

The background of the cover features a high-contrast, low-angle photograph of two individuals shaking hands. The scene is backlit by a bright sun, creating a strong silhouette effect and a lens flare. The hands are clasped together in a firm grip, symbolizing agreement or partnership. The overall mood is one of optimism and collaboration.

The Economical Insurance Group

ANNUAL REPORT 2008



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**THE ECONOMICAL INSURANCE GROUP®
IS A CANADIAN-OWNED MUTUAL
COMPANY, HEADQUARTERED IN
WATERLOO, ONTARIO.**

**IN ITS ALMOST 140 YEARS OF
OPERATION, IT HAS GROWN FROM
A SINGLE POLICY FOR FIRE COVERAGE
ON A BARN TO A LEADING CANADIAN
COMPANY WITH
OVER \$4.4 BILLION
IN TOTAL ASSETS.**

Our mission:

To be a leading property and casualty insurance company through the delivery of high-quality insurance products and superior service, built upon a foundation of innovation and financial strength.

This will be achieved by:

- Delivering operational excellence in underwriting, claims and technology management.
- Collaborating with our brokers to become their insurance company of choice.
- Creating an execution-oriented, high-performance culture that attracts, develops and retains quality people.



A Stable Foundation

Report of the Board of Directors of Economical Mutual Insurance Company

The property and casualty industry is cyclical and it was predicted that the soft market would continue in 2008.

This proved to be true and The Economical Insurance Group (“The Group”) operated in extremely competitive market conditions across the country, making it difficult to grow and achieve an underwriting profit. The Group experienced an abnormally high number of severe weather-related losses in 2008. As well, the average cost of Ontario automobile claims substantially escalated and this inflationary trend continues.

Two unprecedented events added to these challenges: first, the global financial meltdown and the associated economic impact; and, second, the magnitude of interest rate decreases which had a negative impact to the combined operating ratio as a result of the requirement to discount reserves for future liabilities.

Under this accounting treatment and with the decline in interest rates, in 2008, an additional \$53.7 million was added to the loss ratio. However, as a result of our strategy to match a subset of our bond portfolio against our claims reserves, we also posted \$55.9 million in realized and unrealized investment gains to offset the impact on the bottom line.

In the future, when interest rates go up, the effect of these requirements will have a positive effect on our loss ratio and negative to our realized and unrealized gains.

The financial crisis, with stock markets plummeting resulted in a reduction of surplus.

The Group, with an investment portfolio of over \$3.1 billion, experienced a market value decrease of \$160.4 million in the value of our investment portfolio. The potential losses were, however, mitigated due to the conservative policies of our Company and the high grade of our investments.

This unprecedented combination of deteriorating underwriting results and the write-downs of investments culminated in a very disappointing year for The Group.

In 2008, the underwriting loss was \$210.4 million, interest and dividend income was \$136.4 million, other investment losses were \$52.7 million and other expenses were \$15.2 million. As a result of the deterioration of the capital markets, we took a one-time charge in our investment portfolio of \$80.3 million after tax recoveries. The combined impact of the underwriting and investment losses is a \$176.7 million reduction in surplus.

Report of the Board of Directors of Economical Mutual Insurance Company cont'd

To ensure future profitability, substantial rate increases were taken in 2008, especially on the Ontario automobile product. We anticipate the market to harden in the second half of 2009. Further rate increases are planned at that time.

The Economical Insurance Group continues to have a strong balance sheet. We are well capitalized and continue to operate from a sound financial base. Through the volatility, The Group will continue to maintain a long-term focus.

In the last five years, investments at market value increased from \$2.3 billion to \$3.2 billion.

We continue to strengthen the reserves for future liabilities. During this same period, they have increased from \$1.4 billion to \$2.3 billion; policyholders' surplus increased from \$849.4 million to \$1.1 billion; and total assets from \$3.3 billion to \$4.4 billion.

In 2008, The Group demonstrated its longstanding value of supporting the independent broker network and providing superior protection for our policyholders by accomplishing the following goals:

- Development and implementation of a new private passenger vehicle product in Quebec
- Development and deployment of commercial products to meet the needs of specific commercial markets and to achieve the strategic objective of balancing the total portfolio
- Development of new processes to maintain the highest level of claims service and satisfaction

- Continued development of user-friendly technologies to further enhance our "ease of doing business" objective for brokers, staff and policyholders
- Expansion of Waterloo Insurance group business.

The Group has experienced soft cycles before and has successfully worked its way back to profitability.

The Group's conservative approach provides us with the financial stability, the fortitude and the experience to navigate through this phase.

The Board would like to take this opportunity to thank our brokers for their ongoing loyalty and support and our employees for their dedication and efforts in 2008.

Sincerely,



Gerald A. Hooper
Chairman



Noel G. Walpole
President and CEO

THROUGHOUT ITS SUCCESSFUL HISTORY, THE GROUP HAS CONSTANTLY LOOKED FOR OPPORTUNITIES TO DEVELOP AND ENHANCE PRODUCTS AND SERVICES. FROM THAT FIRST POLICY OF 1871, OUR GROWTH, DETERMINATION AND COMMITMENT HAVE KEPT PACE WITH THE NEEDS OF OUR POLICYHOLDERS.

Economical Mutual Insurance Company, the parent company of The Economical Insurance Group, has locations coast to coast.

The members of The Group include:

- Economical Mutual Insurance Company®
- Western General®
- Federation Insurance Company of Canada™
- The Missisquoi Insurance Company®
- Perth Insurance Company™
- Waterloo Insurance Company™
- Family Insurance Solutions Inc.
- The Mattei Companies
- Westmount Financial Inc.

To deliver on the promise we make to every policyholder, our claims department has developed several programs to meet the needs of our policyholders. When tragedy hits, our policyholders receive fast, uncomplicated service, bringing their lives back to where they were, prior to the incident.

Looking forward, The Group will continue its tradition of successfully providing property and casualty products to the Canadian marketplace.

**WE WILL
CONTINUE
TO FOSTER
THE STRONG
RELATIONSHIP**

**WE HAVE WITH THE BROKERS WHO
TAKE OUR PRODUCTS AND SERVICES
OUT INTO THE MARKETPLACE EVERY
DAY. WE WILL CONTINUE TO INVEST
IN TECHNOLOGY AND IN DEVELOPING
OUR PEOPLE. THE ECONOMICAL
INSURANCE GROUP...
NEIGHBOUR HELPING NEIGHBOUR...
RIGHT ACROSS CANADA.**

A black and white photograph of a young boy with a short haircut, wearing a plaid button-down shirt. He is holding the hand of an adult, whose arm is visible on the right side of the frame. The boy is looking upwards and to the right with a joyful expression, showing his teeth. The background is blurred, suggesting an indoor setting with large windows or doors.

**Bright
Futures**

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Management Discussion and Analysis

For the Year Ended December 31, 2008

March 24, 2009

The following management discussion and analysis of The Group's financial condition and results of operations should be read in conjunction with the audited financial statements and accompanying notes.

This document contains forward-looking statements that involve risks and uncertainties. Actual results could differ materially from these forward-looking statements as a result of various factors, including those discussed in this document. Certain totals, subtotals and percentages may not agree due to rounding.

Overview

About The Economical Insurance Group

The Economical Mutual Fire Company of Berlin (now Kitchener, Ontario) was founded as a mutual company in 1871. The Economical Insurance Group has grown to be one of Canada's foremost property and casualty ("P&C") insurance organizations.

Canadian owned and operated, The Group provides a wide range of personal and commercial insurance products throughout North America.

In Canada, The Group protects over 1.3 million policyholders exclusively through the independent broker network.

The Group reflects the combined strength of its member companies. As a whole, The Group is committed to providing its broker partners and policyholders with the products and services that today's market demands.

The Economical Insurance Group is comprised of:

- Economical Mutual Insurance Company, including the Western General Division;
- Federation Insurance Company of Canada;
- The Missisquoi Insurance Company;
- Perth Insurance Company;
- Waterloo Insurance Company;
- Family Insurance Solutions Inc. (Canadian-based subsidiary and managing general agent);
- The Mattei Companies (U.S.-based subsidiary and managing general agent);
- Westmount Financial Inc.

Corporate Strategy

The Economical Insurance Group's mission is to be a leading property and casualty insurance company through the delivery of high quality insurance products and superior service, built upon a foundation of innovation and financial strength.

In an unprecedented economic slowdown, insurance companies are under pressure to re-evaluate their strategies and capitalize on opportunities. The Group's management is being called upon to protect The Group's assets and capital, and mitigate the exposure to loss. The Group continues to build on the strong foundation of the past, and strives to grow the business and maintain a position as one of the Top 10 insurers in the Canadian P&C marketplace. Chosen strategies will focus on pursuing growth while maintaining profitability. In light of the changes in economic conditions, The Group has placed emphasis on the areas requiring the greatest focus. In order to achieve the goal of profitable growth, strategic and underwriting discipline must be maintained, while at the same time, aggressively pursuing the most attractive segments of business. This means being willing to reduce policies in force ("PIF") to achieve adequate rates. This protects policyholders by maintaining a stable company with strong capital and financial strength.

In 2008, this strategy resulted in a decline in PIF of 3.3%, but at the same time, average gross written premium per policy has increased by 5.2%. However, this increase was unable to keep pace with the severe escalation in claims costs encountered during the course of the year. Despite a market undergoing continued intensive price competition and erosion of terms and conditions, total gross written premium is up approximately 1.8% over 2007. As a result, The Group has maintained a surplus in excess of \$1.0 billion providing comfort to policyholders and regulators that the company is financially stable despite these challenging times.

In 2009, focus will be placed on the mix of business and seeking rate increases in those areas, most notably Ontario automobile, that are creating the greatest challenge for the Canadian Insurance industry. The Group has one of the largest Ontario automobile books of business in the industry and this has driven the combined ratio higher than that of competitors due to the increased severity of personal automobile claims. As a result, discussions will continue with industry groups to understand the challenges of the market, and diligence will be maintained to facilitate appropriate pricing of this product.

Finally, innovation will continue to be a priority. Technology is instrumental in The Group's ability to achieve profit and growth targets. The Group will continue its efforts to be a leader in developing innovative technological solutions and ensure a position as an insurer of choice with its independent broker partners by making it easier for them to do business with The Group.

Industry and Economic Analysis

The events in financial markets over the last year are a stark reminder that insurance companies have exposures well beyond the risks assumed from their insurance policies. The credit crisis, which initially began with an increase in the incidence of defaults on U.S. sub-prime mortgages and asset-backed securities in Canada,

has quickly extended to every corner of the global economy and resulted in a dramatic change to the competitive dynamics in the financial services sector.

Insurance companies need to protect their assets and capital base, maintain liquidity, and mitigate exposure to losses that may be developing. The market has not shown signs of improvements, and yet competition for personal and commercial business is fierce. Despite the current crisis, the business model for The Group is not likely to fundamentally change. However, a number of factors will impact The Group and the industry as a whole in 2009.

Equity and fixed income markets—The negative impact of equity and credit markets is reflected in the decline in realized gains in the investment portfolio as well as in the significant investment impairment charges taken in 2008. The Group has evaluated its portfolio and investment decisions and believes it is well positioned for 2009.

The decrease in market interest rates impacts the discounting of reserves and has had a negative impact on underwriting results in 2008. As interest rates declined during the course of the year, it led to an increase in the present value of claims reserves and a negative impact on the combined ratio. The company mitigated the bottom-line impact of this expense through effective asset-liability matching activities. Realized and unrealized gains in the matched bond portfolio of \$55.9 million offset the discounting impact of \$53.7 million.

Capital requirements—Available capital has been adversely affected by investment portfolio devaluations. Generally in the P&C insurance industry additional capital will be needed to cover reinsurance risks and provide protection from exposure to credit and liquidity risks. The Group is well positioned in this regard demonstrating a strong capital position and a regulatory capital position well in excess of the Office of the Superintendent of Financial Institutions (“OSFI”) minimum capital requirement. This will continue to be an area of focus for both regulators and The Group for the foreseeable future.

Counterparty risk—All four major rating agencies have maintained stable outlooks on the global reinsurance industry for 2009. A major contributing factor to these forecasts was the significant amount of capital held at the beginning of 2008 that enabled reinsurers to remain healthy heading into 2009. The Group only allows participants with an “A-” rating or better in its reinsurance program. A stable reinsurance market allows the company to maintain the appropriate focus on executing strategies and delivering outstanding service and protection to policyholders and brokers.

The strong economic headwind paints a challenging picture for the P&C insurance industry in 2009. The risk of increased moral hazard will lead to upward pressure in claims costs and difficult economic times often lead to more uninsured motorists causing additional uncertainty in a difficult business environment. The Group will act as needed to safeguard capital and minimize exposure to loss by increasing rates where necessary. Over the longer term, management believes that The Group is positioned to take advantage of the gradual return to profitability and improved macroeconomic fundamentals.

Definitions

The financial figures used to determine the key performance indicators (“KPI”) below are in accordance with Canadian GAAP but the KPI themselves are considered non-GAAP measures. These KPI are consistent with financial metrics used in the P&C insurance industry, but do not have any standardized meaning under Canadian GAAP. Readers are cautioned that the KPI may not be comparable to similar metrics presented by other companies.

Policies in Force (“PIF”)	The number of insurance policies for which the company is on risk at a specified date.
Gross Written Premiums (“GWP”)	The total premiums from the sale of insurance during a specified period.
Claims Ratio	Claims and adjustment expenses during a defined period, expressed as a percentage of net premiums earned for the same period.
Expense Ratio	Underwriting expenses including commissions, operating expenses and premium taxes during a defined period, expressed as a percentage of net premiums earned for the same period.
Combined Ratio	The sum of the claims ratio and the expense ratio.
Underwriting Profit	The difference between net premiums earned and the sum of claims and adjustment expenses, commissions, operating expenses and premium taxes.
Return on Equity (“ROE”)	Net income after tax for the 12 months ended at a specified date divided by the average operating surplus over the same 12-month period.
Minimum Capital Test (“MCT”)	A regulatory formula defined by OSFI that is a risk-based test of capital available relative to capital required.
Net Risk Ratio (“NRR”)	A regulatory test of financial leverage, defined as the ratio of net written premiums to policyholders’ surplus.
Provision for Adverse Deviation	An amount that is added to the discounted policy liabilities to reduce the potential adverse effect of the uncertainty that is inherent in the assumptions and data used to estimate policy liabilities.

The Year in Review

Results from Operations

(in millions of dollars, except as otherwise noted)

Year ended December 31

	2008	2007	Increase (Decrease)
Gross written premiums	1,939.7	1,906.1	33.6
Net premiums written	1,862.7	1,833.0	29.7
Net premiums earned	1,844.8	1,829.6	15.2
Claims and adjustment expenses	1,501.9	1,265.6	236.3
Other underwriting expenses	553.3	560.6	(7.3)
<i>Underwriting (loss) profit</i>	<i>(210.4)</i>	<i>3.4</i>	<i>(213.8)</i>
Interest and dividend income	136.5	130.3	6.2
Realized gain on sale of investments	27.9	41.4	(13.5)
Impairment loss on available for sale investments	(124.0)	–	(124.0)
Unrealized gains on investments held for trading	43.3	2.9	40.4
Other expenses	(15.2)	(3.6)	(11.6)
<i>Net (loss) income before income taxes</i>	<i>(141.9)</i>	<i>174.4</i>	<i>(316.3)</i>
Income tax (recovery) expense	(39.5)	56.8	(96.3)
Net (loss) income	(102.4)	117.6	(220.0)
Claims ratio	81.5%	69.2%	12.3%
Expense ratio	29.9%	30.6%	(0.7%)
Combined ratio	111.4%	99.8%	11.6%
Return on equity	(8.4%)	9.7%	(18.1%)
Policies in force (in thousands)	1,341.5	1,387.2	(45.7)

Figure 1.

Overall, gross written premiums increased 1.8% in 2008. There was excellent growth in all lines of business in the Western Region. Growth was also strong in the Ontario Region while the Quebec Region continued to experience a significant decline in GWP and PIF due to strong competitive pressures in all lines of business. Growth in Atlantic Region GWP was flat year over year.

A large increase in claims and adjustment expenses contributed significantly to the underwriting loss sustained in 2008. This movement is primarily a result of the substantial increase in claims frequency and severity during the course of the year relating to automobile claims, as well as a significant increase in weather-related catastrophic losses. Weather-related claims are becoming more prevalent and this is an area of concern for P&C insurance companies. The Group's proportionately higher mix of Ontario automobile business has also resulted in a higher claims ratio and combined ratio in comparison to its competitors. More detail is provided in Figure 2.

The impact of discounting claims reserves at the market interest rate was significant in 2008. As interest rates decreased during the year, claims reserves increased as they were discounted at these lower market interest rates. The movement in interest rates had the impact of increasing the combined ratio by 2.9% compared to a decrease of 0.9% in 2007. As mentioned earlier, from a bottom-line standpoint, the impact of discounting was offset by prudent asset-liability matching activities.

The ultimate result of the increased claims costs was a notably higher claims ratio and combined ratio. The additional effect of the deterioration in global equity markets resulted in insufficient investment income to offset the underwriting loss. This resulted in an overall net loss for The Group in 2008.

Claims and Adjustment Expenses

(in millions of dollars, except as otherwise noted)

	Year ended December 31		
	2008	2007	Increase (Decrease)
Net incurred losses:			
Current year claims	1,503.0	1,307.9	195.1
Favourable prior year claims development	(1.1)	(42.3)	41.2
Total	1,501.9	1,265.6	236.3

Figure 2.

The overall claims ratio has increased from 69.2% in 2007 to 81.5% due to substantial increases in total claims and adjustment expenses in 2008.

The 2008 claims experience was affected by an increase in claims frequency across all lines of business during the course of the year as well as a significant increase in the severity of claims. Higher severity was due primarily to weather-related catastrophic losses that were approximately \$55.0 million greater than 2007, coupled with a large increase in personal automobile injury claims, particularly in Ontario. The Group is focused on appropriately pricing the Ontario automobile policies to obtain an appropriate return given the severity of the claims.

The Group's prior year experience (claims development) was relatively flat for 2008, in contrast to a \$42.3 million favourable development in 2007. The dramatic change in claims development was due entirely to the decline in market interest rates during 2008.

Additional detail is provided in Figure 8.

Other Underwriting Expenses

(in millions of dollars, except as otherwise noted)

Year ended December 31

	2008	2007	Increase (Decrease)
Commissions	346.1	351.3	(5.2)
Operating expenses	143.9	145.6	(1.7)
Premium taxes	63.3	63.7	(0.4)
Total	553.3	560.6	(7.3)

Figure 3.

The Group has experienced deteriorating underwriting results, and therefore, contingent profit commissions have decreased during 2008. Premium taxes have remained consistent with the prior year both in total and as a percentage of net earned premium. The Group continues to focus on operational expenses, to invest where it is strategic and to decrease costs where reasonable. This has resulted in a year over year decrease in operating expenses.

Interest and Dividend Income

(in millions of dollars, except as otherwise noted)

Year ended December 31

	2008	2007	Increase (Decrease)
Interest income	111.5	107.5	4.0
Dividend income	25.0	22.8	2.2
Total	136.5	130.3	6.2

Figure 4.

Interest income is mainly derived from the bond portfolio. The increase in interest income reflects the growth of the underlying bond portfolio. The average book yield of the bond portfolio in 2008 was down slightly from 2007 (2008: 4.0%; 2007: 4.5%) as a result of lower market interest rates during the year.

The change in dividend income is reflective of the increase in dividend paying holdings in the investment portfolio.

Realized Gains on Sale of Investments

(in millions of dollars, except as otherwise noted)

	Year ended December 31		
	2008	2007	Increase (Decrease)
Realized gain (loss) on sale of bonds	17.5	(10.6)	28.1
Realized gain on sale of equities	10.4	52.0	(41.6)
Impairment loss on available for sale bonds	(13.5)	–	(13.5)
Impairment loss on available for sale equities	(110.5)	–	(110.5)
Unrealized gains on bonds held for trading	43.3	2.9	40.4
Total	(52.8)	44.3	(97.1)

Figure 5.

Realized gains declined in 2008 due to the sharply deteriorating capital market conditions, particularly in the common equity market as the liquidity of the global banking system virtually disappeared and large financial institutions faced the threat of bankruptcy. The impact has been a significant drop in certain values of the investment portfolio resulting in reduced selling volume relative to the prior year. The Group suffered impairment losses of \$124.0 million (2007: nil) as a result of the market meltdown. For more information on these losses, please refer to the 'Impairment and Valuation of Invested Assets' discussion.

A subset of the bond portfolio, which is matched in quantum and duration to the claims reserves, is designated as held for trading ("HFT"). Changes in the market value of HFT instruments flow through the consolidated statement of income. The balance of the bond portfolio and The Group's equity portfolio is designated as available for sale ("AFS"). Changes in fair value of AFS instruments flow through other comprehensive income (loss). For 2008, \$43.3 million (2007: \$2.9) of unrealized gains on the HFT bond portfolio were included in investment income.

The Group does not have any direct exposure to the U.S. sub-prime mortgages or mortgage-backed securities, or to Canadian non-bank asset-backed commercial paper. The Group has indirect exposure through securities held in companies that may have such exposure.

Provision for Income Taxes

The current year loss has resulted in a net income tax recovery position for The Group. The Group has had considerable taxable income in prior years to offset the current year losses, and as a result, there will be a significant income tax cash in-flow in 2009 as a portion of the income taxes paid in prior years is recovered.

For additional information please see note 4 to the audited consolidated financial statements.

Net Loss

The Group incurred a net loss in 2008 primarily due to extreme increases in claims costs. Increases in claims frequency and severity, particularly related to weather-related events, were the main contributor to the net loss. Total claims incurred increased 18.7% year over year. The discounting of claims reserves at lower market

interest rates also had a significant impact on the combined ratio. As noted earlier, the impact of discounting on the bottom line was mitigated by The Group's asset-liability matching activities.

Competitive pressures in the Quebec Region caused GWP and PIF to decline markedly in 2008. Increased severity in the Ontario Region, most notably claims related to personal automobile, also contributed to the poor results in 2008.

The extremely challenging capital market conditions, particularly as they relate to investment impairments, also had a significant negative impact on The Group's 2008 performance.

Return on Equity

The Group encountered a negative return on equity for 2008 due to the net loss position.

Key Performance Indicators

(in millions of dollars, except as otherwise noted)

	Year ended December 31				
	2008	2007	2006	2005	2004
Policies in force (thousands)	1,341.5	1,387.2	1,396.6	1,333.2	1,275.8
Gross written premiums	\$ 1,939.7	\$ 1,906.1	\$ 1,921.0	\$ 1,778.0	\$ 1,696.9
Claims ratio	81.5%	69.2%	68.9%	64.3%	60.5%
Expense ratio	29.9%	30.6%	30.7%	30.6%	31.5%
Combined ratio	111.4%	99.8%	99.6%	94.9%	92.0%
Underwriting (loss) profit	\$ (210.4)	\$ 3.4	\$ 6.3	\$ 84.6	\$ 123.4
Net (loss) income	\$ (102.4)	\$ 117.6	\$ 130.0	\$ 172.1	\$ 161.8
Return on equity	(8.4%)	9.7%	12.0%	18.4%	21.1%
Investments at cost	\$ 3,243.4	\$ 3,195.0	\$ 2,950.5	\$ 2,572.3	\$ 2,234.4
Investments at market value	\$ 3,151.8	\$ 3,167.3	\$ 2,999.8	\$ 2,644.6	\$ 2,335.1
Operating surplus	\$ 1,167.4	\$ 1,269.8	\$ 1,151.6	\$ 1,021.5	\$ 849.4
Policyholders' surplus	\$ 1,079.0	\$ 1,255.7	\$ 1,151.6	\$ 1,021.5	\$ 849.4
Total assets	\$ 4,441.2	\$ 4,341.3	\$ 4,103.5	\$ 3,648.0	\$ 3,294.1

Figure 6.

The Management Discussion and Analysis focuses on the changes from 2007 to 2008. The discussion below provides some insight to the movement between 2004 and 2007.

Net income was lower in 2007 compared to 2006 primarily due to lower underwriting profit, which was attributable to increased competition and continued difficulty in the market. Claims frequency continued to increase in 2007 from the all-time lows experienced in 2004. 2006 underwriting profit declined significantly from 2005 as the market began to soften and competition for commercial business intensified. 2006 claims severity continued to increase and claims frequency also began to rise. 2005 underwriting profit declined

marginally from 2004 as a result of two large catastrophic claims. Strong investment returns in 2005 enabled net income to surpass that of 2004.

Financial Strength

Cash and Investments

(in millions of dollars,
except as otherwise noted)

	As at December 31, 2008			As at December 31, 2007		
	Cost*	Fair Value	% @ Fair Value	Cost*	Fair Value	% @ Fair Value
Cash and cash equivalents	103.0	103.0	3.2%	89.0	89.0	2.7%
Short-term investments	–	–	0.0%	36.1	36.1	1.1%
Bonds						
Federal	1,319.1	1,371.4	42.1%	1,209.9	1,210.4	37.2%
Provincial	298.7	306.1	9.4%	98.0	97.6	3.0%
Municipal	–	–	0.0%	30.0	30.5	0.9%
Corporate	854.3	812.3	25.0%	1,043.9	1,021.1	31.4%
	2,472.1	2,489.8	76.5%	2,381.8	2,359.6	72.5%
Canadian preferred stocks	291.7	264.5	8.1%	297.1	277.1	8.6%
Common stocks						
Canadian	240.6	207.6	6.4%	264.9	289.6	8.9%
Foreign	160.7	113.5	3.5%	161.1	156.5	4.8%
	693.0	585.6	18.0%	426.0	446.1	13.7%
Canadian income trusts	9.9	9.5	0.3%	20.4	17.5	0.5%
Commercial loans	68.4	66.9	2.0%	33.6	30.9	0.9%
	3,346.4	3,254.8	100.0%	3,284.0	3,256.3	100.0%
Unrealized losses		(91.6)			(27.7)	

Figure 7.

* Bonds are presented at amortized cost

The Group adheres to a conservative investment strategy. It focuses on maximizing long-term returns while taking advantage of current market opportunities. This is achieved by investing in a diversified mix of securities and by shifting between asset classes as trends in the capital markets evolve. The Group has an established investment policy and strategy that is based upon the prudent person approach, regulatory guidelines and the expected settlement pattern of claim liabilities. Current cash flow is used to settle claims and pay operating expenses, and excess cash flow is invested.

The fair value of cash and cash equivalents and invested assets on the consolidated balance sheet was \$3,254.8 million at December 31, 2008 (2007: \$3,256.3), representing approximately 73.3% of total assets (2007: 75.0%). In accordance with the adoption of the new financial instruments accounting standards commencing January 1, 2007, cost no longer equals the carrying value. The carrying value includes the bonds, stocks and income trust securities at market value and the commercial loans at amortized cost using the effective interest rate method.

The increase in the total cost of investments and cash of \$62.4 million or 1.9% over the prior year resulted from cash provided by operating activities of \$179.3 million less the investment write-downs taken as a result of the challenging investment market during 2008.

The mix in the bond portfolio changed during the year increasing its weights in federal and provincial bonds, while decreasing investments in corporate, municipal and other bonds. This change in mix was implemented to manage risk and maintain The Group's financial strength during a time of significant market uncertainty.

As at December 31, 2008, 99.5% of the entire bond portfolio was rated "A-" or better, 98.5% of the corporate bonds were rated "A-" or better and 98.5% of the preferred stocks were rated "P2" or better.

The Group has reviewed its investment portfolio for investments determined to be impaired either due to the significance of the decrease in market value, or the length of time that the investment has had a market value below its original cost. The Group believes it has taken reasonable impairment reserves across the investment portfolio while still maintaining a strong diversified portfolio.

For further information on the Group's investment portfolio please see Note 5 to the audited consolidated financial statements.

Unpaid Claims and Adjustment Expenses

Claim liabilities represent an estimate of the amount required to settle all outstanding and unreported claims incurred. They are measured using accepted actuarial practice and take into account the time value of money and provisions for adverse deviation. The basic assumptions made in establishing claim liabilities are best estimates. For 2008, the discount rate used to determine the actuarial value of claim liabilities is based on the fair value yield of The Group's held-for-trading bond portfolio, which was 3.0% (2007: 4.6%). The provisions for adverse deviation in claims development and reinsurance were set on a consistent basis as in prior years. The provision for adverse deviations for changes in interest rates was reduced compared to last year to better reflect the matching of the investment portfolio and the claim liabilities as well as the reduction in market rates.

Figure 8 shows the change in The Group's claim liabilities for the past two years.

(in millions of dollars, except as otherwise noted)

Year ended December 31

	2008	2007
Net unpaid claim liabilities at the beginning of the year	1,912.3	1,778.9
Adjustment for discount rate change	–	(7.6)
Change in estimated losses and expenses for claims occurring in prior years:		
Core lines of business	(42.0)	(31.3)
Industry pools	(1.7)	(6.9)
Impact of discounting	42.6	(4.1)
Losses and expenses on claims occurring in the current year	1,503.0	1,307.9
Paid on claims occurring during:		
Current year	(693.2)	(652.3)
Prior years	(532.9)	(472.3)
Net unpaid claim liabilities at the end of the year	2,188.1	1,912.3

Figure 8.

Unpaid claim liabilities have risen substantially (14.4%) from 2007 to 2008. The increase is due largely to the significant increase in claims occurring in the current year as discussed earlier. The Group experienced favourable development in both 2007 and 2008 on the core lines of business (2007: \$31.3 million; 2008: \$42.0 million). The impact of discounting in 2008 offset the 2008 favourable development as market rates declined and case reserves were increased. This is in contrast to 2007, a year in which market interest rates increased and caused claims reserves to decrease further.

Surplus

Figure 9 illustrates the change in The Group's surplus over the last five years.

(in millions of dollars, except as otherwise noted)

Year ended December 31

	2008	2007	2006	2005	2004
Operating surplus	1,167.4	1,269.8	1,151.6	1,021.5	849.4
Accumulated other comprehensive loss	(88.4)	(14.1)	–	–	–
Policyholders' surplus	1,079.0	1,255.7	1,151.6	1,021.5	849.4

Figure 9.

The Group experienced a decline in policyholders' surplus in 2008. On an operating surplus basis there was a reduction of \$102.4 million during the year, however, this capital remains above 2006 levels. The introduction of new accounting standards related to financial instruments in 2007 resulted in the recording of accumulated other comprehensive loss. The unprecedented turmoil in financial markets during 2008 led to a significant increase in the accumulated other comprehensive loss balance. This represents the increase in the net unrealized losses of equities and a small portion of the bond portfolio.

Despite the decrease in earnings and unrealized losses, The Group has continued to maintain a strong capital base with more than \$1.0 billion in policyholders' surplus and a strong level of regulatory capital.

Minimum Capital Test

As federally regulated P&C insurance companies, The Group's capital position is monitored by The Office of the Superintendent of Financial Institutions ("OSFI"). OSFI measures The Group's financial strength using the Minimum Capital Test ("MCT"). This test measures available capital against capital required under the MCT. Capital required is calculated by applying risk factors to the assets and liabilities of The Group. Available capital is comprised of surplus, plus or minus adjustments prescribed by OSFI. The threshold MCT prescribed by OSFI is 150%. The Group has set an internal benchmark of 175%.

The following table shows the MCT for The Group over the past five years, since the introduction of the measurement.

	Year ended December 31				
	2008	2007	2006	2005	2004
MCT	200.2%	231.9%	220.6%	235.4%	221.5%

Figure 10.

As the policyholders' surplus of the company has declined in 2008, so has the MCT. Despite the negative market conditions, as of December 31, 2008, The Group has capital of \$240.9 million in excess of the 150% minimum required by OSFI and \$120.8 million in excess of the 175% internal benchmark.

The Group regularly monitors the MCT ratio including the performance of annual stress testing. The Group has always maintained a strong regulatory capital position and takes corrective actions as necessary. For more information, please refer to note 17 of the audited consolidated financial statements.

Net Risk Ratio

Another ratio used by OSFI to measure the financial strength of insurers is the NRR. The NRR measures the financial leverage of The Group, expressing net written premiums for a 12-month period as a ratio of policyholders' surplus. The OSFI guideline for NRR is 3:1 or less. The following table shows The Group's NRR for the past five years.

	Year ended December 31				
	2008	2007	2006	2005	2004
NRR	1.73	1.46	1.60	1.67	1.93

Figure 11.

Off Balance Sheet Liabilities and Contingencies

In common with the insurance industry in general, The Group is subject to litigation arising in the normal course of conducting its insurance business. The Group is of the opinion that this litigation will not have a significant effect on the financial position, results of operations, or cash flows of The Group.

The Group holds credit default swaps in its investment portfolio, which represent financial guarantees to compensate a counterparty following the occurrence of a default in relation to a specified bond. The issuers of these obligations underlying the credit default swaps are rated "AA-" or above by independent rating agencies. The Group's exposure with respect to these financial instruments was not directly impacted by the numerous corporate failures that took place in 2008. However, a market loss of approximately \$3.6 million was recognized on the credit default swap portfolio in The Group's 2008 consolidated statement of income.

The Group does not actively trade in derivatives for either hedging or speculative purposes.

Note 14 to the audited consolidated financial statements outlines The Group's financial commitments under existing operating leases.

Accounting and Internal Control Matters

Internal Controls and Procedures

The Group has designed internal controls and procedures to ensure that accurate financial information is available to senior management in a timely manner. Inherent limitations exist in all control systems, and as such, an evaluation of those control systems can provide only reasonable assurance that all issues, fraud or errors are detected.

Critical Accounting Estimates and Assumptions

Significant accounting policies are disclosed in note 1 to the audited consolidated financial statements. The preparation of the audited consolidated financial statements, in conformity with Canadian GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as at the date of the audited consolidated financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Management judgement and estimation is required in relation to the valuation of policy liabilities, impairment and valuation of investments, goodwill and intangible assets, income taxes, and pensions and other post-employment benefits. Although some variability is inherent in these estimates and assumptions, management believes that the amounts provided are adequate. The most significant estimates and assumptions used in preparing the audited consolidated financial statements are described below.

Policy Liabilities

Policy liabilities consist of claim liabilities and premium liabilities net of reinsurance. In accordance with Canadian accepted actuarial practice, future investment income has been considered in the determination of policy liabilities. Consequently, policy liabilities have been determined on a discounted basis. They also include provisions for adverse deviation, as required by Canadian accepted actuarial practice and OSFI. The appointed

actuary of The Group evaluates the policy liabilities using appropriate actuarial techniques. Periodically, the assumptions and conclusions of The Group's appointed actuary are evaluated by an independent actuarial review conducted by a third party.

Claim liabilities include insured losses with respect to reported and unreported claims incurred as of the end of each period, as well as claims expenses and the impact of discounting. They are determined taking into account the consistency of The Group's claims handling procedures, the amount of information available, the characteristics of the line of business from which the claim arises, and the delay in reporting claims. These provisions for unpaid claims and adjustment expenses are estimates and, as such, are subject to variability which could be material in the near term. Changes to the estimates could result from future events such as receiving additional claim information, changes in the market yield of the held-for-trading bond portfolio, changes in judicial interpretation of contracts or significant changes in severity or frequency of claims from past trends. In general, the longer the term required for the settlement of a group of claims, the more variable the estimates.

The estimates are principally based on The Group's historical experience. Methods of estimation have been used that The Group believes produce reasonable results given current information. As additional experience and other data become available, the estimates could be revised. The future changes in estimates would be reflected in the consolidated statement of income for the period in which the change occurred.

Premium liabilities are represented by the amount of net unearned premiums less the amount of net deferred policy acquisition expenses. Generally the commissions and premium taxes corresponding to the net unearned premiums are deferrable; however, this amount is written down if the resulting expected future net policy costs are greater than the net unearned premiums. There were no write-downs of premium liabilities required in the past two years.

Reinsurance recoverables include amounts for expected recoveries from reinsurers related to claim liabilities as well as the portion of the reinsured unearned premiums. Amounts recoverable from reinsurers are evaluated in a manner consistent with the gross liabilities and the provisions of the reinsurance contracts. The failure of reinsurers to honour their obligations could result in losses to The Group, as the ceding of insurance does not relieve The Group of its primary liability to its insureds. Note 6 to the audited consolidated financial statements describes how credit risk related to The Group's reinsurers is managed. No information has come to The Group's attention indicating weakness or failure of any of its current reinsurers.

Impairment and Valuation of Invested Assets

The Group obtains values for actively traded securities in recognized security markets or Canadian unlisted markets. Impairment of invested securities results in a charge to earnings when a decline in the market value of an investment to below cost is other-than-temporary. Members of the investment and finance departments meet regularly to assess the impairments and report any impaired securities to the Investment Committee. Any impairment of these assets is written off against income in the period that such impairment becomes evident.

In 2008, The Group wrote down \$124.0 million (2007: nil) of impaired securities due to the severe market downturn experienced in capital markets.

Goodwill

The establishment of goodwill and the continuing review of goodwill for possible impairment requires management to make estimations and exercise judgement. Upon initial recognition of goodwill, The Group analyzes purchase price components of an acquisition and determines fair values for the assets and liabilities acquired using reasonable valuation techniques. The excess of the purchase price above the fair value of net assets (including intangible assets) is determined to be goodwill.

Under Canadian GAAP, goodwill is tested annually for impairment. Management judgement is required to identify reporting units with similar economic characteristics and to select an appropriate valuation model. As is common in the P&C insurance industry and the P&C insurance brokerage industry, fair value is measured using a multiple of earnings, a multiple of book value or a discounted cashflow model as appropriate. When the fair value of the reporting unit exceeds its carrying value, goodwill is considered un-impaired. When the fair value of the reporting unit is less than its carrying value, the fair value of the goodwill is compared with its carrying value to determine if any impairment exists. When the carrying value of goodwill exceeds the fair value of goodwill, an impairment loss is recognized in the consolidated statement of income in an amount equal to the excess.

A discussion of the impact of transactions during the year on goodwill, as well as detail surrounding the impairments recognized during the year, appears in note 10 to the audited consolidated financial statements.

Income Taxes

The Group operates in various tax jurisdictions, each subject to different income tax laws. Various tax laws are subject to different interpretations by the taxpayer and by the tax authority. The provision for income taxes requires management to use judgement in the interpretation of the relevant tax laws and to estimate the current and future tax implications in each jurisdiction in which The Group operates. A future income tax asset or liability is determined for each timing difference based on the future tax rates that are expected to be in effect when the differences reverse.

Pension and Other Post-Employment Benefits

The Group provides certain pension and other future employee benefits through both defined benefit and defined contribution pension plans and a non-pension benefit plan. Management estimation is required relating to the defined benefit pension plan and the non-pension benefit plan. No estimation is required for the defined contribution component of the pension plan.

The contributory defined benefit pension plans provide pension benefits based on length of service and an average of the best five years' pensionable earnings. The cost of the defined benefits is actuarially determined and accrued using the projected benefit method pro-rated on service. This method involves the use of

management's best estimates concerning such factors as expected plan investment performance, salary escalation and retirement ages of employees. The cost of all non-pension future benefits including medical benefits, dental care and life insurance is determined on an accrual basis by actuaries using the projected credit method. This method involves the use of the market interest rate on high-quality debt instruments and management's best estimates concerning such other factors as expected plan salary escalation, retirement age of employees and expected health care costs. All assumptions are determined by management and are reviewed annually by The Group's actuarial advisors. Actual experience that differs from the assumptions will affect the amounts of benefit obligation and expense. The key assumptions are presented in note 13 to the audited consolidated financial statements.

Impact of New Accounting Standards

On January 1, 2008, the Group adopted CICA Handbook Section 1535 ("Section 1535") – *Capital Disclosures*. The adoption of this standard requires disclosure of qualitative and quantitative information that enables users of financial statements to evaluate The Group's objectives, policies and processes for managing capital. The new disclosures are included in note 17 to the audited consolidated financial statements. While the new guidance has not affected the financial position or net income of The Group, comparative information has been revised where required.

On January 1, 2008, The Group adopted CICA Handbook Section 3862 ("Section 3862") – *Financial Instruments – Disclosures* and CICA Handbook Section 3863 ("Section 3863") – *Financial Instruments – Presentation*. Sections 3862 and 3863 replace CICA Handbook Section 3861 ("Section 3861") – *Financial Instruments – Disclosure and Presentation*. Section 3862 requires enhanced disclosures regarding financial instruments, including the impact on financial position and net income and on the risks associated with recognized and unrecognized financial instruments. The new disclosures are included throughout the audited consolidated financial statements. While there has been no effect on the financial position or on the net income of The Group, comparative information has been revised where required. Section 3863 carries forward unchanged the presentation requirements of Section 3861.

International Financial Reporting Standards (IFRS)

In April 2008, the Accounting Standards Board issued an exposure draft proposing to incorporate IFRS into the CICA Handbook over the period extending to December 31, 2010. The move to IFRS will result in the adoption of a common set of world-wide accounting standards, thereby improving financial reporting and transparency. The Group will first report under IFRS for the year ended December 31, 2011, with comparative information presented on an equivalent basis.

Over the next two years, the company will assess the implications of converting to IFRS, estimate the impact, implement the changes, and perform work to ensure the accuracy of opening balances. It is currently not possible to fully determine the impact to the audited consolidated financial statements and any potential business impacts, as accounting standards and related interpretations are changing.

Risk Management

The Group is engaged in the business of gauging, assuming and managing risk. Effective risk management rests on recognizing risk, developing mitigation strategies and using managerial resources to monitor risk. Management must have access to the most timely and accurate information possible in order to make appropriate decisions on the level of risk acceptability. The Board of Directors ensures that management has put appropriate risk management processes in place. Through the Audit Committee, the Corporate Governance and Conduct Review Committee, the Investment Committee and Internal Audit, the Board oversees such risk management procedures and controls. The Group has established a Control and Risk Management Committee made up of senior management that monitors the risk management functions for The Group and provides regular updates to the Audit Committee. A summary of the risks faced by The Group and the processes for managing them is outlined below.

Product and Pricing Risk

Product and pricing risk is the risk of financial loss from entering into insurance contracts when the liabilities assumed exceed the expectation reflected in the pricing of the insurance product. The Group prices its products by taking into account several factors including claims frequency, severity trends, product line expense ratios, special risk factors, capital requirements and investment income. These factors are reviewed and adjusted as needed on a regular basis to ensure they are reflective of current trends and market sentiment.

For automobile insurance certain pricing must be submitted to each provincial regulator. It is possible that decisions by provincial regulators may restrict automobile rate changes or other actions that The Group may wish to take.

When there is intense competition in the marketplace for any product line, The Group's competitors may price their products below market rates in an effort to gain market share. In these instances, The Group may choose to adjust pricing below levels deemed to be adequate in order to maintain a competitive position. However, The Group always endeavours to maintain a pricing level that ensures the ability to produce an acceptable return. The Group is willing to sacrifice market share to ensure profitability during such periods when it is otherwise unable to produce acceptable returns.

Underwriting Risk

Underwriting risk is the risk of financial loss resulting from economic situations or the rate of incident occurrence that alters the forecast from the rates established. Accepting underwriting risks that do not fall within the appetite of The Group or not applying clauses within the insurance contract properly can result in deviations from the expected actuarial results used in the product design. The Group has adopted policies that specify our tolerance for maximum financial risk retention. Once the retention limits are reached, reinsurance is utilized to cover the excess risk.

The Group has established quality review processes to ensure that its activities fall within established guidelines, appetites and pricing structures. The review process includes branch and regional self-reviews, and head office reviews conducted on a predetermined schedule, in addition to internal audit process reviews conducted on a schedule and at locations as determined by management and the Audit Committee of the Board of Directors. The results of these quality reviews are distributed to senior management and the appropriate field management staff to ensure any issues identified are remedied.

Insolvency Risk

Insolvency risk is the risk that The Group will not be able to pay out future claims as they arise. OSFI monitors the solvency of The Group by requiring compliance with strict solvency standards based on the risks we assume. The Group is required to submit quarterly reports to OSFI regarding solvency. The Board of Directors has established a minimum solvency standard well above that required by OSFI. On an annual basis, the Chief Actuary must present a report to the Audit Committee on the adequacy of The Group's current and future solvency.

The Group actively monitors its MCT ratio and the effect that external and internal actions have on the capital base of the company. The Group determines the effect on capital before entering into any acquisitions to ensure that policyholders are not put at risk through the depletion of capital to unacceptable levels.

Reinsurance Risk

Reinsurance risk is the risk of financial loss due to the failure of reinsurers to cover their portion of reinsured losses. Ceding risk to reinsurers does not relieve The Group of its obligation to its policyholders. The Group is exposed to credit risk with respect to the amounts ceded to its reinsurers. With the assistance of its reinsurance broker, The Group regularly assesses the financial soundness of the reinsurers it deals with, including, but not limited to, the monitoring of credit ratings of The Group's reinsurers.

More detail on the management of this risk appears in note 11 to the audited consolidated financial statements.

Interest Rate and Equity Market Risk

Shifts in interest rates, as well as the change in value of equity securities, impact the level and timing of recognizing gains and losses on the investment portfolio. Typically, investment income will be reduced during sustained periods of low interest rates but will also create unrealized gains within the bond portfolio. Low interest rates will also create realized gains to be recognized in net income to the extent any bonds are sold during the period. The reverse is true during a sustained period of increasing interest rates.

Economic trends, the political environment and many other factors can positively and adversely impact the equity markets and consequently the equity investments that The Group holds.

More detail on the management of these risks appears in note 6 to the audited consolidated financial statements.

Credit Risk

Credit risk is the risk of financial loss as the result of counterparties' inability to meet payment obligations as they become due. A counterparty is any individual or organization from which cash or other forms of consideration are due to The Group to extinguish a liability. Credit risk is concentrated in the bond and preferred share investment portfolios, reinsurance recoverables and amounts owing from brokers.

More detail on the management of this risk appears in note 6 to the audited consolidated financial statements.

Foreign Exchange Risk

The Group's foreign exchange risk relates primarily to its index holdings denominated in United States dollars as well as its net investment in foreign-based insurance operations.

More detail on this risk appears in note 6 to the audited consolidated financial statements.

Liquidity Risk

Liquidity risk is the risk of having insufficient cash resources to meet current financial obligations.

More detail on this risk and the Group's risk management approach appears in note 6 to the audited consolidated financial statements.

Operational Risk

Operational risk is the risk of financial loss from inadequate or failed processes, people and systems or due to external events. The Group has implemented a risk management program where Risk & Control Self-Assessments are performed on all business units and functions. The Group also monitors and follows-up on risks on an ongoing basis through regular reporting from the Control and Risk Management Committee to the Audit Committee and the Corporate Governance and Conduct Review Committee of the Board of Directors.

The internal auditors conduct an annual risk-based internal audit plan. The plan is developed with the key inherent risks of The Group's operations in mind and is approved by senior management and the Audit Committee of the Board of Directors.

Regulatory Risk

Regulatory risk is the risk of penalties, such as fines or restrictions on The Group's ability to carry on business, arising from non-compliance with regulatory requirements. It also includes the risk that modifications to regulations will threaten The Group's ability and capacity to conduct business as it does today.

As a member of the P&C insurance industry, The Group is subject to significant regulation by government. The Group has established procedures and controls to gain reasonable assurance that it is in compliance with all relevant laws, rules and regulations. It is possible that future regulatory changes may prevent The Group from taking actions, such as raising rates, to enhance operating results. In addition, future regulatory changes or court decisions could drastically change the business environment in which The Group operates. The Group actively participates in discussions with regulators, governments and industry groups to ensure its concerns are understood.

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Financial Review 2008

Report of Management's Accountability

The accompanying consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and have been approved by the Board of Directors.

Management is responsible for ensuring that these statements, which include amounts based on estimates and judgement, are consistent with other information and operating data contained in the Annual Report, and reflect the Company's business transactions and financial position.

The integrity and reliability of Economical Mutual Insurance Company's reporting systems are achieved through the use of formal policies and procedures, the careful selection of employees and appropriate delegation of authority and division of responsibilities. Deloitte & Touche LLP has been retained to act as the Company's internal auditor. The responsibility of the internal auditor is to monitor and assess the integrity of the internal controls within key business processes. Economical's Code of Business Conduct, which is communicated to all levels in the organization, requires employees to maintain high standards in their conduct of the Company's affairs.

The external auditor, Ernst & Young LLP, whose report on their audit of the consolidated financial statements follows, also reviews our systems of internal accounting control in accordance with Canadian generally accepted auditing standards for the purpose of expressing their opinion on the consolidated financial statements.

The actuary is appointed by the Board of Directors pursuant to the Insurance Companies Act (Canada). The actuary is responsible for ensuring that the assumptions and methods used in the valuation of policy liabilities are in accordance with accepted actuarial practice, and applicable legislation and associated regulations or directives. The actuary is also required to provide an opinion regarding the appropriateness of the policy liabilities at the balance sheet date to meet all policyholder obligations of the Company. Examination of supporting data for accuracy and completeness is an important element of the work required to form this opinion.

The Board of Directors annually appoints an Audit Committee comprised of directors who are not employees of the Company. This committee meets regularly with management, the internal auditor and the external auditor to review significant accounting, reporting and internal control matters. Both the internal and external auditors and the actuary have unrestricted access to the Audit Committee. Following its review of the consolidated financial statements and the report of the external auditor, the Audit Committee submits its report to the Board of Directors for formal approval of the consolidated financial statements.



Noel G. Walpole

President and
Chief Executive Officer



Sandeep Uppal

Senior Vice President and
Chief Financial Officer

Waterloo, Canada
February 18, 2009

Appointed Actuary's Report

To the Members of Economical Mutual Insurance Company:

I have valued the policy liabilities of Economical Mutual Insurance Company for its consolidated balance sheet at December 31, 2008, and their change in the consolidated statement of income for the year then ended in accordance with accepted actuarial practice, including selection of appropriate assumptions and methods.

In my opinion, the amount of policy liabilities make appropriate provision for all policyholder obligations and the consolidated financial statements fairly present the result of the valuation.

Linda M. Goss

Fellow, Canadian Institute of Actuaries

Waterloo, Canada

February 18, 2009

Auditors' Report

To the Members of Economical Mutual Insurance Company:

We have audited the consolidated balance sheet of Economical Mutual Insurance Company as at December 31, 2008 and the consolidated statements of income, comprehensive income, changes in policyholders' surplus and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Chartered Accountants

Licensed Public Accountants

Kitchener, Canada,

February 18, 2009.

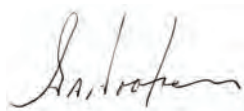
Consolidated Balance Sheet

As at December 31

(in thousands of dollars)	2008	2007
Assets		
Cash and cash equivalents	\$ 102,956	\$ 89,009
Investments (note 5)	3,153,405	3,170,052
Premiums receivable	569,014	554,655
Accrued investment income	24,949	23,401
Income, premium and other taxes receivable	84,113	1,072
Reinsurance receivable and recoverable (notes 7 and 11)	111,871	119,430
Deferred policy acquisition expenses (note 7)	190,458	186,062
Property and equipment (note 9)	49,266	45,921
Future income tax assets	44,432	32,729
Other assets	68,514	71,678
Goodwill (note 10)	42,243	47,246
	\$ 4,441,221	\$ 4,341,255
Liabilities and Policyholders' Surplus		
Unearned premiums	\$ 969,793	\$ 952,269
Provision for unpaid claims (note 7)	2,283,302	2,013,596
Accounts payable and other liabilities	109,118	119,714
	3,362,213	3,085,579
Policyholders' Surplus		
Operating surplus	1,167,393	1,269,752
Accumulated other comprehensive income (loss)	(88,385)	(14,076)
Total policyholders' surplus	1,079,008	1,255,676
	\$ 4,441,221	\$ 4,341,255

See accompanying notes.

On behalf of the Board:



G.A. Hooper

Director



N.G. Walpole

Director

Consolidated Statement of Income

For the year ended December 31

(in thousands of dollars)	2008	2007
Gross premiums written (note 11)	\$ 1,939,673	\$ 1,906,125
Net premiums written (note 11)	\$ 1,862,711	\$ 1,832,988
Net premiums earned (note 11)	\$ 1,844,800	\$ 1,829,554
Underwriting expenses:		
Claims and adjustment expenses (notes 7 and 11)	1,501,949	1,265,570
Commissions	346,058	351,275
Operating expenses	143,939	145,660
Premium taxes	63,285	63,681
	2,055,231	1,826,186
Underwriting income (loss)	(210,431)	3,368
Investment income:		
Interest (note 5)	111,405	107,530
Dividends (note 5)	24,997	22,737
Realized gain on sale of investments (note 5)	27,919	41,470
Impairment loss on available for sale investments (note 5)	(123,955)	–
Unrealized gain on investments designated as held for trading (note 5)	43,317	2,887
	83,683	174,624
Other expense	(15,150)	(3,596)
Income (loss) before income taxes	(141,898)	174,396
Income tax expense (recovery) (note 4)		
Current	(39,543)	60,159
Future	4	(3,318)
	(39,539)	56,841
Net income (loss)	\$ (102,359)	\$ 117,555

See accompanying notes.

Consolidated Statement of Comprehensive Income

(in thousands of dollars)	For the year ended December 31	
	2008	2007
Net income (loss)	\$ (102,359)	\$ 117,555
Other comprehensive income (loss) (note 16)	(74,309)	(51,052)
Comprehensive income (loss)	\$ (176,668)	\$ 66,503

See accompanying notes.

Consolidated Statement of Changes in Policyholders' Surplus

(in thousands of dollars)	2008			2007		
	Operating surplus	Accumulated other comprehensive income (loss)	Total policyholders' surplus	Operating surplus	Accumulated other comprehensive income (loss)	Total policyholders' surplus
Balance, beginning of the year	\$ 1,269,752	\$ (14,076)	\$ 1,255,676	\$ 1,151,553	\$ –	\$ 1,151,553
Transition adjustments (note 2)	–	–	–	644	36,976	37,620
Adjusted balance, beginning of the year	1,269,752	(14,076)	1,255,676	1,152,197	36,976	1,189,173
Net income (loss)	(102,359)	–	(102,359)	117,555	–	117,555
Other comprehensive income (loss)	–	(74,309)	(74,309)	–	(51,052)	(51,052)
Balance, end of the year	\$ 1,167,393	\$ (88,385)	\$ 1,079,008	\$ 1,269,752	\$ (14,076)	\$ 1,255,676

See accompanying notes.

Consolidated Statement of Cash Flows

For the year ended December 31

(in thousands of dollars)	2008	2007
Operating activities:		
Receipts:		
Premiums collected	\$ 1,848,000	\$ 1,821,129
Investment income received	143,413	137,446
	1,991,413	1,958,575
Payments:		
Claims paid (note 7)	1,226,147	1,124,626
Expenses paid	503,755	477,927
Income, premium and other taxes paid	82,182	113,681
	1,812,084	1,716,234
Net cash provided by operating activities	179,329	242,341
Investing activities:		
Investments purchased	(2,478,778)	(2,871,337)
Investments sold, redeemed or matured	2,324,367	2,662,052
Other assets (purchased) sold	(7,284)	2,105
Acquisitions, net of cash acquired	(3,687)	(15,681)
Net cash used in investing activities	(165,382)	(222,861)
Cash and cash equivalents:		
Net increase during the year	13,947	19,480
Balance, beginning of the year	89,009	69,529
Balance, end of the year	\$ 102,956	\$ 89,009
Cash	\$ 102,956	\$ 73,560
Cash equivalents	-	15,449
Total cash and cash equivalents	\$ 102,956	\$ 89,009
Income taxes paid	\$ 18,742	\$ 40,668

See accompanying notes.

Notes to the Consolidated Financial Statements

December 31, 2008

1. Summary of Significant Accounting Policies

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and Canadian accepted actuarial practice and reflect the requirements of the Office of the Superintendent of Financial Institutions Canada ("OSFI"). None of the accounting requirements of OSFI are an exception to Canadian GAAP. The preparation of consolidated financial statements, in conformity with Canadian GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities as at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. The most significant estimation processes are related to the valuation of policy liabilities and financial instruments. Although some variability is inherent in these estimates, management believes that the amounts provided are appropriate. The significant accounting policies used in the preparation of these consolidated financial statements are summarized below:

(a) Basis of consolidation

The consolidated financial statements include the accounts of Economical Mutual Insurance Company and its wholly-owned subsidiaries, Federation Insurance Company of Canada, The Missisquoi Insurance Company, Perth Insurance Company, Waterloo Insurance Company, and consolidated Westmount Financial Inc. (the "Company"). The consolidated financial statements of the Company also include the TEIG Investment Partnership, which manages the investment portfolio for all companies in the group. The Company's minority interest investments in companies subject to significant influence are accounted for using the equity method and included in "Other assets". Under the equity method, the original cost of the investments is increased by the comprehensive income of the minority interest since acquisition and reduced by dividends received. All significant inter-company transactions and balances have been eliminated on consolidation.

(b) Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, balances on deposit with banks and term deposits having original maturities of ninety days or less. Fair values approximate carrying values for term deposits with original maturities of ninety days or less.

(c) Financial instruments including investments

All of the Company's financial instruments are classified into one of the following four categories as defined below:

- available for sale ("AFS")
- held for trading ("HFT")
- loans and receivables
- other financial liabilities

All financial instruments are initially recognized at fair value and are subsequently accounted for based on their classification as described below. The classification depends on the purpose for which the financial instruments

were acquired and their characteristics. Instruments voluntarily designated as HFT to back the claim liabilities may never be reclassified and, except in very limited circumstances, the classification of other financial instruments is not changed subsequent to initial recognition. Financial assets purchased and sold, where the contract requires the asset to be delivered within an established time frame, are recognized on a settlement-date basis. Transaction costs are expensed as incurred for HFT financial instruments. For other financial instruments, transaction costs are capitalized on initial recognition. The effective interest rate method of amortization is used to account for any transaction costs capitalized on initial recognition and purchased premiums or discounts earned on bonds.

The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. Subsequent to initial recognition, the fair values are determined based on available information. The fair values of investments, excluding commercial loans, are based on the quoted bid market prices. The fair values of commercial loans and other financial instruments are obtained using discounted cash flow analysis at the current market interest rate for comparable financial instruments with similar terms and risks.

Available for sale

AFS financial instruments include short-term investments, bonds, preferred and common stocks and income trust units. Short-term investments consist of term deposits having original maturities of greater than ninety days and less than one year. AFS financial instruments are carried at fair value. Changes in fair value are recorded, net of income taxes, in "Other comprehensive income (loss)" ("OCI") in the consolidated statement of comprehensive income until the disposal of the financial instrument. When the financial instrument is disposed of, the gain or loss is reclassified from OCI in the consolidated statement of comprehensive income to "Realized gain on sale of investments" in the consolidated statement of income. Gains and losses on the sale of AFS financial instruments are calculated on an average cost basis.

The Company regularly assesses its AFS financial instruments for objective evidence of impairment. Objective evidence of impairment exists for individual equities (including common and preferred stocks, indexed funds and income trust units) when there has been a significant or prolonged decline in fair value below cost and there is no objective evidence to support recovery in value in the near term. Objective evidence of impairment exists for individual bonds when the Company no longer has reasonable assurance of timely collection of the cash flows associated with the bond or the fair value has been below cost for a prolonged period and the Company does not intend to hold the bond to maturity. When objective evidence of impairment exists for a financial instrument, the impairment loss is measured as the difference between cost and fair value. Impairment losses on AFS financial instruments are reclassified from OCI in the consolidated statement of comprehensive income and are recognized in "Impairment loss on available for sale investments" in the consolidated statement of income in the year such criteria are met. Impairment losses recognized in net income are not reversed.

Held for trading

HFT financial instruments are purchased with the intention of generating profits in the near term or are voluntarily so designated by the Company. OSFI further restricts the elective designation of financial instruments as HFT beyond the parameters defined in the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3855 ("Section 3855") – *Financial Instruments – Recognition and Measurement*. The Company voluntarily designates certain items as HFT with reference to the criteria outlined in OSFI Guideline D-10 ("Guideline D-10"), *Accounting for Financial Instruments Designated as Fair Value Option*. HFT financial instruments include bonds that have been designated as held for trading so as to support the claim liabilities. The Company has no other HFT assets. Changes in fair values of HFT financial instruments are recorded in "Unrealized gain on investments designated as held for trading" in the consolidated statement of income with the related tax impact included in the current and future income tax line items. As changes in the fair value of the HFT financial instruments are reflected in the consolidated statement of income, it is not necessary to record an impairment loss when there has been a significant or prolonged decline in the fair value of HFT financial instruments. When the financial instruments are disposed of the gain or loss is included in "Realized gain on sale of investments" in the consolidated statement of income.

Loans and receivables/Other financial liabilities

Financial instruments classified as loans and receivables, including commercial loans, and other financial liabilities are carried at amortized cost using the effective interest rate method. When there is evidence of impairment, the value of these financial instruments is written down to the estimated net realizable value through the consolidated statement of income. Evidence of impairment exists for individual loans when there is a deterioration in credit quality to the extent that the Company no longer has reasonable assurance of timely collection of the full amount of principal and interest.

Investment income recognition

Interest income is recognized on bonds and commercial loans on the accrual basis and includes the amortization of premiums and discounts over the life of the investment using the effective interest rate method.

Dividend income is recognized on the ex-dividend date.

(d) Credit default swaps

Credit default swaps represent financial guarantees of the Company to compensate a counterparty following the occurrence of a default in relation to a specified reference obligation, such as a bond or a loan. The maximum amount payable under credit default swaps is equal to their notional amount. The credit default swaps are recorded at their fair value in the consolidated balance sheet. The change in fair value and the financial compensation the Company receives in exchange for the financial guarantees is reflected in the consolidated statement of income.

(e) Deferred policy acquisition expenses

Commissions and premium taxes are deferred to the extent they are considered recoverable and are expensed in the accounting periods in which related premiums are recognized as income. To the extent deferred commissions and premium taxes are considered non-recoverable, they are expensed as incurred. The amount deferred is limited to the difference between the unearned premiums and the total future policy costs expected from the unexpired portion of in-force policies.

(f) Property and equipment

Property and equipment are recorded at cost less accumulated depreciation, which is provided at rates sufficient to write off the costs over the estimated useful lives of the assets.

	Basis	Rates
Buildings	Declining balance	5%
Furniture and equipment	Declining balance	20%
Computer equipment	Straight-line	25%
Software	Straight-line	maximum 7 years

(g) Goodwill

Goodwill represents the excess of purchase consideration over the fair value of the total tangible and intangible net assets acquired. Goodwill is recorded at cost and tested at least annually for impairment, in accordance with the CICA Handbook Section 3062, which requires goodwill impairment to be assessed at a reporting unit level. The Company has defined the reporting units to be insurance operations and broker operations. The fair value of each reporting unit is measured using a multiple of earnings, a multiple of book values or a discounted cash flow model as appropriate. Any impairment of these assets is written off against income in "Other expense" in the year that such impairment becomes evident.

(h) Intangible assets

Intangible assets that are determined to have a finite useful life are amortized on a systematic basis over the remaining useful life to a maximum of seven years. Intangible assets that are determined to have an indefinite life are not amortized, but are tested at least annually for impairment. An impairment loss is recognized to the extent the carrying value exceeds the fair value of the intangible asset calculated using a discounted cash flow model. Any impairment of these assets is written off against income in "Other expense" in the year that such impairment becomes evident.

(i) Impairment of long-lived assets

When events and circumstances warrant a review, the Company evaluates the carrying value of its long-lived assets for potential impairment. An impairment loss is recognized when the estimated net recoverable amount of a long-lived asset is less than its carrying value. The impairment loss is measured as the excess, if any, of the carrying value over the fair value of the asset. Any impairment of these assets is written off against income in the year that such impairment becomes evident.

(j) Income taxes

The liability method of tax allocation is used in accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are provided to the extent that it is more likely than not that the future income tax assets will not be realized.

(k) Premiums and unearned premiums

Premiums are recognized in income on a pro-rata basis over the contract period.

Premiums on policies written with monthly payment terms are accounted for on an annualized basis. Premiums receivable includes the premiums due for the remaining months of the contracts.

(l) Provision for unpaid claims

The provision for unpaid claims is calculated based on Canadian accepted actuarial practice. The provision consists of case estimates prepared by claims adjusters and a provision for incurred but not reported claims. The estimates include related investigation, settlement and adjustment expenses. The valuation of claim liabilities, which are valued on a discounted basis, is disclosed in note 7.

(m) Employee future benefits

The Company provides certain pension and other future employee benefits to eligible participants upon retirement.

Pension benefits

The defined benefit plan is based on the employee's length of service and final average pensionable earnings. The cost of the defined benefits is actuarially determined and accrued using the projected benefit method pro-rated on service. This method involves the use of management's best estimates concerning such factors as expected plan investment performance, salary escalation, and retirement ages of employees. The expected long-term return on plan assets is calculated using market-related asset values, where gains and losses are averaged over a five-year period. The assets supporting the pension benefits are held in separate trusteed pension funds.

The estimated excess of the fair value of plan assets over retirement obligations, including adjustments arising from plan amendments and changes in valuation assumptions, is included in income over the estimated average remaining service lives of participants. Actuarial gains and losses are amortized using the 10% corridor method. Under the 10% corridor method, the cumulative actuarial gain or loss in excess of 10% of the greater of the fair value of the pension plan assets or accrued benefit obligations at the beginning of the year is amortized to expense over the expected average remaining service life of the active members. Amounts that fall within the 10% corridor are not amortized.

The accumulated value for pension benefits is recorded in the consolidated balance sheet in "Other assets".

The Company also has a defined contribution plan, for which contributions are expensed in the year.

Non-pension benefits

The Company accounts for the cost of all non-pension future benefits, including medical benefits, dental care and life insurance for eligible retirees, their spouses and qualified dependents, on an accrual basis. These costs are recognized in the consolidated statement of income in the period during which services are rendered and are actuarially determined using the projected unit credit method pro-rated on service. This method involves the use of the market interest rate at the measurement date on high-quality debt instruments for the discount rate and management's best estimates concerning such other factors as expected plan salary escalation, retirement ages of employees and expected health care costs. Past service costs are amortized on a straight-line basis over the expected average remaining service life of employees.

The accumulated value for other employee future benefits is recorded in the consolidated balance sheet in "Accounts payable and other liabilities".

(n) Foreign currency translation

Translation of foreign subsidiaries' accounts

Assets and liabilities of the Company's fully integrated foreign subsidiaries are translated from their functional currencies into Canadian dollars at the exchange rate in effect at the consolidated balance sheet date for monetary assets and liabilities, and at the historical rate in effect for non-monetary assets and liabilities. Revenues and expenses are translated at the weighted average rate prevailing during the year, with the exception of the amortization of assets, which is translated at the same historic rate as the related asset. The adjustments resulting from the translation of the balance sheets of the foreign subsidiaries have been included in income in "Other expense".

Translation of foreign currency transactions

Transactions incurred in currencies other than the functional currency of the reporting entity are converted to the functional currency at the rate in effect on the transaction date. Monetary assets and liabilities denominated in a currency other than the functional currency are converted to the functional currency at the exchange rate in effect at the consolidated balance sheet date. Unrealized foreign currency transaction gains and losses on AFS

financial instruments have been included in OCI. All other foreign currency transaction gains and losses have been included in income.

(o) **Comparative figures**

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the current year's consolidated financial statements.

2. Changes In Accounting Policies

a) **Applied during the current period**

Capital disclosures

On January 1, 2008, the Company adopted CICA Handbook Section 1535 ("Section 1535") – *Capital Disclosures*. The adoption of this standard requires disclosure of qualitative and quantitative information that enables users of financial statements to evaluate the Company's objectives, policies and processes for managing capital. The new disclosures are included in note 17. While the new guidance has not affected the financial position or net income of the Company, comparative information has been revised where required.

Financial instruments disclosure and presentation

On January 1, 2008, the Company adopted CICA Handbook Section 3862 ("Section 3862") – *Financial Instruments – Disclosures*, and CICA Handbook Section 3863 ("Section 3863") – *Financial Instruments – Presentation*. Sections 3862 and 3863 replace CICA Handbook Section 3861 ("Section 3861") – *Financial Instruments – Disclosure and Presentation*. Section 3862 requires enhanced disclosures regarding financial instruments, including the impact on financial position and net income and on the risks associated with recognized and unrecognized financial instruments. The new disclosures are included throughout the consolidated financial statements, except for policy liabilities as the Company has elected to maintain Section 3861 disclosures. While there has been no effect on the financial position or on the net income of the Company, comparative information has been revised where required. Section 3863 carries forward unchanged the presentation requirements of Section 3861.

b) **Applied during the previous period**

Financial instruments

On January 1, 2007, the Company adopted CICA Handbook Section 1530 ("Section 1530") – *Comprehensive Income*; Section 3855; Section 3861; and Section 3865 ("Section 3865") – *Hedges*. The adoption of these standards resulted in changes in the accounting for financial instruments and the provision for unpaid claims, as well as the recognition of certain transition adjustments that were recorded in opening operating surplus or opening accumulated other comprehensive income (loss) ("AOCI") as described below:

1) Classification of all of the Company's financial assets and liabilities as at January 1, 2007 into one of the four financial instrument categories as defined in note 1.

2) Revaluation of the carrying values of AFS and HFT financial instruments as at January 1, 2007 from book values to fair values. Prior to the adoption of the new standards, all financial instruments were accounted for at cost, amortized cost, or, if impaired, at estimated net realizable value. The differences between the book values at December 31, 2006 and the fair values at January 1, 2007 were recorded either in opening operating surplus or opening AOCI, according to the classification or designation of the specific financial instrument.

3) The claim liabilities, net of reinsurance ("net claim liabilities"), were recalculated at January 1, 2007 using a discount rate based on the fair value yield earned on the supporting invested assets. Prior to the Company's adoption of the new standards, net claim liabilities were discounted using the book value yield of the supporting invested assets, which was consistent with the accounting treatment for these assets carried at amortized cost. The change in discount rate to a fair value yield is a consequence of the matching of the claim liabilities with the supporting invested assets, which are now carried at fair value, in accordance with Canadian accepted actuarial practice. The difference between the amount of net claim liabilities at December 31, 2006 and at January 1, 2007 was recorded as a transition adjustment in opening operating surplus.

Transition adjustments to the consolidated financial statements

The following table summarizes the adjustments that were made to adopt the new standards as at January 1, 2007:

(in thousands of dollars)	Operating surplus			Accumulated other comprehensive income (loss)		
	Gross	Future income taxes	Net of future income taxes	Gross	Future income taxes	Net of future income taxes
Classification of investments as AFS	\$ -	\$ -	\$ -	\$ 56,192	\$ (19,216)	\$ 36,976
Designation of investments as HFT	(6,439)	2,157	(4,282)	-	-	-
Provision for unpaid claims at fair value	7,585	(2,659)	4,926	-	-	-
	\$ 1,146	\$ (502)	\$ 644	\$ 56,192	\$ (19,216)	\$ 36,976

3. Future Accounting and Reporting Changes

Goodwill and intangible assets

In February 2008, the CICA issued CICA Handbook Section 3064 ("Section 3064") – *Goodwill and Intangible Assets*, replacing CICA Handbook Section 3062 ("Section 3062") – *Goodwill and Other Intangible Assets*, and CICA Handbook Section 3450 ("Section 3450") – *Research and Development Costs*. Section 3064 addresses when an internally developed intangible asset meets the criteria for recognition as an asset. The objectives of the changes are to reinforce a principles-based approach to the recognition of costs as assets and to clarify the application of the concept of matching revenues and expenses in CICA Handbook Section 1000 ("Section

1000”) – *Financial Statement Concepts*. Collectively, these changes bring Canadian practice closer to International Financial Reporting Standards (“IFRS”) by aligning the definition and initial recognition criteria for intangible assets. The effective date of adoption of this new section is January 1, 2009. The adoption of this standard is not expected to impact the financial position or net income of the Company.

International Financial Reporting Standards

In April 2008, the Accounting Standards Board (“AcSB”) issued an exposure draft proposing to incorporate IFRS into the CICA Handbook over the period extending to December 31, 2010. The move to IFRS will result in the adoption of a common set of world-wide accounting standards, thereby improving financial reporting and transparency. The Company will first report under IFRS for the year ended December 31, 2011, with 2010 comparative information presented on an equivalent basis.

Over the next two years, the Company will assess the implications of converting to IFRS, estimate the impact, implement the changes, and perform work to determine the opening balances under IFRS. It is currently not possible to fully determine the impact to the consolidated financial statements and any potential business impacts, as accounting standards and related interpretations are still under development.

4. Income Tax Expense (Recovery)

Income tax expense (recovery) differs from the combined statutory tax rates primarily as a result of the following:

(in thousands of dollars)	2008	2007
Income tax expense (recovery) based upon statutory tax rates	\$ (46,401)	\$ 61,300
Increase (decrease) in income tax expense (recovery) related to:		
Canadian dividend income not subject to tax	(7,021)	(6,824)
Non-deductible expenses	1,853	443
Effect of change in tax rates	(2,654)	3,001
Other	14,684	(1,079)
Income tax expense (recovery) reflected in the consolidated statement of income	\$ (39,539)	\$ 56,841

5. Investments

(a) Investment income and balances

Investment income by financial instrument classification is as follows:

(in thousands of dollars)	2008				
	HFT	AFS	Loans and receivables	Total	
Interest income	\$ 78,164	\$ 30,035	\$ 3,206	\$ 111,405	
Dividend income	–	24,997	–	24,997	
Realized gain on sale of investments	12,588	15,331	–	27,919	
Impairment loss on AFS investments	–	(123,955)	–	(123,955)	
Unrealized gain on HFT investments	43,317	–	–	43,317	
	\$ 134,069	\$ (53,592)	\$ 3,206	\$ 83,683	

(in thousands of dollars)	2007				
	HFT	AFS	Loans and receivables	Total	
Interest income	\$ 69,979	\$ 35,883	\$ 1,668	\$ 107,530	
Dividend income	–	22,737	–	22,737	
Realized gain (loss) on sale of investments	(6,856)	48,326	–	41,470	
Unrealized gain on HFT investments	2,887	–	–	2,887	
	\$ 66,010	\$ 106,946	\$ 1,668	\$ 174,624	

Investment balances at carrying value by financial instrument classification are as follows:

(in thousands of dollars)	2008			
	HFT	AFS	Loans and receivables	Total
Bonds	\$ 2,012,221	\$ 477,614	\$ –	\$ 2,489,835
Preferred stocks	–	264,470	–	264,470
Common stocks	–	321,110	–	321,110
Income trust units	–	9,524	–	9,524
Commercial loans (note 12)	–	–	68,466	68,466
	\$ 2,012,221	\$ 1,072,718	\$ 68,466	\$ 3,153,405

(in thousands of dollars)	2007			
	HFT	AFS	Loans and receivables	Total
Short-term investments	\$ –	\$ 36,129	\$ –	\$ 36,129
Bonds	1,804,891	554,678	–	2,359,569
Preferred stocks	–	277,146	–	277,146
Common stocks	–	446,094	–	446,094
Income trust units	–	17,490	–	17,490
Commercial loans (note 12)	–	–	33,624	33,624
	\$ 1,804,891	\$ 1,331,537	\$ 33,624	\$ 3,170,052

The commercial loans have an amortized cost of \$68.5 million (2007: \$33.6 million) and fair value of \$66.9 million (2007: \$30.9 million), which reflects the gross unrealized gains of \$1.0 million (2007: \$0.3 million) and the gross unrealized losses of \$2.6 million (2007: \$3.0 million).

The unrealized gains (losses) on AFS investments are detailed on page 48. The cost of all AFS investments, except AFS bonds, is the purchase price unless the investment is impaired. The cost of all AFS bonds is the amortized cost unless the investment is impaired. If the AFS investment is impaired, the cost is reduced to the fair value at the time of impairment.

Unrealized gains (losses) on AFS investments:

(in thousands of dollars)	2008			
	Cost/amortized cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Bonds:				
Federal	\$ 256,317	\$ 6,730	\$ (145)	\$ 262,902
Corporate	246,858	41	(32,187)	214,712
	503,175	6,771	(32,332)	477,614
Canadian preferred stocks	291,669	20	(27,219)	264,470
Common stocks:				
Canadian	240,631	6,501	(39,497)	207,635
Foreign	160,716	–	(47,241)	113,475
	401,347	6,501	(86,738)	321,110
Canadian income trust units	9,883	–	(359)	9,524
	\$ 1,206,074	\$ 13,292	\$ (146,648)	\$ 1,072,718

(in thousands of dollars)	2007			
	Cost/amortized cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Canadian short-term investments:	\$ 36,129	\$ –	\$ –	\$ 36,129
Bonds:				
Federal	283,503	448	(2,850)	281,101
Corporate	289,889	–	(16,312)	273,577
	573,392	448	(19,162)	554,678
Canadian preferred stocks	297,081	344	(20,279)	277,146
Common stocks:				
Canadian	264,932	32,848	(8,181)	289,599
Foreign	161,075	2,638	(7,218)	156,495
	426,007	35,486	(15,399)	446,094
Canadian income trust units	20,407	924	(3,841)	17,490
	\$ 1,353,016	\$ 37,202	\$ (58,681)	\$ 1,331,537

(b) Term to maturity

(in thousands of dollars)	2008				
	Less than 1 year	1-5 years	6-10 years	10 years +	Total
Bonds:					
HFT					
Federal	\$ 90,995	\$ 1,017,514	\$ –	\$ –	\$ 1,108,509
Provincial	69,000	215,346	21,780	–	306,126
Corporate	65,090	507,746	24,750	–	597,586
	225,085	1,740,606	46,530	–	2,012,221
AFS					
Federal	–	139,160	88,594	35,148	262,902
Corporate	986	71,218	142,508	–	214,712
	986	210,378	231,102	35,148	477,614
Canadian preferred stocks	142,503	110,487	11,480	–	264,470
Commercial loans	7,199	52,648	8,619	–	68,466
2008 total at carrying value	\$ 375,773	\$ 2,114,119	\$ 297,731	\$ 35,148	\$ 2,822,771

(in thousands of dollars)	2007				
	Less than 1 year	1-5 years	6-10 years	10 years +	Total
Short-term investments	\$ 36,129	\$ –	\$ –	\$ –	\$ 36,129
Bonds:					
HFT					
Federal	433,115	455,149	41,060	–	929,324
Provincial	36,840	51,436	9,288	–	97,564
Municipal	–	–	30,455	–	30,455
Corporate	296,466	344,017	107,065	–	747,548
	766,421	850,602	187,868	–	1,804,891
AFS					
Federal	30,027	35,136	215,938	–	281,101
Corporate	–	57,819	215,758	–	273,577
	30,027	92,955	431,696	–	554,678
Canadian preferred stocks	102,564	172,613	1,969	–	277,146
Commercial loans	3,530	24,667	5,427	–	33,624
2007 total at carrying value	\$ 938,671	\$ 1,140,837	\$ 626,960	\$ –	\$ 2,706,468

The fair value effective interest rate at December 31 for the HFT bond portfolio was 2.96% (2007: 4.57%) and for the AFS bond portfolio was 5.22% (2007: 5.02%).

(c) Impairment review

During the year ended December 31, the Company reclassified unrealized losses of \$13.5 million (2007: nil) for impaired AFS bonds and \$110.5 million (2007: nil) for impaired AFS stocks from AOCI to net income. Interest income of \$1.3 million (2007: nil) was earned during the year on the impaired AFS bonds.

The Company has determined that any remaining unrealized losses on the AFS investments are temporary in nature and evidence concerning the ongoing viability of current business operations of the issuers has been considered. In connection with the Company's investment management practices and review of its investment holdings, the Company believes that the near term prospects of recovery, based on analyst reports and other analysis, support that the decline is temporary as at the date of these consolidated financial statements.

The Company has determined that there is no evidence of impairment of any individual commercial loan because all balances are current and a review of the financial condition of the debtor and pledged collateral indicates that there is reasonable assurance of timely collection of the full amount of principal and interest.

(d) Securities lending

The Company participates in a securities lending program managed by a major Canadian financial institution whereby the Company lends securities it owns to other financial institutions to allow them to meet delivery commitments. The Canadian financial institution assumes all the risk associated with the lending activity. At December 31, securities with an estimated fair value of \$629.4 million (2007: \$625.4 million) have been loaned and securities with an estimated fair value of \$640.7 million (2007: \$641.6 million) have been received as collateral from the Canadian financial institution. The securities lent under this program have been included in "Investments" on the consolidated balance sheet. The financial compensation the Company receives in exchange for securities lending is reflected in the consolidated statement of income.

(e) Credit default swaps

Credit default swaps represent financial guarantees of the Company to compensate a counterparty following the occurrence of a default in relation to a specified reference obligation, such as a bond or a loan. The issuers of these obligations underlying the credit default swaps are rated "AA-" or above by independent rating agencies. All of the counterparties of the Company's credit default swaps are Canadian financial institutions rated "A-" or above by independent rating agencies. The maximum amount payable under credit default swaps as at December 31 is equal to their notional amount of \$75.0 million (2007: \$75.0 million).

The fair value of the credit default swaps reflects the quoted price from investment dealers on a monthly basis. The fair value is a liability of \$3.6 million as at December 31 (2007: \$0.4 million asset) and has been accrued in "Accounts payable and other liabilities" on the consolidated balance sheet. The change in the fair value of the credit default swaps has been included in "Unrealized gain on investments designated as held for trading" in the consolidated statement of income.

(f) Embedded derivatives

On an annual basis, the Company conducts a search for embedded derivatives. No embedded derivatives were identified.

6. Nature and Extent of Risks Arising from Financial Instruments

The Company has provided herein the disclosures required under Section 3862 related to the nature and extent of risks arising from financial instruments.

The Company's financial instruments, including investments, are exposed to interest rate risk, equity market risk, credit risk, foreign exchange risk and liquidity risk. The Company's Investment Policy Statement establishes asset mix parameters and risk limits to help minimize undue exposure to these risks in the investment portfolio while attempting to maximize the long-term value of policyholders' surplus. The Investment Policy Statement is reviewed annually by the Investment Committee of the Board of Directors. Compliance with the Investment Policy Statement is monitored quarterly by the Investment Committee. As interest rate risk is a significant risk to the Company due to the nature of its investments and claim liabilities, a portion of the Company's bond portfolio has been voluntarily designated as HFT and is managed to match the Company's claim liabilities.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. Typically, interest income will be reduced during sustained periods of low interest rates, but this will also generally increase the fair value of the bond portfolio. The reverse is true during a sustained period of increasing interest rates. The effect of interest rate risk associated with discounting claim liabilities is disclosed in note 7.

Duration is a measure used to estimate the extent fair values of fixed income investments change with changes in interest rates. Using this measure, it is estimated that an immediate hypothetical 100 basis point or 1% parallel decrease in interest rates, with all other variables held constant, would increase the fair value of HFT bonds on the consolidated balance sheet and net income by \$47.0 million (2007: \$44.6 million). Similarly, a 100 basis point or 1% parallel increase in interest rates would generate a corresponding decrease in the fair value of HFT bonds on the consolidated balance sheet and net income. An immediate hypothetical 100 basis point or 1% parallel decrease in interest rates, with all other variables held constant, would increase the fair value of AFS bonds on the consolidated balance sheet and increase OCI by \$24.7 million (2007: \$31.7 million) at December 31. Similarly, a 100 basis point or 1% parallel increase in interest rates would generate a corresponding decrease in the fair value of AFS bonds on the consolidated balance sheet and OCI. For both HFT and AFS bonds that the Company sold during the year, the change in fair market value would be recognized as part of "Realized gain on sale of investments" in the consolidated statement of income during the year.

Equity market risk

Economic trends, the political environment and other factors can positively and adversely impact the equity markets and consequently the value of equity investments the Company holds. The Company's AFS portfolio includes Canadian stocks with fair values that move as a result of market pressures as reflected in the Toronto Stock Exchange Composite Index, and foreign index stocks that move with the Standard & Poor's 500 Index. As the Canadian and foreign stocks are all classified as AFS investments, a 10% change in value of these stock markets indices, with all other variables held constant, would have an estimated effect on the fair values of the Company's Canadian and foreign stocks and OCI of \$54.1 million (2007: \$71.6 million) to the extent the Company did not dispose of the stocks during the year. For stocks that the Company sold during the year, the impact would be recognized as part of "Realized gain on sale of investments" in the consolidated statement of income during the year.

Credit risk

Credit risk is the risk of financial loss as the result of the Company's counterparties not being able to meet payment obligations as they become due. The Company's credit risk is concentrated in the bond, preferred stock and commercial loan portfolios, the securities lending program, premiums receivable and amounts owing from reinsurers. Unless otherwise stated, the Company's credit exposure is limited to the carrying amount of these assets.

The Company's Investment Policy Statement requires the Company to invest in bonds and preferred stocks of high credit quality and to limit exposure with respect to any one issuer. No more than 10% of the market value of the bond portfolio may be in any one issuer, except for Federal or Provincial issuers, and at least 95% of the bonds in the portfolio must have a credit rating of at least an "A-" or higher by independent rating agencies at the time of purchase. For preferred stocks, no single issue can represent more than 25% of the preferred stock portfolio and at least 90% of the preferred stocks must be rated "P2" or higher by independent rating agencies at the time of purchase. "A-" and "P2" represent the ratings provided by two recognized rating services for high-grade bonds and preferred stocks, respectively, where both asset and earnings protection are well assured. On a regular basis, the Company also monitors publicly available information referencing the investments held in the investment portfolio to determine whether there are investments which require closer monitoring of the credit risk. Of the bonds held at December 31, 99.5% (2007: 100.0%) were rated "A-" or better and 98.5% (2007: 98.0%) of the preferred stocks were rated "P2" or better. Of the corporate bonds held, 92.4% (2007: 91.7%) are concentrated in the financial services industry and 7.6% (2007: 8.3%) in other industries.

The Company holds bonds issued by entities that have received financial assistance or have been subject to restructuring to deal with the global liquidity crisis. These bonds were reviewed as part of the AFS financial instrument impairment review. As a result of the AFS financial instrument impairment review, the Company reclassified impairment losses of \$13.5 million (2007: nil) associated with these bonds.

As disclosed in note 5, the Company participates in a securities lending program. The Company minimizes credit risk associated with this program by only dealing with counterparties who are Canadian financial institutions rated "A-" or above by independent rating agencies and by obtaining collateral with a fair value

in excess of the value of the securities loaned under the program. While there have been no issues related to credit risk under the securities lending program during the year, the Company has made the decision to suspend participation in this program to further reduce credit risk.

With respect to credit default swaps, the Company evaluates and monitors the credit risk of its credit default swaps by regularly reviewing the credit ratings of both the counterparty and the debt underlying the credit default swaps. The maximum credit exposure and the credit ratings of both the counterparty and the underlying debt related to the credit default swaps are disclosed in note 5.

The Company's credit exposure to any one individual policyholder included in premiums receivable is not material. The Company's broker appointment process ensures a full financial review of each brokerage before they are granted a contract. This review includes an assessment of the ability of the brokerage to meet payment obligations as they become due. Periodic broker reviews are conducted to ensure continued profitability and solvency. The allowance for doubtful accounts is immaterial as delinquent accounts are regularly monitored and the Company takes action against non-payment.

The Company periodically lends amounts to brokers in order to finance the growth of their business. Sufficient collateral, in the form of an assignment over the ownership interest in the brokerage, is held to protect the Company against default on these loans. Annual financial reviews are undertaken to determine if the broker will be able to make the required payments when due. The Company's gross credit exposure on these loans is limited to the carrying value of commercial loans as disclosed in note 5. As disclosed in note 5, there is no evidence of impairment of any individual commercial loan.

The Company is exposed to credit risk with respect to the amounts ceded to its reinsurers. With the assistance of a reinsurance broker, the Company regularly assesses the financial soundness of the reinsurers it deals with, including but not limited, to the monitoring of credit ratings of its reinsurers. All reinsurers have a credit rating of "A-" or better as determined by independent rating agencies. Allowance for losses on reinsurance receivable and recoverable is established when a reinsurance counterparty may become unable or unwilling to fulfill its contractual obligations. The allowance for loss is based on current receivables and ceded claim liabilities. There has been no material provision in 2008 or 2007 related to the credit worthiness of reinsurers.

The Company has purchased annuities from life insurers to provide for fixed and recurring payments to claimants. As a result of these arrangements, the Company is exposed to credit risk to the extent to which any of the life insurers fail to fulfill their obligations. This risk is managed by acquiring annuities from life insurers with proven financial stability, all of which are rated "A" or better by independent rating agencies. As at December 31, no information has come to the Company's attention that would suggest any weakness or failure in life insurers from which it has purchased annuities. Consequently, no provision for credit risk is required. An approximate measure of the maximum credit risk exposure is the original purchase price of the annuities of \$184.3 million (2007: \$162.6 million).

Foreign exchange risk

Foreign exchange risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Company's foreign exchange risk relates primarily to its foreign common stock holdings in the AFS portfolio denominated in United States dollars as well as its net investment in foreign-based insurance operations.

A 1% increase in the value of the United States dollar relative to the Canadian dollar would decrease the fair value of the foreign common stock holdings on the consolidated balance sheet and OCI by \$1.1 million (2007: \$1.5 million). Similarly, a 1% decrease in the value of the United States dollar relative to the Canadian dollar would have a corresponding increase in the fair value of the foreign common stock holdings on the consolidated balance sheet and OCI. A 1% change in the value of the United States dollar, relative to the Canadian dollar, would have a negligible impact on the net investment in foreign-based insurance operations and net income. The exchange gain on the net investment in foreign-based insurance operations was \$1.9 million for the year (2007: \$3.1 million loss).

Liquidity risk

Liquidity risk is the risk of having insufficient cash resources to meet current financial obligations. Liquidity risk arises from the Company's general business activities and in the course of managing the assets and liabilities. The liquidity requirements of the Company's business are met primarily by funds generated by operations, asset maturities and investment returns. Cash provided from these sources normally exceeds cash requirements to meet claim payments and operating expenses.

As at December 31, the Company has \$103.0 million (2007: \$89.0 million) of cash and cash equivalents and short-term investments of nil (2007: \$36.1 million). The Company also has a highly liquid investment portfolio. As at December 31, Canadian fixed-income investments issued or guaranteed by domestic governments, investment-grade corporate bonds, and publicly traded Canadian and foreign equities have a fair value of \$3.1 billion (2007: \$3.1 billion).

The Company believes that it has the flexibility to obtain, from internal sources, the funds needed to meet cash and regulatory requirements on an ongoing basis.

7. Policy Liabilities

These consolidated financial statements contain an actuarial estimate of the policy liabilities of the Company. Policy liabilities represent the amount of the obligation of the Company on account of policies effective on or before December 31, and consist of premium and claim liabilities.

(a) Premium liabilities

Premium liabilities are represented by the amount of net unearned premiums less the amount of net deferred policy acquisition expenses. Generally, the commissions and premium taxes corresponding to the net unearned premiums are deferrable; however, this amount is written down if the resulting expected future net policy costs are greater than the net unearned premiums. No write-down to deferred policy acquisition expenses is required for the year ended December 31 (2007: nil).

(b) Claim liabilities

Determining the provision for unpaid claims, adjustment expenses and the related reinsurers' share involves an assessment of the future development of claims. The process takes into account the consistency of the Company's claim handling procedures, the amount of information available, the characteristics of the line of business from which the claim arises, and the delays in reporting claims. The provision for unpaid claims and adjustment expenses includes estimates that are subject to variability, which could be material in the near term. Changes to the estimate could result from future events such as receiving additional claim information, changes in judicial interpretation of contracts or significant changes in severity or frequency of claims from past trends. In general, the longer the term required for the settlement of a group of claims, the more variable the estimate.

The estimates are principally based on the Company's historical experience. Methods of estimation have been used that the Company believes produce reasonable results given current information. As additional experience and other data become available, the estimates could be revised. Any future changes in estimates would be reflected in the consolidated statement of income in the year in which the change occurred.

The table on page 56 details the provision for unpaid claims and adjustment expenses by risk categories. Short settlement-term lines of business are those lines of business where claims are substantially paid within a year of being reported. Approximately two-thirds of the long settlement-term claim liabilities are expected to be paid within five years.

The Company must participate in industry-operated pools providing coverage for residual market automobile risks based on its automobile market share. The Company records its share of the claim liabilities provided by the actuaries of the pools.

Type of claim liability:

(in thousands of dollars)	2008			2007		
	Gross	Ceded	Net	Gross	Ceded	Net
Long settlement-term lines of business						
Automobile – bodily injury and accident benefits	\$ 1,580,234	\$ 40,638	\$ 1,539,596	\$ 1,389,222	\$ 46,714	\$ 1,342,508
General liability	352,946	26,073	326,873	327,695	28,758	298,937
	1,933,180	66,711	1,866,469	1,716,917	75,472	1,641,445
Short settlement-term lines of business						
Automobile	70,336	5,437	64,899	63,463	6,275	57,188
Property	230,330	23,020	207,310	181,796	19,517	162,279
	300,666	28,457	272,209	245,259	25,792	219,467
Facility Association and other residual pools	49,456	–	49,456	51,420	–	51,420
	\$ 2,283,302	\$ 95,168	\$ 2,188,134	\$ 2,013,596	\$ 101,264	\$ 1,912,332

(c) Reinsurance recoverable

The amounts relating to reinsurance ceded are shown in note 11. The reinsurance recoveries are evaluated in a manner consistent with the gross liabilities and the terms of the reinsurance contracts.

(d) Future investment income

Claim liabilities have been discounted to reflect future investment income in accordance with Canadian accepted actuarial practice.

The discount rate used to determine the actuarial value of claim liabilities is based on the fair value yield of the Company's HFT bond portfolio, which has been matched to the claim liabilities (see note 5). In assessing the risks associated with investment income, the Company considers the nature of the investment portfolio and the timing of claim payments and their matching to investment cash flows. Future changes in the HFT bond portfolio could change the value of these claim liabilities by impacting the fair value yield.

An interest rate sensitivity analysis demonstrating the impact on claim liabilities of a 1% change in interest rates as at December 31 for the next twelve-month period yields a result of \$60.6 million (2007: \$43.0 million).

(e) Incurred claims

The incurred claims in the consolidated statement of income and the changes in claim liabilities recorded in the consolidated balance sheet have developed as follows:

(in thousands of dollars)	2008	2007
Unpaid claim liabilities at the beginning of the year (net)	\$ 1,912,332	\$ 1,778,973
Adjustment for discount rate change (note 2)	–	(7,585)
Change in estimated losses and expenses for claims occurring in prior years	(1,087)	(42,277)
Losses and expenses on claims occurring in the current year	1,503,036	1,307,847
Paid on claims occurring during:		
Current year	(693,217)	(652,301)
Prior years	(532,930)	(472,325)
Unpaid claim liabilities at the end of the year (net)	\$ 2,188,134	\$ 1,912,332

(f) Canadian accepted actuarial practice

Under Canadian accepted actuarial practice, the appropriate amount representing future obligations is defined as policy liabilities, which take into consideration the time value of money and include a provision for adverse deviation. OSFI requires valuation of policy liabilities on this basis.

The basic assumptions made in establishing policy liabilities are best estimates. To allow for possible deterioration in experience, and to increase the likelihood that the policy liabilities are adequate to pay future benefits, actuaries are required to include margins in some assumptions. A range of allowable margins is prescribed by the Canadian Institute of Actuaries relating to claim development, reinsurance recoveries and investment income variables. The effect of the margins produces the provision for adverse deviation.

The fair value of claim liabilities is calculated using the same margins for adverse deviation, discounting the expected cash flows at the fair value rate of return on the HFT bond portfolio. The impact of the time value of money in the table below is calculated using the fair value yield.

The following table details the amounts:

(in thousands of dollars)	2008	2007
Undiscounted claim liabilities	\$ 2,155,168	\$ 1,932,967
Impact of the time value of money	(144,314)	(174,503)
Provision for adverse deviation	177,280	153,868
Fair value of net claim liabilities	\$ 2,188,134	\$ 1,912,332

8. Rate Regulation

In common with the insurance industry in general, the Company is subject to regulation in certain jurisdictions whereby rates charged to customers for certain automobile insurance policies must be approved by the applicable regulatory body. This type of business comprises 51.7% of the Company's total direct premiums written during the year (2007: 52.7%).

The following table outlines the jurisdictions, regulatory authorities and regulatory processes that the Company is subject to:

Jurisdiction	Regulatory authority	Regulatory process
Alberta	Alberta Automobile Insurance Rate Board	File and use rate regulation for physical damage coverages and prior approval rate regulation for mandatory coverages on individually rated vehicles.
Newfoundland and Labrador	Public Utilities Board	File and use rate regulation for instances where there is no increase in rate for any coverage for any insured; any filing not meeting these requirements will be subject to prior approval rate regulation.
New Brunswick	New Brunswick Insurance Board	Prior approval rate regulation on individually rated vehicles.
Nova Scotia	Nova Scotia Utility and Review Board	File and use rate regulation for instances where the overall impact is a decrease and no insured will receive a rate increase of more than +2% per annum; any filing not meeting these requirements will be subject to prior approval rate regulation.
Ontario	Financial Services Commission of Ontario	File and use rate regulation on individually rated miscellaneous and commercial vehicles and prior approval rate regulation on individually rated private passenger vehicles.
Prince Edward Island	Island Regulatory and Appeals Commission	File and use rate regulation on individually rated vehicles.
Québec	Autorité des Marchés Financiers	Use and file rate regulation on private passenger, miscellaneous and commercial vehicles.

9. Property and Equipment

(in thousands of dollars)	2008			2007		
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Buildings	\$ 35,770	\$ 15,031	\$ 20,739	\$ 35,939	\$ 13,810	\$ 22,129
Furniture and equipment	18,294	13,822	4,472	17,793	12,790	5,003
Computer equipment	8,443	7,293	1,150	5,087	3,709	1,378
Software	56,920	35,262	21,658	47,232	31,070	16,162
	119,427	71,408	48,019	106,051	61,379	44,672
Land	1,247	–	1,247	1,249	–	1,249
	\$ 120,674	\$ 71,408	\$ 49,266	\$ 107,300	\$ 61,379	\$ 45,921

Depreciation charged to operating expenses amounted to \$6.2 million (2007: \$4.9 million). Included in software is \$5.3 million (2007: \$9.8 million) that has not yet commenced being depreciated as it is still under development.

10. Goodwill and Intangible Assets

Intangible assets with a net book value of \$2.0 million (net of accumulated amortization of \$1.2 million) are included in "Other assets" (2007: \$8.2 million, net of accumulated amortization of \$4.0 million).

Annual impairment testing of goodwill and intangible assets determined that due to the economic slowdown, the cash flows generated by a wholly-owned subsidiary of the Company would decline for an unforeseeable length of time. Under the discounted cash flow model, the change in expected cash flows resulted in the subsidiary incurring an impairment of goodwill and intangible assets of \$5.0 million (2007: nil) and \$3.9 million (2007: nil) respectively as at December 31. These amounts are included in the consolidated statement of income in "Other expense".

11. Reinsurance

The Company follows the policy of underwriting and reinsuring contracts of insurance which, in the main, limits the liability of the Company to varying amounts up to a maximum on any one loss of \$1.0 million (2007: \$1.0 million) in the event of a property claim, and an amount of \$2.5 million (2007: \$2.5 million) in the event of a liability claim. In addition, the Company has obtained reinsurance having an upper amount of \$900.0 million (2007: \$700.0 million), which limits the Company's net retention to \$20.0 million (2007: \$20.0 million) in the event of a series of claims arising out of a single occurrence.

In conjunction with the Company's reinsurance program, the Company has assumed a portion of business from third parties.

The following amounts relate to reinsurance ceded and assumed recorded on a net basis in the consolidated financial statements:

(in thousands of dollars)	2008	2007
Reinsurance assumed		
Assumed premiums written	\$ 17,861	\$ 16,310
Premiums earned	\$ 17,255	\$ 17,911
Claims and adjustment expenses	\$ 14,845	\$ 10,429
Reinsurance ceded		
Ceded premiums written	\$ 76,962	\$ 73,137
Premiums earned	\$ 77,345	\$ 82,224
Claims and adjustment expenses	\$ 18,190	\$ 28,767
Reinsurance receivable	\$ 16,703	\$ 18,166

12. Related Party Transactions

From time to time, the Company enters into transactions in the normal course of business, which are measured at the exchanged amounts, with certain directors, senior officers and companies with which it is related. Management has established procedures to review and approve transactions with related parties and reports annually to the Corporate Governance and Conduct Review Committee of the Board of Directors, on the procedures followed and the results of the review.

At December 31, commercial loans of \$22.3 million (2007: nil) are due from companies subject to significant influence. The loans are included in "Investments" and are initially measured at exchanged amounts. The loans are subsequently measured in accordance with the accounting policy for loans and receivables (note 1).

13. Employee Future Benefits

The Company provides certain pension and other future employee benefits through defined benefit, defined contribution and other post-retirement benefit plans to eligible participants upon retirement. The contributory defined benefit pension plans provide pension benefits based on length of service and final average pensionable earnings. The most recent actuarial valuation was prepared as of January 1, 2006.

Information about the Company's benefit plans, in aggregate, is as follows:

(in thousands of dollars)	Pension plans		Other benefit plans	
	2008	2007	2008	2007
Accrued benefit obligation	\$ (109,983)	\$ (139,842)	\$ (27,745)	\$ (34,043)
Fair value of plan assets	131,361	146,835	–	–
Plan surplus (deficit)	\$ 21,378	\$ 6,993	\$ (27,745)	\$ (34,043)
Funded status				
Plan surplus (deficit)	\$ 21,378	\$ 6,993	\$ (27,745)	\$ (34,043)
Unamortized actuarial (gain) loss	27,697	39,999	(6,332)	3,385
Unamortized transitional asset	(5,007)	(5,786)	–	–
Unamortized past service cost	–	–	(1,359)	(1,529)
Accrued benefit asset (liability)	\$ 44,068	\$ 41,206	\$ (35,436)	\$ (32,187)
Actuarial assumptions				
Discount rate	7.3%	5.5%	7.3%	5.5%
Expected long-term return on plan assets	6.8%	7.5%	–	–
Rate of compensation increase	3.5%	4.0%	–	–
Health care cost increase	–	–	7.5%	8.0%
Average remaining service life of employees (in years)	12	13	19	19

(in thousands of dollars)	Pension plans		Other benefit plans	
	2008	2007	2008	2007
Employer contributions	\$ 6,184	\$ 5,101	\$ –	\$ –
Employee contributions	578	584	–	–
Benefits paid	4,608	4,554	578	620
Net expense for benefit plans	\$ 3,322	\$ 4,755	\$ 3,827	\$ 3,754

Pension plan assets:

The table below shows the allocation of defined benefit pension plan assets as at December 31:

	% of Plan assets	
	2008	2007
Cash	1.0%	4.3%
Fixed income securities		
Canadian	38.8	29.1
Foreign	7.9	7.1
Equity securities		
Canadian	26.4	32.2
Foreign	25.5	26.9
Other	0.4	0.4
	100.0%	100.0%

Under the defined contribution plan, the Company contributes a fixed percentage of employees' pensionable earnings to the plan. Contributions under the defined contribution pension plan totalled \$7.2 million (2007: \$6.7 million).

14. Commitments

The Company has the following obligations under long-term non-cancellable leases for automobiles, buildings and equipment:

	Year		
		2009	\$
	2010	\$	11.3 million
	2011	\$	7.8 million
	2012	\$	6.0 million
	2013	\$	5.3 million
	thereafter	\$	17.3 million

15. Contingent Losses

In common with the insurance industry in general, the Company is subject to litigation arising in the normal course of conducting its insurance business. The Company is of the opinion that this litigation will not have a significant effect on the financial position, results of operations, or cash flows of the Company.

16. Other Comprehensive Income (Loss)

OCI, as presented in the consolidated statement of comprehensive income, is composed of the following items:

(in thousands of dollars)	2008	2007
Net unrealized losses during the year on AFS investments, net of income tax recovery of \$75,616 (2007: \$8,931)	\$ (144,611)	\$ (19,671)
Less:		
Net realized gains on sale of AFS investments reclassified to net income during the year, net of income tax expense of \$5,348 (2007: \$16,945)	9,983	31,381
Impairment loss on AFS investments reclassified to net income during the year, net of income tax recovery of \$43,670 (2007: nil)	(80,285)	–
Other comprehensive income (loss)	\$ (74,309)	\$ (51,052)

17. Capital Management

Management develops the capital strategy for the Company and oversees the capital management processes. As a federally regulated property and casualty insurance company, the Company's capital position is monitored by OSFI. OSFI evaluates the Company's financial strength through the Minimum Capital Test ("MCT"), which measures available capital against required risk-weighted capital. Available capital comprises total policyholders' surplus plus or minus adjustments prescribed by OSFI. Capital required is calculated by applying risk factors to the assets and liabilities of the Company. As at December 31, the Company's available capital exceeded the minimum capital of 150% required by OSFI.

Management actively monitors the MCT and the effect that external and internal actions have on the capital base of the Company. In particular, management determines the effect on capital before entering into any significant transactions to ensure that policyholders are not put at risk through the depletion of capital to unacceptable levels. The Board of Directors reviews the MCT on a quarterly basis.

Reinsurance is also used to protect the Company's capital level from large losses, including those of a catastrophic nature, which could have a detrimental impact on capital. The Company has adopted policies that specify tolerance for financial risk retention. Once the retention limits are reached, reinsurance is utilized to cover the excess risk.

On an annual basis, the Company performs Dynamic Capital Adequacy Testing on the MCT to ensure that the Company has sufficient capital to withstand a number of significant adverse scenarios.

Unaudited Comparative Financial Information (Consolidated)

(in millions of dollars)	2008		2007		2006		2005	
Gross premiums written	\$	1,939.7	\$	1,906.1	\$	1,921.0	\$	1,778.0
Net premiums written	\$	1,862.7	\$	1,833.0	\$	1,839.7	\$	1,703.4
Net premiums earned	\$	1,844.8	\$	1,829.6	\$	1,767.6	\$	1,665.6
Claims and adjustment expenses		1,501.9		1,265.6		1,218.1		1,070.8
Other underwriting expenses		553.3		560.6		543.2		510.2
Total underwriting expenses		2,055.2		1,826.2		1,761.3		1,581.0
Underwriting profit (loss)		(210.4)		3.4		6.3		84.6
Interest and dividend income		136.4		130.3		109.9		91.9
Gain (loss) on investments		(52.7)		44.3		74.5		71.1
Total investment income		83.7		174.6		184.4		163.0
Other income (expenses)		(15.2)		(3.6)		3.9		9.3
Goodwill amortization expense		–		–		–		–
Income (loss) before income taxes		(141.9)		174.4		194.7		256.8
Income taxes provided (recovered)		(39.5)		56.8		64.7		84.7
Net income (loss)	\$	(102.4)	\$	117.6	\$	130.0	\$	172.1
Investments at carrying value	\$	3,153.4	\$	3,170.1	\$	2,950.5	\$	2,572.3
Policyholders' surplus	\$	1,079.0	\$	1,255.7	\$	1,151.6	\$	1,021.5
Total assets	\$	4,441.2	\$	4,341.2	\$	4,100.9	\$	3,645.6
Investments at market value	\$	3,151.8	\$	3,167.3	\$	2,999.8	\$	2,644.6

	2004	2003	2002	2001	2000	1999
\$	1,696.9	\$ 1,522.8	\$ 1,342.7	\$ 1,191.1	\$ 1,075.9	\$ 819.2
\$	1,639.6	\$ 1,449.6	\$ 1,235.1	\$ 1,101.6	\$ 943.1	\$ 776.6
\$	1,555.4	\$ 1,333.3	\$ 1,158.9	\$ 1,068.0	\$ 974.1	\$ 762.8
	941.8	965.4	876.7	855.3	787.2	548.5
	490.2	430.5	358.8	332.6	301.3	229.4
	1,432.0	1,395.9	1,235.5	1,187.9	1,088.5	777.9
	123.4	(62.6)	(76.6)	(119.9)	(114.4)	(15.1)
	82.1	81.2	80.0	86.3	90.3	85.6
	27.2	23.7	14.0	38.1	51.6	21.2
	109.3	104.9	94.0	124.4	141.9	106.8
	9.2	5.2	3.1	1.3	(3.4)	–
	–	–	–	4.2	4.2	–
	241.9	47.5	20.5	1.6	19.9	91.7
	80.1	12.6	(3.1)	(2.0)	0.3	27.7
\$	161.8	\$ 34.9	\$ 23.6	\$ 3.6	\$ 19.7	\$ 64.0
\$	2,234.4	\$ 1,859.4	\$ 1,688.5	\$ 1,506.3	\$ 1,436.5	\$ 1,315.4
\$	849.4	\$ 687.6	\$ 652.7	\$ 655.1	\$ 651.5	\$ 631.9
\$	3,292.1	\$ 2,869.4	\$ 2,564.3	\$ 2,397.2	\$ 2,280.2	\$ 1,869.7
\$	2,335.1	\$ 1,939.2	\$ 1,736.0	\$ 1,566.1	\$ 1,518.6	\$ 1,366.1

Board of Directors

Mary N . Bales (2,3,6)

A. Scott Carson (1,2,6)

Karen L. Gavan (1,5)

Gerald A . Hooper
(Chairman) (1,2,3,4,5,6)

David A . MacIntosh (4,5)

Charles M. W. Ormston (2,3,6)

Terry J . Reidel (1,3,6)

Brian J . Ruby (1,4,5)

Noel G . Walpole (4)

Committee

1. Audit
2. Corporate Governance and Conduct Review
3. Human Resources and Compensation
4. Investment
5. Pension
6. Selection

Honorary Directors

John S. Acheson

Douglas W. Brown

Ralph A. Forbes

Gordon A. Mackay

William D. McGregor

John H. Panabaker

Harold E . Seegmiller

Peter H. Sims

Senior Management Team

Noel Walpole, FCIP, ICD.D

President and Chief Executive Officer

Jorge Arruda, BComm

Senior Vice President, Operations

Yvan Aubin, BA, CA

Vice President, Finance and Controller

Dean Bulloch, MBA, CHRP

Vice President, Human Resources

Catherine Coulson, BA (Hons), FCIP

Vice President, Personal Insurance

David Crozier, BA (Hons), CIP, CRM

Vice President, Commercial Insurance

Louis Durocher, BSc, FCIA, FCAS, ASA

Vice President, Quebec Region

David Fitzpatrick, BA

Vice President, Sales and Distribution

Linda Goss, BSc (Hons), FCIA, FCAS

Senior Vice President and Chief Actuary

Katherine Kipper, BA, CHRP

Vice President, Marketing and Communications

Scott Lennox, BMath, ASA, FCAS, FCIA

Vice President, Pricing and Research and Development

Bill Lowe, BA, CIP

Vice President, Reinsurance

Rocco Neglia, BA (Hons), CIP

Vice President, Claims

Michael O'Neill, BA, MBA, CFA

Vice President, Investments

Colin Smith, BMath

Vice President and Chief Information Officer

William Stinson, BMath, FLMI

Vice President, Information Technology Operations

Sandeep Uppal, (Hons) BAdmin, CA, MBA

Senior Vice President and Chief Financial Officer

Chris Van Kooten, FCIA, FCAS

Vice President, Corporate Actuarial

Robert Gow, CCLA, CFE

Regional Vice President, Western Region

Walter Leszkowicz, BA, CIP

Regional Vice President, Ontario Region

Dan Spears, FCIP

Regional Vice President, Atlantic Region

Member Companies



Westmount Financial Inc.

