

**EGI FINANCIAL HOLDINGS INC.**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION**  
**AND RESULTS OF OPERATIONS**  
**For the period ending June 30, 2010**

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References to "EGI" or "Company" in this Management's Discussion and Analysis 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 unaudited interim consolidated financial statements for the second quarter of fiscal 2010 with the notes to the unaudited interim consolidated financial statements for the second quarter of fiscal 2010, with management's discussion and analysis (MD&A) set out on pages 3 to 51 of the Company's 2009 Annual Report and with the notes to the audited consolidated financial statements for fiscal 2009 set out on pages 59 to 80 of the Company's 2009 Annual Report. The financial data in this discussion has been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and has been derived from the unaudited interim consolidated financial statements for the three and six months ended June 30, 2010, and 2009.

The following commentary is current as of August 3, 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 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 of EGI for 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.

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 MD&A. Additional information about the general risks and uncertainties regarding 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.

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## **Company Overview**

EGL operates in the property and casualty (P&C) insurance industry in Canada and, commencing in 2007, in 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, EGL has since developed its business to focus on underwriting opportunities not served by many of the larger, standard insurers. EGL 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 continues to focus on the underwriting of non-standard automobile insurance and motorcycle business but has expanded into other non-standard products and specialty lines of business. Through its Niche Products division, EGL 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, EGL 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, EGL entered the U.S. non-standard auto insurance market under reinsurance agreements with three arms-length insurance companies. These companies provide P&C 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, EGL terminated the reinsurance agreements. EGL is now pursuing its U.S. expansion exclusively as an insurer in its own right, through its wholly-owned U.S. subsidiary, American Colonial Insurance Company (ACIC), where the Company can exercise greater underwriting control. The Company recently acquired ACIC, then an inactive insurer licensed in several southeastern states. At the end of the first quarter, 2010, Echelon Insurance Company of America (EICA) and ACIC were amalgamated to continue business under the ACIC name. The amalgamated company is currently pursuing premium growth in Florida and Texas and plans to expand to Georgia and other southeastern States.

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

## **Overall Performance**

The Company recorded net income of \$1.9 million in the three months ended June 30, 2010, resulting in year to date net income of \$0.1 million for the first half of the year. EGL experienced an underwriting loss in the second quarter of the year; however it was an improvement over the underwriting loss in the first quarter. These underwriting losses were offset by an increase in investment income, which included realization of gains on the sale of investments.

Property & Casualty insurance companies continued to operate in a challenging environment in the first half of 2010. Escalating claims costs, particularly in the Ontario automobile market, and more specifically arising from the Accident Benefit coverage, continue to increase loss ratios and erode profitability. Recently announced auto reforms by the Ontario government are expected to address

several of the factors contributing to the increase in claims cost; however the extent that the reform related product changes will alleviate the situation cannot yet be determined.

In the face of these challenges, EGI experienced an underwriting loss of \$3.2 million in the second quarter of the year, resulting in an underwriting loss of \$9.0 million on a year to date basis to June 30. Large automobile claims in, and immediately surrounding, the Greater Toronto area continue to have a disproportionate effect on overall Company results. Poor claims experience in certain Niche lines also contributed to the underwriting loss in the first half of the year.

Total volume of premiums written increased by 25% in the first half of 2010 compared to the same period in 2009. This is the result of hardening market conditions and difficulties faced by our direct competitors.

The volatility of the financial markets and the realization of gains from sale of investments resulted in an other comprehensive loss of \$3.3 million in the second quarter of 2010. This reflects a decrease in the fair value of our investment portfolio during the period. Despite a net income of \$1.9 million, this loss has reduced the results for the quarter to a comprehensive loss of \$1.4 million which resulted in the net book value per share decreasing to \$11.01 as at June 30, 2010, compared to \$11.14 as at March 31, 2010.

## Financial Overview

(\$ THOUSANDS except per share amounts)	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
Direct written and assumed premiums	55,991	48,487	99,981	80,103
Net earned premiums	40,379	35,486	78,603	77,059
Underwriting income (loss)	(3,178)	1,703	(8,988)	(169)
Interest expense	269	305	568	604
Investment income	6,135	6,017	9,819	7,891
Net income	1,902	4,831	131	4,601
Net loss per share				
Basic	0.16	0.41	0.01	0.39
Diluted	0.15	0.38	0.01	0.36
Net operating income (loss) <sup>(1)</sup>	65	2,659	(2,310)	3,477
Net operating income (loss) per share – diluted	0.01	0.21	(0.18)	0.28
Return on equity (ROE) <sup>(2)</sup>			0%	5.4%

(1) Net operating income (loss) is defined as net income (loss) plus or minus after-tax realized losses or gains on the sale of investments.

(2) Represents EGI's net income for the twelve months ended on the date indicated, divided by the average shareholders' equity over the same twelve-month period.

	Three months ended June 30		Six months ended June 30	
	2010	2009	2010	2009
Loss ratio	73.3%	61.8%	78.2%	67.2%
Expense ratio	34.6%	33.4%	33.3%	33.0%
Combined ratio	107.9%	95.2%	111.5%	100.2%

(\$ THOUSANDS except per share amounts)	As at June 30 2010	As at Dec 31 2009
Investments (excluding premium finance receivables)	297,888	294,365
Premium finance receivables	31,737	27,007
Total assets	460,565	446,465
Total shareholders' equity	132,585	133,431
Book value per share <sup>(1)</sup>	11.01	11.12

(1) Shareholders' equity divided by the number of shares issued and outstanding.

#### *Quarter ended June 30, 2010*

Net income of \$1.9 million for the three months ended June 30, 2010 represents a decrease of \$2.9 million, or 60% compared to net income of \$4.8 million in the second quarter of 2009. An underwriting loss of \$3.2 million was incurred in the second quarter of 2010 compared to underwriting income of \$1.7 million in the same period in 2009. Investment income of \$6.1 million was recorded in the three months ended June 30, 2010 compared to \$6.0 million in the same period in 2009.

Direct written premiums were \$56.0 million in the second quarter of 2010 representing an increase of \$7.5 million or 15% compared to \$48.5 million in the same period in 2009. The majority of the increase was recorded in the Personal Lines division, in the automobile line of business, providing further evidence of the tightening market conditions.

However, while total written premiums increased, the loss ratio incurred in Canada increased in the quarter compared to the second quarter of 2009. Adverse claims experience in both Canadian operating divisions resulted in a total Company loss ratio of 73.3% in the quarter, compared to a loss ratio of 61.8% incurred in the second quarter of 2009. As noted earlier, the 2010 result is largely influenced by escalating claims costs in the Ontario auto market. Partially offsetting the negative influence of higher claims costs on current year claims was positive development of prior year claims reserves of \$3.6 million recorded in the second quarter of 2010 compared to positive development of \$0.8 million in the second quarter of 2009.

A slight increase in the expense ratio to 34.6% of net earned premiums in the quarter compared to 33.4% in the three months ended June 30, 2009, resulted in a combined ratio of 107.9% in the second quarter of 2010 compared to 95.2% in the same period last year.

Investment income of \$6.1 million earned in the second quarter of 2010 compares to \$6.0 million

earned in the same period last year. Realized gains were recorded in both years, with \$2.7 million recorded in the second quarter of 2010 compared to \$3.2 million in the same period last year.

Earnings per share on a diluted basis, were \$0.15 in the second quarter of 2010, compared to \$0.38 in the same period in 2009. Book value per share increased to \$11.01 as at June 30, 2010, a small increase compared to \$10.98 as at June 30, 2009.

Net operating income, defined as net income excluding after-tax realized losses or gains, on the sale of investments, was \$0.1 million or \$0.01 per share on a diluted basis for the second quarter of 2010. This compares to net operating income of \$2.7 million or \$0.21 per share for the same period in 2009.

#### *Six months ended June 30, 2010*

For the six month period ended June 30, 2010, net income of \$0.1 million was recorded compared to net income of \$4.6 million for the same period in 2009. An underwriting loss of \$9.0 million was incurred in the first six months of 2010 compared to an underwriting loss of \$0.2 million in the same period last year. Partially offsetting the increase in the underwriting loss was an increase in investment income in the six month period ended June 30, 2010, to \$9.8 million compared to \$7.9 million in the same period last year.

Direct written premiums increased significantly to \$100.0 million in the first six months of 2010 representing an increase of \$19.9 million or 25% compared to \$80.1 million in 2009. As noted above, the majority of the increase was attributable to the Personal Lines division. Direct written premiums for this division totaled \$71.5 million in the first six months of 2010, an increase of \$12.7 million compared to the same period in 2009. The Niche Products division recorded an increase of \$6.5 million to \$28.5 million in the six months ended June 30, 2010, compared to \$22.0 million in the same period last year.

A total Company loss ratio of 78.2% was incurred in the first six months of 2010 compared to 67.2% in the same period last year. Higher than expected loss ratios, due to adverse loss experience in the 2010 accident year, were incurred in both the Personal Lines and Niche Products divisions. On a year to date basis, positive prior year loss development of \$1.6 million was recorded to June 30, 2010 compared to \$3.7 million for the same period in 2009.

An expense ratio of 33.3% was recorded in the six months ended June 30, 2010, compared to 33.0% in 2009, bringing the combined ratio to 111.5% and 100.2% for the first six months of 2010 and 2009 respectively.

Investment income of \$9.8 million earned in the first six months of 2010 compares to \$7.9 million earned in the same period last year. Realized gains were recorded in both periods, with \$3.6 million recorded in 2010 compared to \$1.7 million in the same period last year.

Earnings per share on a diluted basis, were \$0.01 in the first half of 2010, compared to \$0.36 in the same period in 2009. During the first six months of 2010 book value per share decreased to \$11.01 as at June 30, 2010 compared to \$11.12 as at December 31, 2009.

A net operating loss of \$2.3 million or (\$0.18) per share on a diluted basis was incurred for the six months ended June 30, 2010. This compares to net operating income of \$3.5 million or \$0.28 per share for the same period in 2009.

## Segmented Financial Information

Three months ended June 30								
2010					2009			
(\$THOUSANDS)	Canada			International	Canada			International
	Personal Lines	Niche Products	Total		Personal Lines	Niche Products	Total	
Net earned premiums	30,591	9,788	40,379	–	25,080	8,743	33,823	1,663
Underwriting income (loss)	(1,371)	(800)	(2,171)	(731)	2,588	1,003	3,591	(1,436)
Loss ratio	74.1%	70.2%	73.1%	N/A (1)	61.4%	47.2%	57.7%	145.0%
Expense ratio	30.5%	38.0%	32.3%	N/A (1)	28.3%	41.4%	31.7%	41.4%
Combined ratio	104.6%	108.2%	105.4%	N/A (1)	89.7%	88.6%	89.4%	186.4%

(1) Due to the minimal earned premium in the International division the ratios are not meaningful.

The segmented information, for the second quarter of 2010, shows that Personal Lines incurred an underwriting loss of \$1.4 million and the Niche Products division recorded an underwriting loss of \$0.8 million, resulting in an underwriting loss of \$2.2 million for the Canadian business segments combined. The International division, which continues to be in the business development phase, recorded an underwriting loss of \$0.7 million due primarily to ongoing costs associated with the start up of U.S. operations.

The loss ratio in Personal Lines was 74.1% for the quarter ended June 30, 2010, compared to 61.4% for the same period in 2009. Escalating claims costs, particularly in the Ontario automobile line, continue to negatively impact this result. Partially offsetting the adverse current year claims experience was favourable prior year loss development related to Personal Lines claims reserves in the second quarter of 2010, totaling \$2.3 million compared to positive development of \$1.4 million in the same period in 2009.

The Niche Products division loss ratio was 70.2% in the second quarter of 2010 compared to 47.2% for the same period in 2009. The commercial property and commercial automobile lines of business experienced higher than expected loss ratios.

Six months ended June 30								
2010					2009			
(\$THOUSANDS)	Canada			International	Canada			International
	Personal Lines	Niche Products	Total		Personal Lines	Niche Products	Total	
Net earned premiums	58,982	19,615	78,597	6	50,256	22,245	72,501	4,558
Underwriting income (loss)	(5,353)	(2,057)	(7,410)	(1,022)	2,994	(269)	2,725	(2,185)
Loss ratio	80.5%	72.1%	78.4%	N/A (1)	65.7%	61.7%	64.5%	111.1%
Expense ratio	28.6%	38.4%	31.0%	N/A (1)	28.3%	39.5%	31.7%	36.9%
Combined ratio	109.1%	110.5%	109.4%	N/A (1)	94.0%	101.2%	96.2%	148.0%

(1) Due to the minimal earned premium in the International division the ratios are not meaningful.

The segmented information, for the first half of 2010, shows that Personal Lines recorded an underwriting loss of \$5.3 million while the Niche Products division recorded an underwriting loss of \$2.1 million, resulting in a combined underwriting loss of \$7.4 million for the Canadian business segments. The International division recorded an underwriting loss of \$1.0 million primarily related to start up costs of the US operation.

The loss ratio in Personal Lines was 80.5% for the six month period ended June 30, 2010, compared to 65.7% for the same period in 2009. The increase is primarily attributable to an increase in current year claims occurrence in the non-standard auto line of business. Positive development of prior year claims in the first half of 2010 for this division was \$0.3 million compared to positive development of \$3.9 million last year.

The Niche Products division loss ratio was 72.1% for the six month period compared to 61.7% for the same period in 2009. The increase resulted from higher than expected losses incurred in the commercial property and commercial automobile lines of business.

### Critical Accounting Estimates and Assumptions

For a description of EGI's accounting policies, refer to notes 2 and 3 in the 2009 audited financial statements as set out on pages 59 to 62 of the Company's 2009 Annual Report. A further description of EGI's critical accounting estimates and assumptions is also detailed on pages 20 to 22 of the 2009 Annual Report.

There have been no changes to the Company's accounting policies or assumptions made in critical accounting estimates in the second quarter of 2010.

## Future Changes in Accounting Policies and Disclosure

### Transition to 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 our 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 evaluation of IFRS 1 transition exemptions and an analysis of financial systems have been performed. Determinations regarding the application and election of transitional exemptions available under IFRS 1, and accounting policy choices related to various IFRS standards have been completed in 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 be completed in the second half of 2010.

To date the total financial impact to the financial position of EGI on transition to IFRS and the future quarterly results of the Company have been determined as immaterial. The following is a summary of the areas that are expected to result in an adjustment to the opening balance sheet as at January 1, 2010, and have an ongoing impact to the quarterly results of the Company:

#### *Cumulative translation differences*

##### *Adjustment to opening balance sheet as at January 1, 2010*

IFRS 1 provides an exemption which provides relief from retrospective application of the IAS 21 requirement to restate all financial statements of foreign operations from date of inception and determine the cumulative translation differences.

Management has elected to take this exemption and will therefore reset the cumulative translation differences related to foreign operation to zero as at January 1, 2010.

The effect of this election will be to reduce the cumulative translation loss of \$678,000 in accumulated other comprehensive income (AOCI) (Reserves) as at January 1, 2010, to zero, therefore increasing retained earnings by \$678,000. There is no impact to the total equity.

### ***Foreign exchange***

#### *Adjustment to opening balance sheet as at January 1, 2010*

IFRS requires that unrealized gains or losses related to the foreign currency translation of monetary investments designated as available for sale (AFS), held in a Canadian subsidiary, be recorded in income at each reporting date. Fair value changes that are not related to foreign currency fluctuations are recorded as other comprehensive income (OCI) adjustments.

Under Canadian GAAP these unrealized amounts were included in OCI with the other fair value changes related to the investment.

As at December 31, 2009, Echelon General Insurance Company (Echelon) held bonds denominated in US\$ with total par value of \$3,125,000. The bonds, designated as AFS, were purchased in various amounts between 2006 and 2009. Management has determined that total unrealized losses related to foreign currency fluctuations arising from the date of purchase to December 31, 2009, was \$130,938, before taxes. After accounting for taxes, the total net adjustment (increase) to AOCI (Reserves) and increase to Retained earnings as at January 1, 2010, is \$88,514. There is no impact to total equity related to this adjustment.

#### ***Impact on future quarterly earnings***

As noted, unrealized gains or losses related to the foreign currency translation of monetary investments designated as AFS will be recorded to income on a quarterly basis. Due to the relatively low amount of US\$ bonds expected to be held by Echelon, it is expected that the amounts recorded to income on a quarterly basis will be immaterial.

#### ***Share based compensation***

For determination of compensation expenses and contributed surplus related to stock option grants, IFRS and Canadian GAAP differ in two respects which will impact EGI. Stock options which contain a graded vesting feature (the total options granted vest on a graded basis such as annually over 5 years) are accounted for separately based on the date of vesting. Under Canadian GAAP the total options granted are accounted for as one grant and one vesting period is used. Under IFRS at the time that options are granted expected forfeiture rates are estimated and used to reduce the amount expensed over the life of the options. The estimated forfeiture rate is adjusted to actual forfeiture experience as information becomes available. Under Canadian GAAP, EGI has recorded the impact of forfeitures in the period that the forfeiture occurred.

Both of the differences noted above are expected to result in an impact to the opening balance sheet as at January 1, 2010 and the future quarterly earnings of the Company but neither is expected to be significant. Management is in the process of finalizing these adjustments.

#### ***Income taxes***

Based on work done to date management does not expect to make an adjustment which will impact the financial position of EGI related to income taxes to the opening balance sheet as at January 1, 2010; however, it is expected that presentation differences between IFRS and Canadian GAAP will impact the format and disclosure of certain lines and notes in the IFRS based financial statements.

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

## **Controls and Procedures**

### ***Disclosure Controls and Procedures***

Our 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 June 30, 2010, 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 Ontario Securities Commission Multilateral 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 quarter ended June 30, 2010, the Chief Executive Officer and the Chief Financial Officer evaluated the design 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 design of internal controls as at June 30, 2010, was effective to provide 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 quarter ended June 30, 2010, that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting. The Company is also undergoing a review to determine the changes, if any, to internal controls over financial reporting anticipated due to the implementation of IFRS.

## Summary of Quarterly Results

A summary of the Company's last eight quarters is as follows:

(\$ THOUSANDS except per share amounts)	2010		2009				2008	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3 (Restated)
Direct written and assumed premiums	55,991	43,990	39,303	44,455	48,487	31,616	39,948	46,067
Total revenues (excluding investment income)	40,379	38,224	36,439	35,881	35,486	41,573	39,547	36,150
Underwriting income	(3,178)	(5,810)	(9,454)	284	1,703	(1,872)	(489)	2,896
Income (loss) before income taxes	2,688	(2,425)	(3,280)	3,381	7,415	(297)	(3,272)	5,776
Net income (loss)	1,902	(1,770)	(2,347)	2,261	4,831	(230)	(2,322)	3,958
Earnings per adjusted share								
– Basic	\$0.16	\$(0.15)	\$(0.20)	\$0.19	\$0.41	\$(0.02)	\$(0.20)	\$0.36
– Diluted	\$0.15	\$(0.14)	\$(0.19)	\$0.18	\$0.38	\$(0.02)	\$(0.19)	\$0.33
Selected financial ratios (%)								
Loss ratio	73.3	83.4	92.1	63.6	61.8	71.9	68.7	60.2
Expense ratio	34.6	31.8	33.8	35.6	33.4	32.6	32.5	31.7
Combined	107.9	115.2	125.9	99.2	95.2	104.5	101.2	91.9

### Quarter Ended June 30, 2010, Compared to Quarter Ended June 30, 2009

The following financial information compares second quarter 2010 results with the second quarter of 2009.

(\$ THOUSANDS)	2nd Quarter 2010	2nd Quarter 2009	Variance \$	Variance %
Direct written premiums	55,991	48,487	7,504	15.5
Net written premiums	51,207	44,121	7,086	16.1
Net earned premiums	40,379	35,486	4,893	13.8
Claims incurred	29,593	21,931	7,662	35.0
Acquisition costs	9,376	8,078	1,298	16.1
Operating expenses	4,588	3,774	814	21.6
Underwriting income (loss)	(3,178)	1,703	(4,881)	(286.6)
Investment income	6,135	6,017	118	2.0
Interest expense	269	305	(36)	(11.8)
Net income (loss) before income taxes	2,688	7,415	(4,727)	(63.7)
Income taxes expense	786	2,584	(1,798)	(69.6)
Net income (loss)	1,902	4,831	(2,929)	(60.6)

## Insurance Operation

### *Written Premiums*

Significant premium growth was achieved in Canada across all lines of business. Personal Lines premiums increased 18% to \$42.3 million in 2010 compared to the second quarter of 2009, primarily in non-standard automobile insurance. Recently implemented rate increases, the hardening of the auto insurance market and difficulties faced by direct competitors contributed to the premium growth. Non-standard auto recorded growth of 21.8% to \$32.3 million for the quarter, compared to \$26.5 million in 2009. Motorcycle direct written premiums of \$8.7 million in the second quarter of 2010 increased by 2% over the amount written in the second quarter of 2009. Premium volumes for recreational and miscellaneous vehicles grew significantly but are not yet material to the overall results.

Direct written premiums for the Niche Products division increased 3% to \$13.7 million for the three months ended June 30, 2010.

A cautious entry strategy, related to our new U.S. insurer, has resulted in lower than expected premium growth in the second quarter of 2010. Minor adjustments have been made to the product's market position and we will continue to monitor and adjust as required.

Net written premiums increased 16.1% to \$51.2 million compared to the same period last year. This increase was in line with the increase in direct written premiums in the period compared to 2009.

### *Earned Premiums*

Net earned premiums for the three months ended June 30, 2010, totaled \$40.4 million, an increase of 13.8% over the second quarter in the prior year. This rate of increase is slightly lower than the increase in net written premiums due to the time lag in the earning of premiums written on annual policies.

### *Incurred Claims Expense*

Net incurred claims expense increased for the three months ended June 30, 2010 by 35% over the prior year. The increase, which is larger than the 13.8% increase in net earned premiums, was due to rising claims costs, particularly large automobile accident benefits claims in the greater Toronto and surrounding area and, to a lesser extent, claims in commercial property. As a result the loss ratio increased to 73.3% in the second quarter of 2010 compared to 61.8% for the same period in 2009.

### *Acquisition Costs*

Net acquisition costs, which mainly consist of commissions and premium taxes, increased \$1.3 million, or 16.1%, to \$9.4 million for the three months ended June 30, 2010, compared to \$8.1 million in the same period in 2009. The increase is slightly higher than the 13.8% increase in earned premiums due to a change in the mix of business earned by the Company in the quarter.

### *Operating Expenses*

Due to the growth in the business and the investment in the U.S. startup operation, operating expenses increased to \$4.6 million for the three months ended June 30, 2010, compared to \$3.8 million in the second quarter of 2009.

### *Underwriting Income (Loss)*

Underwriting results reflect revenues from net earned premiums less claims, acquisition and operating expenses. In the quarter ended June 30, 2010, total underwriting contribution decreased \$4.9 million to an underwriting loss of \$3.2 million, compared to an underwriting gain of \$1.7 million for the comparable period in 2009. The underwriting results for 2010 and 2009 include \$0.3 million and \$0.5 million of corporate and other expenses, respectively, which have not been allocated to the operating divisions.

The underwriting loss from the Personal Lines division for the three months ended June 30, 2010, was \$1.4 million, a deterioration of \$4.0 million, compared to income of \$2.6 million for the same period of 2009. This decline was primarily due to the increase in the loss ratio experienced in our Personal Lines division compared to the second quarter of 2009.

The underwriting loss from the Niche Products division for the three months ended June 30, 2010, was \$0.8 million, compared to a gain of \$1.0 million for the same period last year.

The International division experienced an underwriting loss of \$0.7 million in the second quarter of 2010, compared to a loss of \$1.4 million in the second quarter of 2009. As noted above the underwriting loss in 2010 is primarily due to expenses incurred related to the start up of the US operation.

### *Investment Income*

Investment income for the quarter was \$6.1 million compared to \$6.0 million for the same period in 2009. Income from interest and dividends net of investment expenses was \$3.3 million, compared to \$3.1 million for the same period last year. Net realized gains on the sale of investments were \$2.7 million compared to \$3.2 million in the same period in 2009. No investment impairments were recorded in the second quarter of 2010.

Foreign exchange gains of \$0.1 million were also earned in the second quarter of 2010 compared to losses incurred of \$0.3 million for the same period last year. Foreign exchange gains/losses result from the holding of USD funds used to fund claims liabilities denominated in U.S. dollars.

EGI's investment portfolio and finance receivables increased to \$329.6 million, or 19.3%, compared to total fair values of \$276.2 million as at June 30, 2009.

### *Interest Expense*

During the three months ended June 30, 2010, interest expense of \$0.2 million related to bank indebtedness was incurred. The amount incurred in the second quarter of 2010 was slightly less than the interest expense incurred in the same period last year. In early June 2010, the bank indebtedness was repaid in full and no further interest expense is anticipated for the remainder of 2010.

### *Net Income Before Income Taxes*

Net income before income taxes of \$2.7 million was recorded in the quarter, compared to income before income taxes of \$7.4 million for the three months ended June 30, 2009.

For the three months ended June 30, 2010, an underwriting loss of \$3.2 million plus investment income of \$6.1 million, less interest expense on bank indebtedness of \$0.2 million, comprised the net income before income taxes of \$2.7 million. This compares to underwriting income of \$1.7 million, plus investment income of \$6.0 million, less interest expense of \$0.3 million, in the same period of 2009.

### *Income Taxes*

Income tax expense of \$0.8 million was recorded in the quarter ended June 30, 2010, compared to \$2.6 million recorded for the second quarter of 2009. The effective tax rate of 29% recorded in the second quarter of 2010 compares to 34.8% in the second quarter of 2009. Minor adjustments made in the second quarter of 2010 lowered the effective tax rate in 2010.

### *Net Operating Income (Loss)*

The net operating income decreased to \$0.1 million in the second quarter of 2010 compared to a net operating income of \$2.7 million in the same period last year. Net operating income or loss excludes the after-tax impact of net realized gains or losses. Realized gains of \$2.7 million and losses of \$3.2 million have been excluded from the second quarter of 2010 and 2009 net loss, respectively.

### *Other Comprehensive Income*

Other comprehensive income (loss) decreased to a loss of \$3.3 million in the second quarter of 2010 compared to income of \$4.8 million for the same period in 2009. This amount represents the change in fair value of investments during the quarter, less the reclassification of realized gains/losses to net income and the unrealized gain/loss on translation of financial statements of self-sustaining foreign operations.

## **Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009**

### *Written and Assumed Premiums*

Direct written premiums increased \$19.9 million, or 24.8%, to \$100.0 million for the six-month period, compared to \$80.1 million for the first half of 2009. Growth has been achieved in both Canadian divisions in 2010. Direct written premiums from Personal Lines totaled \$71.5 million in the first half of 2010 which represents a 21.6% increase compared to \$58.8 million in 2009. Non-standard auto recorded growth of 25.1% to \$58.6 million, and the motorcycle line recorded a modest increase of 1.5% compared to the same period in 2009. The Niche Products division recorded written premiums of \$28.5 million in the first six months of 2010 compared to \$21.9 million for the same period of 2009 for a growth rate of 29.8%.

Net written and assumed premiums increased \$16.2 million, or 22%, to \$89.4 million compared to \$73.2 in the six-month period last year. This increase is consistent with the increase in direct written and assumed premiums in the period compared to 2009.

### *Earned Premiums*

Net earned premiums for the six months ended June 30, 2010, totaled \$78.6 million, an increase of \$1.5 million, or 1.9%, compared to \$77.1 million in the first half of 2009. The increase is less than the increase in net written premiums in the period compared to 2009 because of the earned premium lag during periods of premium growth and the earning of \$6.3 million of emergency travel health (ETH) premium in the first half of 2009 related to premiums written in 2008.

### *Incurred Claims Expense*

Net incurred claims expense increased \$9.7 million, or 18.7%, to \$61.5 million for the first half of 2010, compared to \$51.8 million for the same period in 2009. The Personal Lines division loss ratio for the first half of 2010 was 80.5% compared to 65.7% in the same period in 2009. Positive prior year loss development resulted in the release of \$0.3 million of reserves in the period compared to a release of \$2.4 million in the first six months of 2009. Non-standard auto recorded a loss ratio of 84.3% in the first half of 2010 compared to 67.5% last year. The motorcycle line of business incurred a year-to-date loss ratio of 56.4% compared to 56.3% for the six months ended June 30, 2009.

The Niche Products division recorded a loss ratio of 72.1% in the first half of 2010 compared to 61.7% in the same period in 2009.

The International division recorded positive development of claims of \$0.1 million in the first half of 2010 from the run-off of external assumed reinsurance business which were cancelled in late 2008 and early 2009.

For all lines of business combined, positive loss development on prior years' claim reserves was \$1.6 million in the first six months of 2010 compared to \$2.2 million in the same period of 2009.

### *Acquisition Costs*

Net acquisition costs, which mainly consist of commissions and premium taxes, decreased \$0.1 million, or 0.5%, to \$17.9 million for the six months of 2010, compared to \$18.0 million in the same period in 2009. This decrease was achieved despite the increase in net earned premiums due to the ETH premiums earned in the first half of 2009 which incur a higher commission rate than other lines of business.

### *Operating Expenses*

Operating expenses increased \$0.8 million, or 10.8%, to \$8.2 million for the first six months of 2010, compared to \$7.4 million in 2009. The increase is primarily the result of increases in salaries, information systems amortization and start-up costs of the U.S. operation.

### *Underwriting Income (Loss)*

Underwriting results reflect revenues from net earned premiums less claims, acquisition and operating expenses. In the first six months of 2010 total underwriting contribution decreased \$8.8 million to an underwriting loss of \$9.0 million, compared to an underwriting loss of \$0.2 million for the comparable period in 2009. The underwriting results for 2010 and 2009 include \$0.6 million and \$0.7 million of corporate and other expenses, respectively, which have not been allocated to the operating divisions.

The underwriting loss from the Personal Lines division for the first half of 2010 was \$5.4 million, a decrease of \$8.4 million, compared to income of \$3.0 million for the same period of 2009. This result was caused by the higher loss ratio in Personal Lines in the first half of 2010 compared to 2009.

The underwriting loss in the Niche Products division for the first six months of 2010 was \$2.1 million, a decline of \$1.8 million compared to an underwriting loss of \$0.3 million in the corresponding period of 2009.

The International division experienced an underwriting loss of \$1.0 million in the first half of 2010 compared to an underwriting loss of \$2.2 million in the same period in 2009.

#### *Investment Income*

Investment income for the six months ended June 30, 2010 was \$9.8 million compared to \$7.9 million for the same period in 2009. Income from interest and dividends, net of investment expenses, increased to \$6.3 million compared to \$6.1 million in the same period last year, due to the growth in the investment portfolio. Net realized gains on the sale of investments increased to \$3.6 million in the first half of 2010 compared to \$1.7 million in the same period in 2009.

#### *Interest Expense*

During the first six months of 2010 and 2009, interest expense related to bank indebtedness of \$0.5 million and \$0.6 million, respectively, was incurred on bank indebtedness of \$19.55 million. As noted earlier, the bank indebtedness was repaid in full in June 2010.

#### *Net Income before Income Taxes*

Income before income taxes for the six months ended June 30, 2010, was \$0.3 million, a decrease of \$6.8 million compared to income of \$7.1 million for the six months ended June 30, 2009.

For the six months ended June 30, 2010, an underwriting loss of \$9.0 million plus investment income of \$9.8 million, reduced by interest expense on bank indebtedness of \$0.5 million, comprised net income before income taxes of \$0.3 million. This compares to an underwriting loss of \$0.2 million, plus investment income of \$7.9 million, reduced by interest expense of \$0.6 million, in the same period of 2009.

#### *Income Taxes*

The provision for income taxes for the first half of 2010 was \$0.1 million compared to \$2.5 million for the same period in 2009. The effective tax rate was 50% for the first six months of 2010 compared to 35% in 2009. The change relates to minor adjustments made in the tax provision in the first half of 2010 which impact the effective tax rate disproportionately, due to the low net income before taxes.

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

The net operating results decreased to a loss of \$2.3 million in the first half of 2010 compared to a net operating income of \$3.5 million in the same period last year. Net operating income or loss excludes the after-tax impact of net realized gains or losses. Realized gains of \$3.6 million and \$1.7 million have been excluded from the first half 2010 and 2009 net loss, respectively.

## Other Comprehensive Income

Other comprehensive income (loss) decreased to a loss of \$1.4 million in the first six months of 2010 compared to income of \$6.7 million for the same period in 2009. The income or loss represents the change in fair value of investments during the period, less the reclassification of realized gains/losses to net income and the unrealized gain/loss on translation of financial statements of self-sustaining foreign operations.

## BALANCE SHEET ANALYSIS

The Balance Sheet analysis that follows should be read in conjunction with the unaudited interim consolidated second quarter 2010 financial statements and notes therein, which include additional disclosures related to balance sheet risk management.

### Investments

The following table sets forth EGI's invested assets as at June 30, 2010, and December 31, 2009.

(\$ THOUSANDS)	June 30, 2010	December 31, 2009
	Carrying and fair values	Carrying and fair values
<b>Available-for-sale</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

The Company 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 regarding those investments whose estimated fair values are less than carrying values. For those securities whose decline in fair value is other-than-temporary, the Company records 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 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 loss has been recognized in net income during the first half of 2010 and 2009.

## **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 2010, the maximum net retention on a single risk is \$1.5 million (2009 – \$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. Policy liabilities rank in priority to any subordinated 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 June 30, 2010, EGI was the assigned beneficiary of such trust accounts totaling \$5.9 million (December 31, 2009 – \$4.6 million) in guarantees from unlicensed reinsurers.

EGI purchases renewable excess of loss and catastrophe reinsurance from third party reinsurers, covering its automobile and general liability business. In 2010, excess of loss coverage on a single occurrence is for a total of \$23,500,000, and in 2009 it was for \$23,500,000. Total catastrophic coverage is \$23,000,000 in 2010 and was \$23,000,000 in 2009. Other than general liability, coverages comprising 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 on any one claim to not more than 2% of its shareholders' equity.

## **Recoverable from Reinsurers**

As at June 30, 2010, the recoverable from reinsurers increased to \$49.5 million compared to \$43.7 million as at December 31, 2009. The increase represents an increase in reinsurance utilized by EGI, primarily related to a self retention arrangement with a new Niche distributor in 2010. All reinsurers, with balances due, have a rating of A- or above as determined by A.M. Best, except for certain Niche Products distributors who share a portion of the risk with EGI, for whom EGI holds deposits.

## **Accounts Receivable**

Premium financing receivables are the largest component of this asset as at June 30, 2010, and represent approximately 82% or \$31.7 million of total receivables. During the second quarter of 2010, premium financing receivables increased \$4.7 million from \$27.0 million at December 31, 2009. These premiums are primarily billed directly to policyholders who are provided with a monthly payment financing option.

## Provision for Unpaid Claims

EGL 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, and related to events that have occurred but have not yet been reported to EGL. Claims provisions (i.e., reserves for claims liability) are established at the individual file level by the “case method” as claims are reported. Provision for unpaid claims consists of the aggregate 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 EGL’s provision for unpaid claims (often called “reserves”) is adequate, management has retained the services of an independent actuary.

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 four years and for the six months ended June 30, 2010.

(\$ THOUSANDS)	Years ended December 31				
	2009	2008	2007	2006	2005
Reserve Carried (actuarial present value basis) <sup>(1)</sup>	207,220	185,255	168,091	145,942	129,041
Reserve at December 31, 2006					88,029
Cumulative paid to December 31, 2006					25,817
Cumulative Redundancy (Deficiency)					15,195
Reserve at December 31, 2007				107,992	67,408
Cumulative paid to December 31, 2007				30,432	46,413
Cumulative Redundancy (Deficiency)				7,267	15,220
Reserve at December 31, 2008			117,541	81,172	50,013
Cumulative paid to December 31, 2008			44,265	53,325	62,210
Cumulative Redundancy (Deficiency)			6,450	11,194	16,818
Reserve at December 31, 2009		133,196	89,063	59,530	31,595
Cumulative paid to December 31, 2009		53,253	73,327	74,206	78,561
Cumulative Redundancy (Deficiency)		(1,194)	6,701	12,206	18,885
Reserve at June 30, 2010	176,451	115,561	75,930	49,682	25,954
Cumulative paid to June 30, 2010	29,949	70,938	86,381	83,546	84,161
Cumulative Redundancy (Deficiency)	820	(1,244)	6,780	12,714	18,926

1) Amounts include Provision for Adverse Deviation (PfAD) of \$22,688 for 2009; \$20,102 for 2008; \$17,401 for 2007; \$14,756 for 2006; and \$12,473 for 2005.

The table above, which is reflected on a gross basis for all years, shows that in the first six months of 2010 the total prior year reserve redundancies included in the first half of 2010 financial results, pursuant to the June 30, 2010, actuarial report, were \$0.8 million.

The uncertainties regarding EGL’s reserves could result in a liability exceeding the reserves by an amount that would be material to EGL’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.

## Share Capital

As of August 3, 2010, there were 12,047,582 common shares issued and outstanding. (See Note 6 to the unaudited interim consolidated second quarter 2010 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. 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 incurred interest of 6.2% per annum which was payable monthly over the three-year term of the agreement. After three years, EGI was obligated to repay the amounts drawn as at the termination of the agreement. Pursuant to the credit facility agreement, EGI was required to comply with various financial covenants and financial information reporting requirements.

The loan, which was due in October 2010, was repaid in full by EGI in June 2010. Internal resources were used to fund the \$19.55 million payment and EGI continues to be well capitalized.

As at June 30, 2010, EGI has no bank indebtedness.

EGI's contractual obligations relating to operating leases are \$1.1 million, due in less than a year, and \$8.2 million, due in the next nine years.

## Capital Resources

For the six months ended June 30, 2010, shareholders' equity decreased by \$0.8 million from December 31, 2009, to \$132.6 million. The net decrease was the result of net income of \$0.1 million in the period, plus an increase in share capital of \$0.4 million due to the issuance of shares on the exercise of stock options, offset by an other comprehensive loss of \$1.3 million in the period.

As at June 30, 2010, Echelon's Minimum Capital Test (MCT) ratio was 235% compared to 314% as at December 31, 2009, significantly exceeding the minimum regulatory capital level required by the Office of the Superintendent of Financial Institutions. The main reason for the reduction in the MCT ratio from December 2009 is because of a \$13 million dividend from Echelon General to EGI Financial during the second quarter of 2010.

EGI remains well capitalized with a Net Premiums Written to Equity ratio of 1.3:1.