

Consolidated Financial Statements of

**EGI FINANCIAL HOLDINGS INC.**

June 30, 2010

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Balance Sheets**  
(unaudited, in \$ thousands)

<b>Assets</b>	<b>June 30 2010</b>	<b>December 31 2009</b>
Cash and short-term deposits	40,456	46,885
Investments (note 2)	297,888	294,365
Reinsurers' share – unearned premiums	7,723	4,972
– provision for unpaid claims (note 3)	41,782	38,736
Accounts receivable	38,553	32,950
Income taxes recoverable	2,882	–
Due from insurance companies	5,899	5,545
Deferred policy acquisition costs	16,992	14,807
Property and equipment	740	838
Intangible assets	427	468
Future income taxes	5,147	3,952
Prepaid expenses and other assets	2,076	2,947
	<b>460,565</b>	<b>446,465</b>
 <b>Liabilities</b>		
Bank indebtedness (note 7)	–	19,550
Provision for unpaid claims (note 3)	231,892	207,220
Unearned premiums	86,214	72,643
Unearned commission	845	513
Income taxes payable	–	4,151
Accounts payable and accrued liabilities	6,090	6,312
Payable to insurance companies	1,777	1,829
Other liabilities	1,162	816
	<b>327,980</b>	<b>313,034</b>
 <b>Shareholders' Equity</b>		
Share capital (note 6)	68,993	68,618
Contributed surplus	412	403
Retained earnings	60,432	60,301
Accumulated other comprehensive income	2,748	4,109
	<b>132,585</b>	<b>133,431</b>
	<b>460,565</b>	<b>446,465</b>

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Statements of Income**  
(unaudited, in \$ thousands, except per share amounts)

	3 months ended June 30		6 months ended June 30	
	2010	2009	2010	2009
Revenue				
Direct written and assumed premiums	55,991	48,487	99,981	80,103
Net written and assumed premiums	51,207	44,121	89,423	73,179
Net earned premiums	40,379	35,486	78,603	77,059
Investment income (note 2)	6,135	6,017	9,819	7,891
	46,514	41,503	88,422	84,950
Expenses				
Incurred claims	29,593	21,931	61,453	51,821
Acquisition costs	9,376	8,078	17,913	18,038
Operating costs	4,588	3,774	8,225	7,369
Interest expense	269	305	568	604
	43,826	34,088	88,159	77,832
Income before income taxes	2,688	7,415	263	7,118
Income tax expense	786	2,584	132	2,517
Net income	1,902	4,831	131	4,601
Earnings per share (note 8)				
Net income per share – basic	\$0.16	\$0.41	\$0.01	\$0.39
Net income per share – diluted	\$0.15	\$0.38	\$0.01	\$0.36

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**and Comprehensive Income**  
(unaudited, in \$ thousands)

	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
<b>Share capital</b>				
Balance, beginning of period	68,636	67,221	68,618	67,056
Common shares issued	357	526	375	691
Balance, end of period	68,993	67,747	68,993	67,747
<b>Contributed surplus</b>				
Balance, beginning of period	472	433	403	403
Stock options – granted (net of forfeitures)	70	53	143	103
– exercised	(130)	(64)	(134)	(84)
Balance, end of period	412	422	412	422
<b>Retained earnings</b>				
Balance, beginning of period	58,530	55,556	60,301	56,605
Net income	1,902	4,831	131	4,601
Dividends – Common shares	–	–	–	(819)
Balance, end of period	60,432	60,387	60,432	60,387
<b>Accumulated other comprehensive income (loss)</b>				
Balance beginning of period	6,061	(3,624)	4,109	(5,460)
Other comprehensive income (loss)	(3,313)	4,816	(1,361)	6,652
Balance, end of period	2,748	1,192	2,748	1,192
<b>Shareholders' equity, end of period</b>				
	132,585	129,748	132,585	129,748
<b>Comprehensive income</b>				
Net income	1,902	4,831	131	4,601
Other comprehensive income, net of taxes				
Change in unrealized gains on available-for-sale securities:				
Net unrealized gains (losses) on available-for-sale investments	(1,348)	6,913	1,165	7,463
Reclassification of net realized (gains) losses to net income	(1,845)	(2,205)	(2,452)	(884)
Unrealized gains (losses) on translation of financial statements of self-sustaining foreign operations	(120)	108	(74)	73
Other comprehensive income (loss)	(3,313)	4,816	(1,361)	6,652
Total comprehensive income (loss)	(1,411)	9,647	(1,230)	11,253

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Statements of Cash Flows**  
(unaudited, in \$ thousands)

	Three months ended		Six months ended	
	June 30		June 30	
	2010	2009	2010	2009
Cash provided by (used in):				
Operating activities				
Net income	1,902	4,831	131	4,601
Items not involving cash:				
Amortization	142	191	590	414
Amortization of premiums on bonds	159	216	332	317
Realized gains on investments	(2,742)	(3,243)	(3,644)	(1,678)
Decrease in accrued investment income	1,071	1,102	180	380
Other	70	53	143	103
	602	3,150	(2,268)	4,137
Net change in other non-cash balances	13,256	7,644	18,195	8,799
	13,858	10,794	15,927	12,936
Financing activities				
Repayment of bank indebtedness	(19,550)	-	(19,550)	-
Issue of common shares	226	460	241	606
Common share dividends	-	-	-	(819)
	(19,324)	460	(19,309)	(213)
Investing activities				
Acquisition of subsidiary, net of cash acquired	-	-	221	-
Purchase of property and equipment and intangible assets	(171)	(487)	(451)	(682)
Purchase of investments	(92,616)	(58,169)	(175,794)	(100,345)
Sale/maturity of investments	100,985	79,272	172,977	118,868
	8,198	20,616	(3,047)	17,841
Increase (decrease) in cash and short-term deposits	2,732	31,870	(6,429)	30,564
Cash and short-term deposits, beginning of period	37,724	27,805	46,885	29,111
Cash and short-term deposits, end of period	40,456	59,675	40,456	59,675
Supplementary information				
Income taxes paid	1,433	878	7,535	2,712
Interest paid	266	302	568	604

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements**  
(unaudited, in \$ thousands except per share amounts)

**1 Organization and basis of presentation**

These interim consolidated financial statements include the accounts of EGI Financial Holdings Inc. and its subsidiaries (the Company or EGI) and have not been reviewed by the Company's external auditors. They do not include all disclosures required by Canadian generally accepted accounting principles for annual financial statements, and accordingly, should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2009, as set out on pages 53 to 80 of the Company's 2009 Annual Report. These interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles using the same accounting policies as were used for the Company's consolidated financial statements for the year ended December 31, 2009.

The Company was incorporated on August 18, 1997, under the Business Corporations Act (Ontario). The Company is principally engaged, through its subsidiaries, in property and casualty insurance in Canada and the U.S.

The Company purchased American Colonial Insurance Company (ACIC) during the first quarter of the year for a purchase price of \$4,541. Net assets of \$4,541 consisting primarily of cash and insurance licenses, valued at \$200, were received. The insurance licenses have been recorded at cost as intangible assets. Effective March 31, 2010, Echelon Insurance Company of America (EICA) and ACIC were amalgamated into one entity and continue to operate under the name ACIC.

The Company's wholly-owned subsidiaries are EGI Insurance Managers Inc., Echelon General Insurance Company (Echelon), EGI Insurance Services, Inc., American Colonial Insurance Company (ACIC), EGI Insurance Services (Florida), Inc., and CIM Reinsurance Company Ltd. (CIM Re).

EGI Insurance Services, Inc., ACIC and EGI Insurance Services (Florida), Inc., are U.S.-based subsidiaries whose functional and reporting currency is U.S. dollars. The Company's Barbados based subsidiary, CIM Re also reports in U.S. dollars. All subsidiaries operating outside of Canada are self-sustaining foreign subsidiaries and are therefore subject to foreign currency translation adjustments upon consolidation.

**2 Investments**

The Company utilizes the prudent person approach to asset management, as required by the Insurance Companies Act. An investment policy is in place and its application is monitored by the Board of Directors. Diversification techniques are employed to minimize risk. Policies limit investments in any entity or group of related entities to a maximum of 5% of the Company's assets. Limitations are also placed on the quality of investments, particularly relating to investment grade bonds.

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**Notes to Consolidated Financial Statements (continued)**  
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The following table provides a comparison as at June 30, 2010, and December 31, 2009:

	June 30, 2010	December 31, 2009
<b>Available-for-sale</b>	<b>Carrying and fair values</b>	<b>Carrying and fair values</b>
Bonds		
Canadian		
Federal	83,396	83,777
Provincial	43,102	44,696
Municipal	6,348	6,254
Corporate	84,355	90,024
	217,201	224,751
United States		
Federal	4,612	–
Corporate	8,847	6,819
	13,459	6,819
Total bonds	230,660	231,570
Preferred shares	11,561	7,567
Common shares		
Canadian	53,660	52,210
United States	240	1,072
	53,900	53,282
Investment income due and accrued	1,767	1,946
	297,888	294,365

**Fair value**

The Company is responsible for determining the fair value of its investment portfolio by utilizing market-driven fair value measurements from active markets where available, by considering other observable and unobservable inputs and by employing valuation techniques which make use of current market data. Considerable judgement may be required in interpreting market data used to develop the estimates of fair value. Accordingly, the estimates presented in these consolidated financial statements are not necessarily indicative of the amounts that could be realized in a current market exchange. The Company uses a fair-value hierarchy to categorize the inputs used in valuation techniques to measure fair value. A description of the inputs used in the valuation of financial instruments is as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities. The fair values, of the Company's common and preferred shares, are determined based on quoted prices in active markets obtained from external pricing sources.

Level 2 – Inputs, other than quoted prices that are observable for the investment, either directly or indirectly. These inputs include quoted prices for similar instruments exchanged in active markets; quoted prices for identical or similar instruments exchanged in inactive markets; inputs other than quoted prices that are observable for the instruments, such as interest rates and yield curves, volatilities, prepayment speeds, loss severities, credit risks and default rates where available; and inputs that are derived principally from or corroborated by observable market data and correlation or other means.

**EGI FINANCIAL HOLDINGS INC.**  
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The Company's investments in government securities (including federal, provincial and municipal bonds, corporate securities, private placements and infrequently traded securities) are priced using publicly traded, over-the-counter prices or broker-dealer quotes which are based on market-observable inputs. Observable inputs such as benchmark yields, reported trades, broker dealer quotes, issuer spreads and bids are available for these investments.

Level 3 – Inputs that are not based on observable market data. Management is required to use assumptions regarding unobservable inputs as there is little, if any, market activity in these investments or related observable inputs that can be corroborated at the measurement date. Unobservable inputs require management to make certain projections and assumptions about the information that would be used by market participants in pricing assets. To verify pricing, the Company assesses the reasonableness of the fair values by comparing to industry-accepted valuation models, to movements in credit spreads and to recent transaction prices for similar assets where available.

The following table provides the classification of the Company's investments within the fair value hierarchy, as outlined above, as at June 30, 2010:

	<b>Investments at fair value as at June 30, 2010</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Bonds	–	230,441	219	230,660
Equities	63,461	–	2,000	65,461
	63,461	230,441	2,219	296,121

The fair value of the Company's investments, determined without the use of observable market information as inputs (approximately 0.7% of the total investment portfolio required to be measured at fair value) consists of corporate bonds and preferred shares with a fair value of \$219 and \$2,000 respectively.

A reconciliation of financial instruments measured at fair value on a recurring basis, with the use of significant unobservable inputs from January 1, 2010, to June 30, 2010, follows:

Balance at January 1, 2010	450
Add: Additions during period – preferred shares	2,000
Less: Disposals during period – bonds	(308)
Net unrealized gains included in other comprehensive income	77
Balance at June 30, 2010	2,219

**Impaired assets and provisions for losses**

The Company's policy is to write down or make a provision for any investment with other-than-temporary impairment.

Management has reviewed currently available information regarding those investments whose estimated fair values are less than carrying values. For those investments whose decline in fair value was 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.

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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-specific events, 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 losses were recorded in the first half of 2010 or 2009.

A gross unrealized loss of \$5,420 on investments held as at June 30, 2010 (\$3,277 – December 31, 2009) is recorded, net of tax, in the amount of \$3,664 (\$2,208 – December 31, 2009) as Accumulated Other Comprehensive Loss. The Company concluded during its review that these fair value deficiencies are considered temporary in nature.

**Investment income**

Investment income was derived from the following:

	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
Interest income	3,021	2,939	5,882	5,882
Dividend income	492	345	948	667
Net realized gains	2,742	3,243	3,644	1,678
Foreign exchange gain (loss) <sup>(1)</sup>	137	(283)	(87)	131
Investment expenses	(257)	(227)	(568)	(467)
	6,135	6,017	9,819	7,891

(1) The foreign exchange loss of \$87 (2009 – gain of \$131) arose primarily from cash balances held during the year, denominated in U.S. dollars, used to fund claims liabilities, denominated in U.S. dollars.

**3 Provision for unpaid claims**

The determination of the provision for unpaid claims and adjustment expenses and the related reinsurers' share requires the estimation of three major variables or quanta, being development of claims, reinsurance recoveries and the effects of discounting, to establish a best estimate of the value of the respective liability or asset.

The provision for unpaid claims and adjustment expenses is an estimate subject to variability and the variability could be material in the near term. The variability arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Variability can be caused by receipt of additional claim information, changes in judicial interpretation of contracts, significant changes in the severity or frequency of claims for historical trends, the timing of claim payments, recoverability of reinsurance and future rates of investment return. The estimates are principally based on the Company's historical experience. Methods of estimation have been used, which the Company believes produce reasonable results given current information.

All provisions are periodically reviewed and evaluated considering emerging claims experience and changing circumstances. The process of determining the provisions necessarily involves risks that

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actual results may differ, perhaps materially, from the best estimates made. The resulting changes in estimates of the ultimate liability are recorded as incurred claims in the current year.

The fair value of the provision for unpaid claims approximates carrying value determined in accordance with generally accepted actuarial methods in Canada, which discount estimated future cash flows and include a margin for adverse deviation.

To recognize the uncertainty in establishing these best estimates, to allow for possible deterioration in experience, and to provide greater comfort that the actuarial liabilities are adequate to pay future claims, the Company includes provisions for adverse deviations (PFADs) in some assumptions relating to claims development, reinsurance recoveries and future investment income. The PFADs selected are in the mid-range of those recommended by the Canadian Institute of Actuaries. The aggregate impact of the provision for adverse deviation is to increase the provision for unpaid claims on a gross basis by \$25,398 as at June 30, 2010, (December 31, 2009 – \$22,688).

The Company discounts its best estimate of claim provisions at a rate of interest of 2.56% (2009 – 2.45%) for all lines of business. The Company determines the discount rate based on the expected return on its investment portfolio of assets with appropriate assumptions for interest rates relating to reinvestment of maturing investments.

The Company has recorded a \$1,603 (2009 - \$3,661) reduction to the net provision for unpaid claims relating to redundancies in prior year estimates for the six-month period ended June 30.

The provision for unpaid claims on a gross and ceded basis by line of business is as follows:

	June 30, 2010		December 31, 2009	
	Gross	Ceded	Gross	Ceded
Personal Lines:				
Accident benefits	100,312	20,328	86,805	19,290
Liability	94,964	14,346	92,311	15,169
Other	3,228	455	3,914	667
<b>Total Personal Lines</b>	<b>198,504</b>	<b>35,129</b>	<b>183,030</b>	<b>35,126</b>
Niche Products:				
Property				
Commercial	4,739	648	3,278	266
Personal	269	78	307	109
Liability	19,163	2,691	16,291	2,903
Accident and Sickness	3,663	490	3,222	332
Other	5,554	2,746	1,092	–
<b>Total Niche</b>	<b>33,388</b>	<b>6,653</b>	<b>24,190</b>	<b>3,610</b>
	<b>231,892</b>	<b>41,782</b>	<b>207,220</b>	<b>38,736</b>

**EGI FINANCIAL HOLDINGS INC.**  
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#### **4 Underwriting policy and reinsurance ceded**

In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavourable underwriting results by purchasing reinsurance to share all or part of the insurance risks originally accepted by the Company in writing premiums. This reinsurance does not relieve the Company of its primary obligation to policyholders.

During the second quarter of 2010, the Company followed the policy of underwriting and reinsuring contracts of insurance, which limits the net exposure of the Company to a maximum amount on any one loss to \$1,500 (2009 – \$1,500). In addition, the Company obtained catastrophe reinsurance which limits the loss from a series of claims arising from a single occurrence to \$2,000 (2009 – \$2,000) to a maximum coverage of \$23,000 (2009 – \$23,000).

The Company places all its automobile reinsurance with Canadian registered reinsurers. There are non-registered reinsurers participating in the specialty property and casualty program business. The Company has access to trust funds that, in the Company's judgement, are adequate to secure the liabilities that the Company has ceded to non-registered reinsurers.

Failure of reinsurers to honour their obligations could result in losses to the Company. Consequently, the Company continually evaluates the financial condition of its reinsurers and monitors concentrations of credit risk to minimize its exposure to significant losses. There have been no defaults and no provision made in the accounts for defaults based on management's review of the creditworthiness of its reinsurers.

#### **5 Risk Management**

As a provider of insurance products, effective risk management is fundamental to the Company's ability to protect the interests of its customers and shareholders. The Company is exposed to risks of loss pertaining to insurance products. These include risks surrounding product and pricing, underwriting and claims, catastrophic exposure, and matching of assets and liabilities. The Company is also exposed to potential loss from various risks, including interest rate risk and equity market fluctuation risk, credit risk and liquidity risk, and to a lesser extent foreign exchange risk.

##### **Product and pricing**

The Company 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. The Company's pricing process is designed to ensure an appropriate return on capital and long-term rate stability, avoiding wide fluctuations in rates unless necessary. These factors are reviewed and adjusted periodically to ensure they reflect the current environment.

Pricing for automobile insurance must be submitted to each provincial government regulator and, in certain provinces, pre-approved by the regulator before being implemented. Regulatory decisions may impede automobile rate increases or other actions that the Company may wish to take. Also, during periods of intense competition for any product line, to gain market share, competitors may price their products below the rates the Company considers acceptable. Although the Company may adjust its

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pricing up or down to maintain a competitive position, the Company strives to ensure its pricing will produce an appropriate return on invested capital. There is no assurance that the Company will not lose market share during periods of pricing competition.

### **Underwriting and claims**

The Company is exposed to loss resulting from the underwriting of risks being insured and the exposure to financial loss resulting from greater than anticipated adjudication, settlement and claims costs.

The Company's underwriting objectives are to develop business within its target markets on a prudent and diversified basis and to achieve profitable underwriting results. The Company underwrites automobile business after a review of the applicant's driving record and claims experience. Specialty commercial and personal risks are selected by the Company, working with its external brokers, after consideration of various risk factors associated with these lines of business. Despite its best efforts, and consideration of all known risk factors, there can be no assurance that all risks associated with the insurance policies that it writes can be identified and assessed, and the Company may, therefore, experience increased adjudication, settlement and claims costs.

The Company estimates its claims reserves on a quarterly basis and this is supported by quarterly assessments by the appointed actuary. Every quarter, for each line of business, the Company 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 the Company 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 the Company's financial statements. To the extent provisions prove to be inadequate, the Company would have to re-evaluate such provisions and may incur a charge to earnings in the future.

### **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 business lines. Claims resulting from natural or unnatural catastrophic events could cause substantial volatility in the Company's financial results and could materially reduce its profitability or harm the Company's financial condition. The Company manages the impact of losses which may result from catastrophic events by purchasing excess of loss and catastrophe reinsurance to share all or part of the insurance risks originally accepted by the Company.

The Company's ability to write new business could also be affected. The Company may experience an abrupt interruption of activities caused by unforeseeable and/or catastrophic events. The Company'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. The Company has developed business

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continuity plans designed to allow it to continue operations in case of a catastrophic event; however if these plans cannot be put into action or do not take such events into account, losses may further increase.

**Asset and liability matching**

The Company is exposed to:

- changes in the value of its fixed income securities and policy liabilities to the extent that market interest rates change;
- equity price fluctuations which affect the fair values of equities held by the Company;
- the risk of losses to the extent that the sale of a security prior to its maturity is required to provide liquidity to satisfy policyholder and other cash outflows;
- the risk that future inflation of policyholder cash flows exceeds returns on long-term investment securities; and
- foreign exchange risks with respect to investments, receivables and policy liabilities denominated in foreign currencies.

To mitigate these risks, the Company has policies to ensure that assets and liabilities are broadly matched in terms of their duration and currency. The Company's exposures are monitored on a regular basis and actions are taken to balance investment positions when approved risk tolerance limits are exceeded.

Risk management is carried out by the Investment Committee under policies approved by the Board of Directors.

**Market risk**

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates, equity market fluctuations, foreign 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 financial assets are traded. Below is a discussion of the Company's primary market risk exposures and how these exposures are currently managed.

**Interest rate risk**

Fluctuations in interest rates have a direct impact on the fair valuation and future cash flows of the Company's fixed income securities portfolio. Generally, the Company's investment income will be reduced during sustained periods of lower interest rates as higher yielding fixed income securities mature or are sold and the proceeds are reinvested at lower rates. During periods of rising interest rates, the fair value of the Company's existing fixed income securities will generally decrease and gains on fixed income securities will likely be reduced.

The sensitivity analysis for interest rate risk as set out in the table below illustrates the impact of changes in interest rates on OCI relating to the fixed income securities portfolio as at June 30, 2010, and December 31, 2009, based on parallel 200 basis point shifts in interest rates up and down in 100 basis point increments.

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Change in interest rates	As at June 30, 2010			As at December 31, 2009		
	Fair value of fixed income portfolio	Hypothetical change on fair value	Effect on OCI	Fair value of fixed income portfolio	Hypothetical change on fair value	Effect on OCI
200 basis point rise	208,174	(10%)	(15,200)	209,222	(10%)	(14,302)
100 basis point rise	218,886	(5%)	(7,959)	219,883	(5%)	(7,830)
No change	230,660	–	–	231,570	–	–
100 basis point decline	243,604	5%	8,750	244,428	6%	8,615
200 basis point decline	257,607	11%	18,216	258,510	12%	18,050

As discussed in note 3, the discount rate used in the determination of the provision for unpaid claims is based on the expected return on assets in its investment portfolio with appropriate assumptions for interest rates relating to reinvestment of maturing investments. Fluctuations in market interest rates will therefore have an impact on the discount rate used in the valuation of the net provision for unpaid claims. The table below shows the potential impact of interest rate fluctuations on the net provision for unpaid claims and net income:

Change in discount rate	As at June 30, 2010			As at December 31, 2009		
	Net provision for unpaid claims	Hypothetical change in value	Effect on net income	Net provision for unpaid claims	Hypothetical change in value	Effect on net income
100 basis point rise	185,599	(2%)	3,049	164,529	(2%)	2,650
No change	190,110	–	–	168,484	–	–
100 basis point decline	194,856	2%	(3,208)	172,691	2%	(2,819)

### Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in raising funds to meet cash flow requirements associated with financial instruments. The purpose of liquidity management is to ensure that there is sufficient cash to meet all financial commitments and obligations as they fall due. To manage cash flow requirements, the Company maintains a portion of invested assets in liquid securities.

The maturity profile of bonds as at June 30, 2010, is as follows:

	Less than	1 – 3 years	3 – 5 years	Greater than	Total
	1 year			5 years	
Bonds	16,612	46,902	43,871	123,275	230,660
Percentage of total	7%	20%	19%	54%	100%

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The following table summarizes the expected timing of cash flows arising from insurance obligations, on an undiscounted basis (note 3), as at June 30, 2010:

	Less than 1 year	1 – 3 years	3 – 5 years	Greater than 5 years	Total
Actuarial liabilities (undiscounted)	68,442	81,831	44,031	31,136	225,440
Less: Reinsurance recoverable	14,177	14,097	7,082	3,942	39,298
Net actuarial liabilities	54,265	67,734	36,949	27,194	186,142

All other financial liabilities are for a duration of one year or less.

**Equity price risk**

Fluctuations in the value of equity securities affect the level and timing of recognition of gains and losses on securities held, and cause changes in realized and unrealized gains and losses. General economic conditions, political conditions and many other factors can also adversely affect the stock and bond markets and, consequently, the value of the equity and fixed income securities held.

The Company has policies to limit and monitor its exposure to individual issuers and classes of issuers of equity securities.

The table below summarizes the potential impact of a 20% change in the value of the equity securities (common and preferred shares) on OCI for the three months ended June 30, 2010. Certain shortcomings are inherent in the method of analysis presented, as the analysis is based on the assumptions that all equity holdings increased/decreased by 20% with all other variables held constant.

<u>Change in equity holdings</u>	<u>Effect on OCI</u>
20% rise	8,850
20% decline	(8,850)

**Credit risk**

The Company is exposed to credit risk principally through its investment securities and balances receivable from policyholders and reinsurers. The Company has policies to limit and monitor its exposure to individual issuers and classes of issuers of investment securities which do not carry the guarantee of a national or Canadian provincial government. The Company's credit exposure to any one individual policyholder is not material. The Company has policies which limit its exposure to individual reinsurers and regular review processes to assess the creditworthiness of reinsurers with whom it transacts business.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
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The following table sets forth the Company's fixed income securities portfolio by credit quality according to DBRS as at June 30, 2010, and December 31, 2009.

**Fixed income portfolio**

	As at June 30, 2010		As at December 31, 2009	
	Fair value	Fair value	Fair value	Fair value
AAA	106,871	46%	111,702	48%
AA	58,770	25%	64,446	28%
A	56,926	25%	48,090	21%
BBB	7,874	3%	6,882	3%
B	-	-	321	-
CCC	219	1%	129	-
Total	230,660	100%	231,570	100%

**Reinsurance recoverables**

The following table summarizes the balances outstanding from reinsurers as at June 30, 2010, by risk rating:

Credit rating	Gross reinsurance recoverable	Less: Provisions and securities held	Net reinsurance recoverable
A	47,989	-	47,989
Not rated	3,874	5,891	-
	51,863		47,989

Included in gross reinsurance recoverable is reinsurers' share of unearned premiums of \$7,723, reinsurers' share of provision for unpaid claims of \$41,782 and receivables from reinsurers presented as due from insurance companies of \$2,358.

No balances due from reinsurers are considered past due as at June 30, 2010.

**Foreign exchange risk**

Foreign exchange risk is the possibility that changes in foreign exchange rates produce an unintended effect on earnings and equity when measured in domestic currency.

A portion of the Company's premiums are written in U.S. dollars and a portion of loss reserves are also in U.S. dollars. In addition, premiums relating to the Emergency Travel Health line of business are remitted in Canadian dollars but a significant portion of the claims incurred for this line of business are in U.S. dollars. A portion of the Company's cash and investments are also held in U.S. dollars.

In general, the Company attempts to manage foreign exchange risk on liabilities by investing in financial instruments denominated in the same currency as the financial liabilities which they back. The

**EGI FINANCIAL HOLDINGS INC.**  
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Company may nevertheless, from time to time, experience losses resulting from fluctuations in the value of the U.S. dollar, which could adversely affect operating results.

The table below illustrates the expected impact on net income and OCI of a 10% change in the Canadian dollar ("CAD") compared to the U.S. dollar ("USD") as at June 30, 2010. Computations of the prospective effects of hypothetical foreign exchange changes are based on numerous assumptions, including the maintenance of the existing level and composition of assets and financial liabilities, and should not be relied on as indicative of actual or future results.

Change in CAD/ USD rate	Effect on Net Income	Effect on OCI
10% rise	(85)	(1,362)
10% decline	85	1,362

### Capital management

Capital is comprised of the Company's shareholders' equity and bank indebtedness. As at June 30, 2010, the Company's shareholders' equity was \$132,585 and bank indebtedness was nil. The Company's objectives when managing capital are to maintain financial strength and protect its claims paying abilities, to maintain creditworthiness and to maximize returns to shareholders over the long term.

A common measure of capital adequacy used by management, in the property and casualty industry, is the ratio of net written premiums to surplus (or shareholders' equity). A lower ratio implies a higher measure of capital adequacy. The Company's ratio as at June 30, 2010, was 1.3. This level is well below the 2.5:1 ratio considered by management to be the maximum acceptable ratio.

The Company's Canadian insurance subsidiary, Echelon, is required to maintain minimum capital levels as required by the Office of the Superintendent of Financial Institutions. At June 30, 2010, and December 31, 2009, the Company exceeded the minimum regulatory capital requirement. Legislation applicable to insurance companies imposes certain restrictions on the Company's ability to pay dividends.

### 6 Share capital

	June 30 2010	December 31 2009
Authorized		
Unlimited common shares		
Unlimited special shares issuable in Series		
Issued		
12,047,582 common shares (2009 – 12,000,582 common shares)	68,993	68,618

During the first half of 2010, 47,000 common shares were issued pursuant to the exercise of options under the employee stock option plan.

**EGI FINANCIAL HOLDINGS INC.**  
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**7 Bank indebtedness**

On October 11, 2007, the Company entered into a non-revolving, term loan facility with a major Canadian bank in the amount of \$19,550. The facility had a term of three years, bearing an interest rate of 6.20%. During the term of the loan, monthly payments included interest only and on maturity a balloon payment of \$19,550 was to be made to settle the principal amount.

During the second quarter of 2010 the loan was repaid in full, funded with internal funds. The Company has no bank indebtedness as at June 30, 2010.

**8 Income per share**

	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
Basic income per share:				
Net income available to common shareholders	1,902	4,831	131	4,601
Average number of common shares (in thousands)	12,025	11,765	12,025	11,765
Basic income per share	0.16	0.41	0.01	0.39
Diluted income per share:				
Average number of common shares (in thousands)	12,025	11,765	12,025	11,765
Average number of common shares obligation under employee stock option plan (in thousands)	764	840	764	840
Average number of diluted common shares (in thousands)	12,789	12,605	12,789	12,605
Diluted income per share	0.15	0.38	0.01	0.36

**9 Segmented information**

The Company operates through three divisions. The Personal Lines and Niche Products divisions operate in Canada while the International division operates in the south-eastern U.S non-standard auto market. Through its Personal Lines division, the Company is engaged primarily in the underwriting of high premium, non-standard automobile insurance. Through its Niche Products division, the Company designs and underwrites specialized non-auto insurance programs, such as higher premium property, primary and excess liability, legal expense, accident and health insurance and warranty coverage.

The effect of reinsurance is reflected in the revenue and results of the three divisions. The investment activities consist of managing the investment portfolio for the Company as a whole. Investment income is shown net of investment expenses. The corporate and other activities include holding company expenses not attributable to a division. Interest expense represents interest on bank indebtedness.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
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	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
Revenue				
Earned premiums and other revenue				
Property and casualty insurance				
Canada – Personal Lines	30,591	25,080	58,982	50,256
– Niche Products	9,788	8,743	19,615	22,245
	40,379	33,823	78,597	72,501
International (United States)	–	1,663	6	4,558
	40,379	35,486	78,603	77,059
Interest and dividends, net of investment expenses	3,256	3,057	6,262	6,082
Realized investment gains	2,742	3,243	3,644	1,678
Foreign exchange gains (losses)	137	(283)	(87)	131
<b>Total revenue</b>	<b>46,514</b>	<b>41,503</b>	<b>88,422</b>	<b>84,950</b>
Income (loss) before income taxes				
Property and casualty insurance				
Canada – Personal Lines	(1,371)	2,588	(5,353)	2,994
– Niche Products	(800)	1,003	(2,057)	(269)
	(2,171)	3,591	(7,410)	2,725
International (United States)	(731)	(1,436)	(1,022)	(2,185)
Corporate and other	(276)	(452)	(556)	(709)
Underwriting income (loss)	(3,178)	1,703	(8,988)	(169)
Interest and dividends, net of investment expenses	3,256	3,057	6,262	6,082
Realized investment gains	2,742	3,243	3,644	1,678
Foreign exchange gains (losses)	137	(283)	(87)	131
Interest expense	(269)	(305)	(568)	(604)
<b>Total income before income taxes</b>	<b>2,688</b>	<b>7,415</b>	<b>263</b>	<b>7,118</b>