maintain minimum asset and capital balances in Canada to meet their Canadian obligations. However, policy liabilities rank in priority to any subordinate creditors a reinsurer may have. For reinsurance recoverables with non-licensed reinsurers, EGI maintains security against reinsurance recoverables in the form of cash, letters of credit and/or assets held in trust accounts. At December 31, 2009, EGI was the assigned beneficiary of such trust accounts totaling \$4.6 million (December 31, 2008 – \$2.3 million) in guarantees from unlicensed reinsurers.

Excess of loss and catastrophe reinsurance is used to limit an insurer's exposure to a maximum dollar value per claim and per occurrence. Quota share is a form of proportional reinsurance often used by an insurer to build a book of business larger than can be supported by the insurer's own capital. When used on established, profitable lines of business, quota share is an expensive substitute for equity capital. The insurer is essentially borrowing capital from the reinsurer by transferring unearned premium and claims liabilities from its books to the books of the reinsurer. Within the range of expected loss ratios, this transfer is done at a direct cost to the insurer, which happens through the ceding commission (expense allowance) paid by the reinsurer.

The ceding commission paid to the insurer by the reinsurer varies depending on the gross loss ratio. As the gross loss ratio increases, the amount of ceding commission decreases, subject to agreed upon limits. Above the maximum loss ratio on the ceding commission scale, there is full risk transfer (i.e. the potential to lose money) to the reinsurer. Below the minimum loss ratio on the ceding commission scale, the reinsurer's profit increases. The reinsurer also retains the investment income on the cash balances that develop between the dates premiums are received and the dates claims are paid.

EGI purchases renewable excess of loss and catastrophe reinsurance from third-party reinsurers, covering its automobile and general liability business. In 2009, such coverage was for a total of \$23.0 million, and \$18.0 million in 2008. Other than general liability, coverages for the programs of the Niche Products division are reinsured on a program-by-program basis.

Using reinsurance, EGI's policy is to limit its loss exposure in any one claim to not more than 2% of its shareholders' equity.

EGI depends upon the financial stability of its reinsurers in the same way that EGI's insureds rely upon EGI. Accordingly, EGI carefully selects its reinsurers and only deals with creditworthy reinsurers. EGI's Reinsurance Committee is responsible for evaluating and approving companies to which EGI cedes reinsurance. The committee consults with AON Re Canada Inc. regarding the financial ratings of EGI's reinsurers. Reinsurers are selected based on their financial strength ratings, services, reputation and prices offered on the required reinsurance. As reported to EGI by AON Re Canada Inc., EGI's reinsurance broker, all reinsurers providing coverage under EGI's 2010 excess of loss and catastrophe treaties were rated A or better by A.M. Best at December 2009.

As EGI's insurance and reinsurance company subsidiaries increase their equity (and therefore regulatory capital), they can retain more insurance business for their own account and therefore purchase less reinsurance. The marginal return on this new capital can be very substantial. Each dollar of new equity allows EGI to retain up to two and one-half dollars of additional premium (and the potential downside risk thereon) each year for its own account.

EGI believes that there is currently adequate reinsurance capacity in the marketplace for those classes of business which EGI underwrites, and management is not aware of any developments that might cause a serious shortage of capacity in the future. EGI believes that, through its reinsurance program, it is adequately protected against major underwriting losses arising from a large claim under a single policy or claims under a group of policies arising from a single event.

### **Share Capital**

As of March 15, 2010, there were 12,002,582 common shares issued and outstanding. See also note 11 to the consolidated financial statements.

## Liquidity and Capital Resources

The purpose of liquidity management is to ensure there is sufficient cash to meet all of EGI's financial commitments and obligations as they come due. The Company has suspended quarterly dividends to its common shareholders, to assist in building a stronger capital base to support future growth. EGI believes that it has the flexibility to obtain, from internal sources, the funds needed to fulfill its cash requirements, during the following financial year and to satisfy regulatory capital requirements. Additionally EGI has been able to raise \$20.8 million in net proceeds from a rights offering in July 2008 to supplement current resources and further strengthen its liquidity position. EGI's principal sources of funds are premiums collected, investment income and proceeds from investments that have been sold or have matured. However, such funds may not provide sufficient capital to enable EGI to pursue additional market opportunities.

In October 2007, EGI entered into a non-revolving term credit facility with a major Canadian bank in the amount of US\$20 million, converted to CDN\$19.55 million, the equivalent Canadian dollar amount as of the closing date. The facility bears interest of 6.2% per annum which is payable monthly over the three-year term of the agreement. After three years, EGI is obligated to repay the amounts drawn as at the termination of the agreement. See "Risk Factors – Future Capital Requirements". Pursuant to the credit facility agreement, EGI is required to comply with various financial covenants and financial information reporting requirements.

During the three-year term, EGI has agreed to certain financial covenants, of which the key ones require EGI to maintain a minimum tangible net worth of \$80.0 million and a maximum debt-to-capital ratio of 0.30:1.00.

The initial drawdown of US\$20 million, or CDN\$19.55 million, was used to increase the capital of CIM Reinsurance Company Ltd., EGI's Barbados-based reinsurance company, which has been used to reinsure selected niche and specialty line insurers which underwrite business in the United States.

Contractual obligations include operating leases, for which \$1.1 million was due in less than a year and \$8.2 million is due over the next nine years.

EGI is primarily a holding company and, as such, has limited direct operations of its own. EGI's principal assets are the shares of its insurance, reinsurance and insurance management subsidiaries. Accordingly, its future cash flows depend in part upon the availability of dividends and other statutorily permissible distributions from the insurance subsidiaries. The ability to pay such dividends and to make such other distributions is limited by applicable laws and regulations of the jurisdictions in which the insurance subsidiaries are domiciled, which subject the insurance subsidiaries to significant regulatory restrictions. These laws and regulations require, among other things, that the insurance subsidiaries maintain minimum solvency requirements and may also limit the amount of dividends that the insurance subsidiaries can pay to EGI.

## Transactions with Related Parties

EGI has entered into transactions with two related parties, The Co-operators Group Limited (Co-operators) and Purves Redmond Limited (Purves Redmond). These transactions are carried out in the normal course of operations and are measured at cost which approximates fair value. The transactions involving Co-operators, which is a significant shareholder of EGI, principally consist of an agent distribution channel, support services and investment management. Purves Redmond is involved in arranging insurance coverage for the companies within the EGI group. Robert Purves, a shareholder and director of EGI, is also a shareholder and the chairman of Purves Redmond.

## Risk Management

EGI has developed a comprehensive process of risk management and internal control which emphasizes the proactive identification of risks facing the organization and the effective management and control of these risks. The foundation of the process is the ongoing thorough operational analysis by senior management committees and a structured oversight process undertaken by the Board of Directors and appointed committees. Underlying this structure are strong internal control procedures which are designed to safeguard EGI's assets and protect the organization and its stakeholders from risk.

As a provider of insurance products, effective risk management is fundamental to EGI's ability to protect the interests of EGI's customers and shareholders. EGI is exposed to potential loss from various market risks, including interest rate and equity market fluctuation risk, credit risk, liquidity risk and, to a lesser extent, foreign currency risk.

### *Market Risk*

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates, foreign currency exchange rates, and other relevant market rate or price changes. Market risk is directly influenced by the volatility and liquidity in the markets in which the related underlying assets are traded.

The primary market risk to the investment portfolio is the interest rate risk associated with investments in fixed income securities. EGI's exposure to unhedged foreign exchange risk is not significant and is limited to the common equity portfolio.

For EGI's investment portfolio, there were no significant changes in 2009 in the primary market risk exposures or in how those exposures are managed compared to the year ended December 31, 2008. Management does not currently anticipate significant changes in EGI's primary market risk exposures or in how those exposures are managed in future reporting periods based upon what is known or expected to be in effect in future reporting periods.

### *Interest Rate and Equity Market Fluctuation*

Movements in short and long-term interest rates, as well as fluctuations in the value of equity securities, affect the level and timing of recognition of gains and losses on securities EGI holds, and cause changes in realized and unrealized gains and losses. Generally, EGI investment income will be reduced during sustained periods of lower interest rates as higher yielding fixed income securities are called, mature, or are sold and the proceeds are reinvested at lower rates. During periods of rising interest rates, the market value of EGI's existing fixed income securities will generally decrease and the realized gains on fixed income securities will likely be reduced. Realized losses will be incurred following significant increases in interest rates.

Generally, declining interest rates result in unrealized gains in the value of the fixed income securities EGI continues to hold, as well as realized gains to the extent the relevant securities are sold. General economic conditions, political conditions and many other factors can also adversely affect the stock markets and, consequently, the value of the equity securities EGI owns.

### *Credit Risk*

Credit risk is the possibility that counterparties may not be able to meet payment obligations when they become due. EGI assumes counterparty credit risk in many forms. A counter-party is any person or entity from

which cash or other forms of consideration are expected to extinguish a liability or obligation to EGI. The credit risk exposure is concentrated primarily in the fixed income and preferred share investment portfolios and, to a lesser extent, in reinsurance recoverables.

EGI's risk management strategy and investment policy is to invest in debt instruments of high credit quality issuers and to limit the amount of credit exposure with respect to any one issuer. EGI attempts to limit its credit exposure by imposing fixed income portfolio limits on individual corporate issuers based upon credit quality (see "Investments" – "Fixed Income Securities" and "Reinsurance" sections).

#### *Foreign Exchange Risk*

Foreign exchange risk is the possibility that changes in exchange rates may produce an unintended effect on earnings and equity when measured in domestic currency. This risk is largest when asset backing liabilities are payable in one currency and are invested in financial instruments of another currency.

EGI is exposed to foreign exchange risk, through its U.S. operations with the commencement of an insurance and management services company in Florida. As at December 31, 2009, EGI has provided capital of \$10 million to its Florida-based insurance company

EGI is also exposed to some foreign exchange risk arising from claims on the ETH insurance business, cash held in U.S. dollars, the investment in U.S. dollar denominated investments and business assumed from U.S. domiciled insurers.

Total cash and invested assets denominated in U.S. dollars for this purpose were less than 3% of the total invested assets at December 31, 2009. EGI's general policy is to minimize foreign currency exposure by seeking to maintain investments in the same currency as the offsetting liabilities.

#### **Risk Factors**

Careful consideration should be given to the following factors, which must be read in conjunction with the detailed information appearing elsewhere in this report. Any of the matters highlighted in these risk factors could have a material adverse effect on EGI's results of operations, business prospects or financial condition.

#### *Nature of the Industry*

The P&C insurance business in Canada is affected by many factors which can cause fluctuations in the results of operations of EGI. Many of these factors are beyond EGI's control. An economic downturn in those jurisdictions in which EGI writes business could result in less demand for insurance and lower policy amounts. As a property and casualty insurer, EGI is subject to claims arising out of catastrophes, which may have a significant impact on its results of operations and financial condition. These factors, together with the industry's historically cyclical competitive pricing, could result in fluctuations in the underwriting results and net income of EGI. A significant portion of the earnings of insurance companies is derived from the income from their investment portfolios. EGI's investment income will fluctuate depending on the returns and values of securities in its investment portfolio.

#### *Regulation*

EGI is subject to the laws and regulations of the jurisdictions in which it carries on business. These laws and regulations cover many aspects of its business, including premium rates for automobile insurance; the assets in

which it may invest; the levels of capital and surplus and the standards of solvency that it must maintain; and the amount of dividends which it may declare and pay.

Changes to laws or regulations are impossible to predict and could materially adversely affect EGI's business, results of operations and financial condition. Where the Office of the Superintendent of Financial Institutions (OSFI) is concerned about an unsafe course of conduct or an unsound practice in conducting the business of a federally regulated insurance company, OSFI may direct the insurance company to refrain from a course of action or to perform acts necessary to remedy the situation. In certain circumstances, OSFI may take control of the assets of an insurance company or take control of the company itself. More restrictive laws, rules or regulations may be adopted in the future that could make compliance more difficult and/or expensive. Specifically, recently adopted legislation addressing privacy issues, among other matters, is expected to lead to additional regulation of the insurance industry in the coming years, which could result in increased expenses or restrictions on EGI's operations.

#### *Industry Growth*

EGI is subject to and dependent on fluctuations within the P&C insurance industry. According to *Canadian Underwriter*, from 2001 to 2004, direct written premiums in the P&C insurance industry in Ontario, Alberta and Quebec grew at an abnormally high compound annual growth rate of 12.3%. However, in 2005 and 2006, the growth in direct written premiums slowed significantly to approximately 1% before improving slightly to 4.5% in each year 2007 and 2008. EGI believes that these soft market conditions will continue in the short term, however the market is showing signs of hardening.

#### *Competition*

The P&C insurance business is highly competitive with pricing being a primary means of competition. Other elements of competition include availability and quality of products, quality and speed of service, financial strength, distribution systems and technical expertise.

EGI competes with many other insurance companies. Certain of these competitors are larger and have greater financial resources than EGI has.

In addition, certain competitors have from time to time decreased their prices in an apparent attempt to gain market share.

As competitors introduce new products and as new competitors enter the market, the Company and its insurance subsidiaries may encounter additional and more intense competition. There can be no assurance that EGI will continue to increase revenues or be profitable. To a large degree, future revenues of EGI are dependent upon its ability to continue to develop and market its products and to enhance the capabilities of its products to meet changes in customer needs.

EGI expects to encounter competition from other entities having a business objective similar to that of EGI. Many of these entities are well established and have extensive experience in connection with identifying and effecting business acquisitions directly or through affiliates. Many of these competitors possess greater financial resources, technical personnel and other resources than EGI and there can be no assurance that EGI will have the ability to compete successfully. EGI's financial resources will be relatively limited when contrasted with those of many of its competitors. Although EGI's business strategy assumes that the industry will generate competition, there can be no assurance on how any level of competition may impact the future revenues of EGI.

### *Cyclicality*

Historically, the results of companies in the P&C insurance industry have been subject to significant fluctuations and uncertainties. The profitability of P&C insurers can be affected significantly by many factors, including regulatory regimes, developing trends in tort and class action litigation, adoption of consumer initiatives regarding rates or claims handling procedures, and privacy and consumer protection laws that prevent insurers from assessing risk, or factors that have a high correlation with risks considered, such as credit scoring.

The financial performance of the P&C insurance industry has historically tended to fluctuate in cyclical patterns of “soft” markets characterized generally by increased competition, resulting in lower premium rates and underwriting standards, followed by “hard” markets characterized generally by lessening competition, stricter underwriting standards and increasing premium rates. EGI’s profitability tends to follow this cyclical market pattern with profitability generally increasing in hard markets and decreasing in soft markets. These fluctuations in demand and competition could produce underwriting results that would have a negative impact on EGI’s results of operations and financial condition.

### *Unpredictable Catastrophic Events*

Catastrophes can be caused by various natural and unnatural events. Natural catastrophic events include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Unnatural catastrophic events include hostilities, terrorist acts, riots, crashes and derailments. The incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophes are restricted to small geographic areas; however, hurricanes, windstorms and earthquakes may produce significant damage in large, heavily populated areas. Catastrophes can cause losses in a variety of P&C insurance lines. For example, the ice storm in eastern Canada in 1998 caused P&C insurance losses in several lines of business, including business interruption, personal property, automobile and commercial property. Claims resulting from natural or unnatural catastrophic events could cause substantial volatility in EGI’s financial results for any fiscal quarter or year and could materially reduce EGI’s profitability or harm EGI’s financial condition. EGI’s ability to write new business also could be affected. EGI may experience an abrupt interruption of activities caused by unforeseeable and/or catastrophic events. EGI’s operations may be subject to losses resulting from such disruptions. Losses can relate to property, financial assets, trading positions and also to key personnel. If EGI’s business continuity plans cannot be put into action or do not take such events into account, losses may further increase.

### *Interest Rates*

An increase in interest rates may result in lower values for EGI’s bond portfolio and increased costs of borrowing for EGI on future debt instruments or credit facilities. Such increased costs would negatively affect EGI’s operating results.

### *Negative Publicity in the Industry*

EGI’s products and services are ultimately distributed to individual consumers. From time to time, consumer advocacy groups or the media may focus attention on EGI’s products and services, thereby subjecting its industry to periodic negative publicity. EGI also may be negatively impacted if its industry engages in practices resulting in increased public attention to its business. Negative publicity may also result in increased regulation and legislative scrutiny of practices in the P&C insurance industry as well as increased litigation. Such consequences

may increase EGI's costs of doing business and adversely affect EGI's profitability by impeding its ability to market its products and services or increasing the regulatory burdens under which EGI operates.

#### *Reliance on Brokers*

EGI distributes its products primarily through a network of brokers. These brokers sell EGI's competitors' products and may stop selling EGI products altogether. Strong competition exists among insurers for brokers with demonstrated ability to sell insurance products. Premium volume and profitability could be materially adversely affected if there is a material decrease in the number of brokers that choose to sell EGI products. In addition, some P&C insurance companies offer their products through dedicated, captive sales organizations. If the number of such P&C insurance companies increases, EGI's revenues may decrease, which could have a material adverse effect on EGI's business, financial condition and results of operations. EGI's strategy of distributing through Co-operators' agent channel may also adversely impact its relationship with brokers who distribute EGI products.

#### *Product and Pricing*

EGI prices its products taking into account numerous factors, including claims frequency and severity trends, product line expense ratios, special risk factors, the capital required to support the product line, and the investment income earned on that capital. EGI's pricing process is designed to ensure an appropriate return on capital and long-term rate stability, avoiding wide fluctuations in rate unless necessary. These factors are reviewed and adjusted periodically to ensure they reflect the current environment.

However, pricing for automobile insurance must be submitted to each provincial government regulator and in certain provinces pre-approved by the regulator. It is possible that, in spite of EGI's best efforts, regulator decisions may impede automobile rate increases or other actions that EGI may wish to take. Also, during periods of intense competition for any product line to gain market share, EGI's competitors may price their products below the rates EGI considers acceptable. Although EGI may adjust its pricing up or down to maintain EGI's competitive position, EGI strives to ensure its pricing will produce an appropriate return on invested capital. There is no assurance that EGI will not lose market share during periods of intense pricing competition.

#### *Underwriting and Claims*

EGI is exposed to losses resulting from the underwriting of risks being insured and the exposure to financial loss resulting from greater than anticipated adjudication, settlement and claims costs. EGI's success depends upon its ability to accurately assess the risks associated with the insurance policies that EGI writes.

EGI's underwriting objectives are to develop business within EGI's target markets on a prudent and diversified basis and to achieve profitable underwriting results (i.e. a combined ratio below 100%). EGI underwrites automobile business after a review of the applicant's driving record reports and claims experience. There can be no assurances that EGI will properly assess the risks associated with the insurance policies that it writes and may, therefore, experience increased adjudication, settlement and claims costs.

#### *Loss Reserves and Claims Management*

The amounts established and to be established by EGI for loss and loss adjustment expense reserves are estimates of future costs based on various assumptions, including actuarial projections of the cost of settlement and the administration of claims, estimates of future trends in claims severity and frequency, and the level of

insurance fraud. Most or all of these factors are not directly quantifiable, particularly on a prospective basis, and the effects of these and unforeseen factors could negatively impact EGI's ability to accurately assess the risks of the policies that it writes. In addition, future adjustments to loss reserves and loss adjustment expenses that are unanticipated by management could have an adverse impact upon the financial condition and results of operations of EGI. Although EGI's management believes its overall reserve levels as at December 31, 2009 are adequate to meet its obligations under existing policies, actual losses may deviate, perhaps substantially, from the reserves reflected in EGI's financial statements. To the extent reserves prove to be inadequate, EGI would have to increase such reserves and incur a charge to earnings.

#### *Errors and Omissions Claims*

Where EGI acts as a licensed insurance agency, it is subject to claims and litigation in the ordinary course of business resulting from alleged errors and omissions in placing insurance and handling claims. The placement of insurance and the handling of claims involve substantial amounts of money. Since errors and omissions claims against EGI may allege EGI's potential liability for all or part of the amounts in question, claimants may seek large damage awards and these claims can involve significant defense costs. Errors and omissions could include, for example, EGI's employees or sub-agents failing, whether negligently or intentionally, to place coverage or file claims on behalf of customers, to appropriately and adequately disclose insurer fee arrangements to its customers, to provide insurance providers with complete and accurate information relating to the risks being insured or to appropriately apply funds that it holds for its customers on a fiduciary basis. It is not always possible to prevent or detect errors and omissions, and the precautions EGI takes may not be effective in all cases.

EGI's business, financial condition and/or results may be negatively affected if in the future its errors and omissions insurance proves to be inadequate or unavailable. In addition, errors and omissions claims may harm EGI's reputation or divert management resources away from operating the business.

#### *Investments*

EGI's investment assets are exposed to any combination of risks related to interest rates, foreign exchange rates and changing market values.

EGI's investment portfolio consists of diversified investments in fixed-income securities and preferred and common stocks. Investment returns and market values of investments fluctuate from time to time. A decline in returns could reduce the overall profitability of EGI. A change in interest rates, market values or foreign exchange rates may affect Echelon's regulatory strength tests.

#### *Reinsurance*

Consistent with industry practice, EGI utilizes reinsurance to manage its claims exposure and diversifies its business by types of insurance and geographic area. The availability and cost of reinsurance are subject to prevailing market conditions that are generally beyond the control of EGI and may affect EGI's level of business and profitability. There can be no assurance that developments may not occur in the future which might cause a shortage of reinsurance capacity in those classes of business which EGI underwrites, which could result in the curtailment of issuing of policies in a certain line of business or containing limits above a certain size.

### *Reinsurer Credit Risk*

EGI's reinsurance arrangements are with a limited number of reinsurers. This reinsurance may cause an adverse effect on EGI's results of operations if one or more of its reinsurers are unable to meet its financial obligations. Although all of its reinsurers were rated B++ or higher by A.M. Best at the time of entering into the reinsurance arrangements, these ratings are subject to change and may be lowered.

Although reinsurance makes the assuming reinsurers liable to EGI to the extent of the risk each reinsurer assumes, EGI is not relieved of its primary liability to its insureds as the direct insurer. As a result, EGI bears credit risk with respect to its reinsurers. EGI cannot ensure that its reinsurers will pay all reinsurance claims on a timely basis or at all. EGI evaluates each reinsurance claim based on the facts of the case, historical experience with the reinsurer on similar claims, and existing law and includes in its reserve for uncollectible reinsurance any amounts deemed uncollectible. The inability to collect amounts due to EGI under reinsurance arrangements would reduce EGI's net income and cash flow.

### *Technology*

EGI is heavily dependent on systems technology to process large volumes of transactions and there would be a risk if the technology employed is inadequate or inappropriate to support current and future business needs and objectives. EGI continues to implement new computer applications as part of a comprehensive approach to improve systems technology. EGI regularly tests and improves its Business Recovery Emergency Plan to protect itself, its producers and policyholders in the event of a technology failure; however, there is no assurance that EGI will be able to respond to technology failures effectively and with minimal disruption.

### *Liquidity*

EGI manages its cash and liquid assets in an effort to ensure there is sufficient cash to meet all of EGI's financial obligations as they fall due. As a federally regulated insurance company, Echelon is required to maintain an asset base comprised of liquid securities that can be used to satisfy its ongoing commitments. EGI believes that internally generated funds provide the financial flexibility needed to fulfill cash commitments on an ongoing basis. EGI has no material commitments for capital expenditures. However, there can be no assurances that EGI's cash on hand and liquid assets will be sufficient to meet any future obligations that may come due.

### *Future Capital Requirements*

EGI's future capital requirements will depend upon many factors, including the expansion of EGI's sales and marketing efforts and the status of competition. EGI's current credit facility matures in October 2010. There can be no assurance that any replacement credit facility or other financing will be available to EGI on acceptable terms, or at all. If additional funds are raised by issuing equity securities, further dilution to the existing stockholders will result. If adequate funds are not available, EGI may be required to delay, scale back or eliminate its programs. Accordingly, the inability to obtain such financing could have a material adverse effect on EGI's business, financial condition and results of operations.

## **Corporate Governance**

Active oversight remains a priority for the Board of Directors. The board is directly involved, through its committees, in overseeing all aspects of EGI's operation. The objective of the board is to meet or exceed best

practices in corporate governance. There is independent oversight from the board and the respective committees to key corporate functions such as financial reporting, compliance, risk assessment and management, as well as human resources and succession planning.

EGI's Board of Directors has established the following committees to ensure that risks are effectively identified, monitored, controlled and reported on:

***Audit and Risk Committee:*** This committee of directors of the Company reviews all financial information, monitors internal controls and provides oversight of management's risk control processes, specifically focusing on financial related risks. Echelon also has an audit and risk committee of its directors in accordance with the requirements of the Insurance Companies Act (Canada).

***Conduct Review & Compensation Committee:*** The Conduct Review & Compensation Committee of directors of the Company monitors related party transactions affecting EGI and reviews and approves officer compensation and benefit plans. The Conduct Review Committee of directors of Echelon is responsible for the identification and reporting of related party transactions to Echelon's board of directors and the monitoring of regulatory compliance and market conduct programs put in place by management to ensure their effectiveness.

***Investment Committee:*** This committee, composed of directors and supported by senior executives, ensures that risks associated with the investment of corporate and policyholder funds are effectively managed to accomplish EGI's investment objectives of prudent, conservative management of funds and compliance with regulatory restrictions while achieving competitive rates of return.

***Reinsurance Committee:*** This committee of senior executives works closely with AON Re Canada Inc., EGI's reinsurance brokers, to ensure that effective reinsurance programs are in place, which facilitate the desired growth of EGI's business and provide EGI with protection against the occurrence of significant and unusual claims risk and development.

In addition to these committees, management has formed a number of working committees which have been assigned the responsibility of identifying and managing specific corporate risks, including (i) a strategic initiatives committee to consider the strategic risks faced by EGI; (ii) underwriting and claims committees to manage the risks associated with the development and pricing of EGI's products, claims adjudication and reserving; (iii) a technology committee and a system prioritization committee to implement effective technology solutions; and (iv) a compliance committee to ensure that the appropriate processes and procedures are in place to ensure compliance with all applicable regulatory requirements. EGI has also established a Business Recovery Emergency Plan with the objectives of protecting life, securing critical infrastructure and facilities from a catastrophic event and resuming business operations in a timely effective manner thus minimizing loss to the organization.

EGI maintains liability insurance covering errors or omissions that may occur while acting in its role as an insurance consultant. The annual premium for this coverage during fiscal 2009 was \$3,900. This coverage has an aggregate limit of liability of \$2 million.

## Controls and Procedures

### *Disclosure Controls and Procedures*

EGI's disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by EGI is recorded, processed, summarized and reported in a timely manner. This includes controls and procedures that are designed to ensure that information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

As of December 31, 2009, an evaluation was carried out, under the supervision of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures as defined under National Instrument 52-109. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the design of these disclosure controls and procedures was effective.

### *Internal Controls over Financial Reporting*

As at the financial year ended December 31, 2009, the Chief Executive Officer and the Chief Financial Officer evaluated the effectiveness of the Company's internal control over financial reporting. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the internal control over financial reporting was effective as at December 31, 2009, and provided reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

There have been no changes in the Company's internal control over financial reporting during the year ended December 31, 2009, that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

## Capital Resources

The total capitalization of EGI at December 31, 2009, was \$133.4 million compared to \$118.6 million at December 31, 2008. The elements that increased shareholders' equity consist of net income of \$4.5 million, the issuance of common shares for proceeds of \$1.6 million and comprehensive income of \$9.5 million in 2009, reflecting (i) an increase in the fair value of investments designated as available-for-sale investments of \$14.3 million, net of income tax, (ii) a reclassification for gains realized in 2009 of \$4.3 million, net of income tax, and included in net income in the year, and (iii) unrealized losses on translation of financial statements of self-sustaining foreign operations of \$0.5 million.. These increases were offset by the payment of common share dividends of \$0.8 million in 2009.

The continued growth in capitalization reflects the strengthening of EGI's balance sheet and provides for better capital adequacy as a property and casualty insurance underwriter. A common measure of capital adequacy is the net written premium ratio to surplus (or common shareholders' equity). This ratio was 1.2 as at December 31, 2009, compared to 1.33 in 2008. This level of leverage continues to be well below the 2.5:1 ratio which management feels is fully leveraged capital. Therefore, EGI's current capitalization provides it with adequate financial resources for planned growth.

Shareholders' Equity (\$ THOUSANDS)	As at December 31	
	2009	2008
Common shares	68,618 (12,000,582 shares)	67,056 (11,676,282 shares)
Retained earnings	60,301	56,605
Contributed surplus	403	403
Accumulated other comprehensive income (loss)	4,109	(5,460)
Total capitalization	133,431	118,604

## Future Accounting Changes

### *International Financial Reporting Standards (IFRS)*

During 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises will be required to adopt International Financial Reporting Standards (IFRS) in place of Canadian GAAP for interim and annual reporting purposes. The required changeover date is for fiscal years beginning on or after January 1, 2011.

The Company began its IFRS conversion process in 2008 and has established a project plan and governance structure. The plan includes regular reporting to the Audit and Risk Committee of the Company's Board of Directors from the Project Management Committee which consists of members of Finance and IT, headed by the Chief Financial Officer. The Company will be using an external advisor to assist in the conversion project, in addition to receiving guidance from its external auditors.

The Company has completed the assessment and design phase of the project. This phase involved completion of a detailed diagnostic review to identify and assess the impact of IFRS differences in relation to Canadian GAAP. In addition, an initial evaluation of transition exemptions under IFRS 1 (which covers First-time Adoption of IFRS) and an analysis of financial systems has been performed. Final determinations regarding the application and election of transitional exemptions available under IFRS 1, and accounting policy choices related to various IFRS standards are expected to be completed in the first quarter of 2010. Management is also in the process of identifying the financial statement presentation and disclosure differences between IFRS and Canadian GAAP. IFRS provides enhanced presentation of financial statements and more relevant disclosures which will be specifically identified. This stage will also be completed in the first half of 2010.

At this time, the impact, of the implementation of IFRS on the financial statements of the Company is not expected to be material.

The Company will continue to report on the key elements and timing of its IFRS implementation plan in its interim MD&A reports throughout 2010.

## GLOSSARY OF SELECTED INSURANCE TERMS

**“Case method”** means establishing a reserve liability equal to the most probable expected outcome for an individual claim.

**“Cede”** means the act of an insurer transferring or assigning part or all of the risk on an insurance policy written by it to a reinsurer by purchasing insurance from such reinsurer to cover the risk or part thereof.

**“Combined ratio”** of an insurer for any period means the sum of the loss ratio and the expense ratio of the insurer for such period.

**“Direct written premiums”** of an insurer for any period means the total premiums on insurance, including assumed reinsurance, written by the insurer during such period.

**“Expense ratio”** for any period means the sum of expenses, including commissions, premium taxes and operating expenses incurred, expressed as a percentage of net earned premiums.

**“Facility Association”** or **“Facility”** refers to an organization of the Canadian automobile insurance industry which exists to ensure that all drivers can obtain basic insurance, even if their application fails to meet the criteria of individual insurance companies.

**“Groupement”** refers to a Quebec organization of the automobile insurance industry which exists to ensure that all drivers in Quebec can obtain basic insurance, even if their application fails to meet the criteria of individual insurance companies.

**“Loss adjustment expenses”** or **“LAE”** means the expense of settling claims, including certain legal and other fees and the expense of administering the claims adjustment process.

**“Loss ratio”** for any period means the sum of claims and claims adjustment expenses incurred, net of reinsurance, expressed as a percentage of net earned premiums.

**“Minimum Capital Test”** means the OSFI's Minimum Capital Test Guideline under which a federally regulated insurer is measured for the adequacy of its capital.

**“Net earned premiums”** of an insurer means the portion of the written premium equal to the expired portion of the time for which insurance or reinsurance was in effect.

**“Net written premiums”** of an insurer means direct written premiums less amounts ceded to reinsurers.

**“Producers”** refers to, collectively, insurance brokers, agents and managing general agencies.

**“Quota share”** means a type of reinsurance where the reinsurer agrees to assume the risk on a fixed portion of a specified line of business in return for the same portion of the ceding company's premium for that line of business.

**“Reinsurance”** means an arrangement in which an insurance company, the reinsurer, agrees to indemnify another insurance or reinsurance company, the ceding company, against all or a portion of the insurance or reinsurance risks underwritten by the ceding company under one or more policies.

**“Retention”** means the amount of liability for which an insurance company will be responsible after it has completed its reinsurance arrangements.

**“Return on equity”** or **“ROE”** for a period means net income expressed as a percentage of the average shareholders' equity in that period.

**“Risk”** means a person or thing insured on an insurance policy.

**“Underwriting”** means the assumption of risk for designated loss or damage by issuing a policy of insurance in respect thereof.

**“Unearned premiums”** means the portion of premiums received relating to the period of risk in subsequent accounting periods and which is deferred to such subsequent accounting periods.