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## REPORT OF THE BOARD OF DIRECTORS OF ECONOMICAL MUTUAL INSURANCE COMPANY

In 2009 soft market conditions in the property and casualty insurance market persisted. This cyclical industry challenge was compounded by continuing deterioration of results in the Ontario automobile market.

The Economical Insurance Group® “The Group” continued to focus on long-term profitable growth, with an emphasis on ensuring competitiveness into the future. The Group took industry-leading corrective measures in 2009 to ensure member companies emerge from the global economic downturn with financial strength.

Specifically, The Group:

- reformed its approach to underwriting;
- continued to invest in broker relationship management technologies;
- implemented cost-containment measures in claims;
- increased rates across regions and lines of business;
- strategically retreated from unprofitable policies and segments, and;
- diversified, strengthened, and even further de-risked its investment portfolio.

Automobile claims in Ontario, compounded by the challenging regulatory environment in this province, generated a need for strict underwriting practices and reduction of risk exposure which has begun to improve that key product’s performance. With one of the industry’s largest books of Ontario automobile business, The Group has implemented measures to reduce exposure to this business over time. We anticipate that the Government of Ontario’s proposed reforms to automobile insurance regulations will improve this book’s performance.

Financial markets remained volatile last year. In spite of this challenging financial environment, The Group posted an \$84.9 million gain on securities sold during 2009 and remained focused on a conservative investment policy. Investment income continues to be uncertain as the equity market remains volatile and low interest rates reduce income from fixed income securities.

Declining interest rates negatively impacted The Group’s combined operating ratio due to the requirement to discount reserves. As interest rates begin their cyclical ascent applying higher interest rates has the effect of reducing the expense to The Group.

In addition to taking responsive measures, such as those employed within our Ontario automobile book of business and the further de-risking of our investment portfolio, The Group continued to stride forward with pro-active initiatives designed to facilitate sustainable and long-term profitable growth.

We deepened and broadened our commitment to the independent broker force throughout the year. The Group introduced innovative technology solutions designed to simplify brokers' interaction with The Group, mutually enhancing efficiency and partnership.

The Group's dedication to staff wellness, training and development has been not only appreciated by employees, but acknowledged throughout the industry. Training Magazine, the training industry's premier publication, recently named The Group to 19th position in its annual ranking of the world's top 125 organizations that excel in human capital development. The impressive performance of The Group's employees amidst challenging market conditions was a vital enabler of our achievements over the past year.

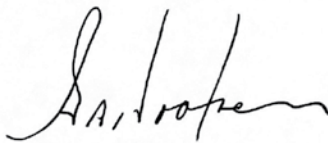
Industry analysis continues to indicate that The Group's decisive management of unfavourable market conditions in 2008-2009 has resulted in a relatively expeditious and positive emergence from the global economic downturn. Compared to similarly sized industry competitors in Canada, The Group is positioned competitively in advance of the hardening of the market.

With a strong balance sheet, assets of approximately \$4.6 billion and a surplus exceeding \$1.1 billion, The Group remains an exceptionally stable organization. Our investment portfolio, managed in the spirit of prudence, is valued at \$3.4 billion.

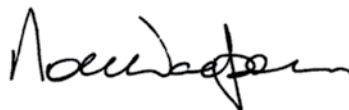
Our conservative approach to business continues to provide this organization with stability, strength and direction. Since 1871, The Group has been confronted with soft markets and deep recessions many times, and history dictates that the receding global recession and ebbing soft market will soon give way to more favourable business conditions.

The Group would like to take this opportunity to extend sincere thanks to our brokers for the support, advice, dedication and partnership they rendered in 2009.

Sincerely,



**Gerald A. Hooper**  
Chairman



**Noel G. Walpole**  
President and CEO

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Traditional in our roots, we are progressive in our approach. We are committed to ongoing growth through innovation, continually moving forward to deliver high quality insurance products and superior service.

# MANAGEMENT DISCUSSION AND ANALYSIS

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# MANAGEMENT DISCUSSION AND ANALYSIS

For the Year Ended December 31, 2009

## March 30, 2010

The following management discussion and analysis of The Group's financial condition and results of operations should be read in conjunction with the audited consolidated 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 when a group of concerned citizens banded together to help their neighbours during times of hardship and disaster. From these humble beginnings, 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 1.1 million policyholders exclusively through the independent broker network. The financial stability of The Group is clearly evident as it has assets of approximately \$4.6 billion and surplus exceeding \$1.1 billion.

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.

As the North American economy begins to stabilize after an unprecedented economic slowdown, it will be crucial to maintain focus on strategies that will allow The Group to emerge from the current economic climate in a stronger competitive position. Necessary rate increases are being implemented across all lines of business. The commitment to the independent broker force continues through the introduction of innovative technology solutions, making it easier for brokers to do business with The Group, while continuing to pro-actively manage profitability. The exposure to systemically unprofitable Ontario automobile business will decrease over time as improved diversification across Canada takes hold and the proportion of commercial business increases. In short, The Group maintains its desire to achieve rate adequacy by taking rate increases where necessary. This may result in a reduction of policies in force (PIF) if rate adequacy cannot be achieved. In order to achieve the goal of profitable growth, strategic and underwriting discipline must be maintained. This protects policyholders by ensuring a stable company with strong capital and financial strength.

In 2009, this strategy resulted in a PIF decline of 11.4%, but at the same time, average gross written premium per policy has increased 6.8%. This increase in premium per policy is quite consistent with industry trends; however, it was insufficient to keep pace with escalating claims costs, particularly evident in the continued escalation of Ontario personal automobile accident benefit costs. Gross written premiums declined 5.8% during the year from approximately \$1.9 billion in 2008 to \$1.8 billion in 2009. Underpinning this gross written premium is a surplus in excess of \$1.1 billion. This provides comfort to policyholders and regulators that financial stability has been maintained given the recent challenges posed by the industry and investment markets.

The Group has one of the largest Ontario automobile books of business in the industry and this continues to drive the combined ratio higher than that of our competitors. In addition to The Group taking action to reduce exposure to this business over time, the Ontario government announced a set of proposed changes to automobile insurance regulations that should temper the pace of increasing claims costs, while improving the options and price points for consumers. The Group is actively developing its plans to rapidly leverage the potential favourable elements of the proposed Ontario regulation to enable tighter management of claims costs and options on the structuring of coverages.

## Industry and Economic Analysis

Financial markets continued to be extremely volatile with both record lows and unprecedented recoveries. Although many economic indicators have improved in 2009, it is still expected to be a long road to recovery as the P&C insurance industry generally lags improvements in the financial markets. Claims costs have continued to rise and competition has continued to be intense as insurers vie to keep profitable business. Additionally, the low interest rate environment has placed significant pressure on the ability of P&C insurers to generate the investment returns that were typical in years past in similar economic recovery periods.

Given this backdrop of the current operating environment, as well as the outlook for 2010, there are some key factors that will impact The Group and the industry as a whole.

### Equity and Fixed Income Markets

In 2009, equity markets experienced a high level of volatility compared to recent times. While there was significant recovery for many investments, The Group prudently took an impairment charge of \$23.5 million (2008: \$124.0) on certain investments that have not recovered in value. However, The Group was able to realize capital gains of \$84.9 million on securities sold during the year.

There was unprecedented worldwide government spending during 2009, while simultaneously, government bond yields reached historical lows. As the economy began to recover in 2009 the bond credit spreads that had provided The Group with better returns in 2008 were significantly reduced.

These factors contributed to lower than expected returns in 2009. The Group has continued to review the risk of the investment portfolio and took action during the year to reduce its exposure to equity markets and increase investment in Government of Canada Bonds. The prospect of increasing interest rates towards the middle of 2010 will result in additional interest income, but it will also increase the volatility of the value of The Group's bond portfolio. Management continues to actively monitor The Group's investment portfolio and take action as required to maintain a conservative and high-quality portfolio. Additionally, the defined benefit pension plan has ended the year in a surplus position in both 2009 and 2008.

The decrease in market interest rates impacts the discounting of reserves and has had a negative impact on underwriting results in 2009. 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 \$32.9 million (2008: \$55.9) offset the discounting impact of \$32.4 million (2008: \$53.7).

### Regulatory Environment

The P&C industry is subject to the oversight of several regulatory bodies such as The Office of the Superintendent of Financial Institutions ("OSFI"), the Financial Services Commission of Ontario ("FSCO"), federal and provincial taxation authorities, and others, which have varying impacts on the results of The Group. There are a number of developments both positive and negative that have impacted The Group in 2009, as well as the P&C industry as a whole. Additionally, there continues to be active regulatory actions that will be closely monitored in 2010 and future years.

In December 2009, the Supreme Court of Canada declined to hear the appeal of the Minor Injury Cap in Alberta, bringing an end to the challenges to the cap in this province. The cap places an upper limit on the amount that insureds could claim for injuries that have been determined to be minor, in an effort to control the cost of these types of claims and keep insurance affordable. While a similar case in Nova Scotia may be appealed, the decision by the Supreme Court of Canada effectively brings an end to the Nova Scotia challenge as well. Notwithstanding this positive development, the Government of Nova Scotia is currently conducting a review of the Minor Injury Cap and changes may be forthcoming.

The Ontario and British Columbia governments announced in 2009 that they would be migrating to the HST effective July 2, 2010. Certain expenses that previously only attracted provincial sales tax or were tax exempt will now attract HST. This will have a significant impact on the industry as a whole. Although the change is not effective

until 2010, The Group is required to estimate the impact on existing claims that will attract HST that have not yet been closed and are not estimated to be closed prior to July 2, 2010. The Group has estimated this impact on the ending 2009 reserves to be approximately \$13.5 million. This increase in cost was not originally factored into the pricing of the affected insurance. The ongoing future annual cost of the HST will be significant, as it will affect all future claims.

The Ontario government recently proposed a set of automobile insurance regulation changes for accident benefits to come into effect in the fall of 2010. Ontario currently has the richest accident benefits program in the country and claims costs have risen at an alarming rate. While the detailed regulations are not yet finalized, The Group believes that the changes are positive. Although there are a number of points that need further clarification, the proposals appear to provide mechanisms to decrease the momentum of increasing claims costs, while at the same time, improve the level of affordability and choice for Ontario's consumers. The Group will respond rapidly to these regulatory changes to accelerate the return to profitability.

The Group also expects the regulatory framework to continue to evolve, which may well require insurers to maintain higher levels of capital and increase the extent of their risk management reporting to the regulators. Overall, regulators have growing expectations on how companies should be measuring and monitoring risk. The Group will continue to work effectively with regulators and aim to optimize the efficiency of regulatory compliance.

### Capital Requirements

Generally in the P&C insurance industry capital is needed to cover insurance risks and provide protection from exposure to credit and liquidity risks. Strict rules are determined by OSFI that provide the minimum amount of capital companies are required to maintain in order to provide for the protection of policyholders. The Group is well positioned in this regard, demonstrating a strong capital position and a regulatory capital position well in excess of OSFI's minimum capital requirement. The Group actively monitors its regulatory capital position, including performing stress testing on various negative scenarios and takes action where necessary. This has resulted in many actions undertaken by The Group in 2009, including de-risking the investment portfolio and managing unprofitable books of business. This has resulted in a strengthening of The Group's regulatory capital position in 2009.

While positive signs of the actions taken in 2009 are starting to be realized, the upcoming year will continue to present a variety of challenges for The Group and the entire P&C insurance industry. The outlook for 2010 remains cautious, but over the longer-term, management believes that The Group is well positioned to take advantage of improving macroeconomic fundamentals and return to underwriting profitability.

## 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.

The Group actively monitors its regulatory capital position, including performing stress testing on various negative scenarios and takes action where necessary.

<b>Policies in Force (PIF)</b>	The number of insurance policies for which the company is on risk at a specified date.
<b>Gross Written Premiums (GWP)</b>	The total premiums from the sale of insurance during a specified period.
<b>Net Premiums Written (NPW)</b>	GWP less the cost of reinsurance coverage.
<b>Net Premiums Earned</b>	The portion of NPW equal to the expired period of time an insurance policy is in effect.
<b>Claims Ratio</b>	Claims and adjustment expenses during a defined period, expressed as a percentage of net premiums earned for the same period.
<b>Expense Ratio</b>	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.
<b>Combined Ratio</b>	The sum of the claims ratio and the expense ratio.
<b>Underwriting Profit</b>	The difference between net premiums earned and the sum of claims and adjustment expenses, commissions, operating expenses and premium taxes.
<b>Return on Equity (ROE)</b>	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.
<b>Minimum Capital Test (MCT)</b>	A regulatory formula defined by OSFI that is a risk-based test of capital available relative to capital required.
<b>Net Risk Ratio (NRR)</b>	A regulatory test of financial leverage, defined as the ratio of net premiums written to policyholders' surplus.
<b>Provision for Adverse Deviation</b>	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

FIGURE 1 (in millions of dollars, except as otherwise noted)	Year ended December 31		
	2009	2008	Increase (Decrease)
Gross written premiums	1,826.3	1,939.7	(113.4)
Net premiums written	1,747.5	1,862.7	(115.2)
Net premiums earned	1,813.3	1,844.8	(31.5)
Claims and adjustment expenses	1,400.3	1,501.9	(101.6)
Other underwriting expenses	556.8	553.3	3.5
<i>Underwriting loss</i>	<i>(143.9)</i>	<i>(210.4)</i>	<i>66.5</i>
Interest and dividend income	125.2	136.5	(11.3)
Realized gain on sale of investments	84.9	27.9	57.0
Impairment loss on available for sale investments	(23.5)	(124.0)	100.5
Unrealized (losses) / gains on investments held for trading	(20.9)	43.3	(64.2)
Other expenses	(2.0)	(15.2)	13.2
<i>Net income (loss) before income taxes</i>	<i>19.8</i>	<i>(141.9)</i>	<i>161.7</i>
Income tax recovery	4.3	39.5	(35.2)
Net income (loss)	24.1	(102.4)	126.5
Claims ratio	77.2%	81.5%	(4.3%)
Expense ratio	30.7%	29.9%	0.8%
Combined ratio	107.9%	111.4%	(3.5%)
Return on equity	2.0%	(8.4%)	10.4%
Policies in force <i>(in thousands)</i>	1,188.0	1,341.5	(153.5)

In 2009, gross written premiums decreased by 5.8% while PIF declined by 11.4%. The Group continues to navigate the insurance cycle by seeking appropriate rate increases across all lines, managing underperforming books of business and decreasing exposure to currently unprofitable Ontario personal automobile insurance. As a result of these efforts, average gross written premium per policy has increased 6.8% year over year.

The decline in PIF was primarily attributable to a 16.5% reduction in Ontario personal automobile business, which occurred as a result of The Group's effort to address the unprofitable position on this line of business. Aggressive competition across all lines of business in the Quebec Region resulted in a 12.7% decrease in gross written premiums and a 19.7% decrease in PIF, as The Group did not want to accept premiums at unprofitable levels.

Gross written premiums were consistent year over year in the Atlantic Region while they suffered a 5.3% reduction in PIF due to strong competition in all lines of business.

Claims and claims adjustment expenses have decreased by 6.8% year over year while the claims ratio has decreased to 77.2% (2008: 81.5%). Rate increases and more favourable frequency drove the improvements in Ontario and Quebec personal property lines. The results of Ontario personal automobile business continued to deteriorate, as rate increases lag behind the accelerating costs for personal injury claims. The recent Supreme Court of Canada decision not to hear appeals related to Minor Injury Caps in Alberta led to an improvement in the claims ratio for personal automobile in that province.

The Group still faces many challenges to contain claims and adjustment expenses. The severity of claims increased year over year by 10.7% due to the increasing cost pressure from injury claims relating to Ontario personal automobile business.

Catastrophic losses continue to outpace historical norms at \$55.1 million in losses for the year (2008: \$58.1). Finally, the impact of discounting claims reserves at the market interest rate was once again significant in 2009. 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 1.8% in 2009 (2008: 2.9%) as this discounting charge flows through the claims costs. From a bottom-line standpoint, the impact of discounting was offset by prudent asset-liability matching activities.

As discussed earlier, challenges with respect to claims costs, particularly those related to increased severity of Ontario personal automobile claims and discounting charges, led to another underwriting loss for the year. However, the improved health of investment markets allowed The Group to post significant realized gains on sales of investments

## Claims and Adjustment Expenses

**FIGURE 2**

(In millions of dollars, except as otherwise noted)

	Year ended December 31		Increase (Decrease)
	2009	2008	
<b>NET INCURRED LOSSES:</b>			
Current year claims	1,444.2	1,503.0	(58.8)
Prior year claims development ( <i>favourable</i> )	(43.9)	(1.1)	(42.8)
<b>TOTAL</b>	<b>1,400.3</b>	<b>1,501.9</b>	<b>(101.6)</b>

Claims and claims adjustment expenses have decreased by 6.8% year over year while the claims ratio has decreased to 77.2%.

offset by a charge for the impairment of certain assets. The net result is that The Group posted net income of \$24.1 million in 2009 compared to a net loss of \$102.4 million in 2008.

Claims and claims adjustment expenses have decreased by 6.8% year over year while the claims ratio has decreased to 77.2% (2008: 81.5%). The cause of this decline is noted in the discussion related to Figure 1.

While claims and claims adjustment expenses have decreased compared to 2008, they remain well above the level that would allow for The Group to produce an underwriting profit. The severity of claims increased 10.7% year over year. The main driver of the increased severity of claims was Ontario personal automobile claims, particularly

accident benefit claims in the Greater Toronto Area. On average the claims costs for Ontario personal automobile claims have increased by 16.8% in 2009 over 2008 and by 28.9% over 2007. This dramatic increase is not unique to The Group but is an industry issue. As The Group continues to decrease its relative exposure to this business, the rate of increase in the overall severity of claims should improve but will not return to normal levels until reforms are realized for Ontario accident benefits claims. Additionally, catastrophic losses continue to exceed historical norms with \$55.1 million in losses for the year (2008: \$58.1). The impact of discounting claims reserves at the market interest rate was once again significant in 2009. As noted in the discussion related to Figure 1, the decrease in interest rates had the impact of increasing the combined ratio by 1.8% in 2009 (2008: 2.9%). From a bottom-line standpoint, the impact of discounting was offset by prudent asset-liability matching activities that created realized and unrealized capital gains in the investment portfolio of offsetting amounts.

Additional detail is provided in Figure 8.

### Other Underwriting Expenses

**FIGURE 3**

(in millions of dollars, except as otherwise noted)

	Year ended December 31		Increase (Decrease)
	2009	2008	
Commissions	348.8	346.1	2.7
Operating expenses	145.3	143.9	1.4
Premium taxes	62.7	63.3	(0.6)
<b>TOTAL</b>	<b>556.8</b>	<b>553.3</b>	<b>3.5</b>

Commissions have increased slightly due to the improving underwriting results of The Group in 2009 as well as a shift in business mix towards more

commercial business. Expenses and premium taxes have remained consistent with the prior year.

### Interest and Dividend Income

**FIGURE 4**  
(in millions of dollars, except as otherwise noted)

	Year ended December 31		Increase (Decrease)
	2009	2008	
Interest income	99.8	111.5	(11.7)
Dividend income	25.4	25.0	0.4
<b>TOTAL</b>	<b>125.2</b>	<b>136.5</b>	<b>(11.3)</b>

Interest income is mainly derived from the bond portfolio. The decrease in interest income reflects the lower interest rate environment experienced during 2009, as well as a higher concentration

in Government bonds rather than higher-yielding corporate bonds. Dividend income was comparable to the prior year.

### Realized Gains on Sale of Investments

**FIGURE 5**  
(in millions of dollars, except as otherwise noted)

	Year ended December 31		Increase (Decrease)
	2009	2008	
Realized gain on sale of bonds	60.6	17.5	43.1
Realized gain on sale of equities	24.3	10.4	13.9
Impairment gain (loss) on available for sale bonds	2.4	(13.5)	15.9
Impairment loss on available for sale equities	(25.9)	(110.5)	84.6
Unrealized (losses) gains on bonds held for trading	(20.9)	43.3	(64.2)
<b>TOTAL</b>	<b>40.5</b>	<b>(52.8)</b>	<b>93.3</b>

Realized gains increased significantly in 2009 due to the improved performance in equity markets and increased bond trading activity as The Group worked to de-risk the investment portfolio given the uncertain times. Management took the opportunity to capitalize on the recent strength in equity markets and take profits and trim positions where appropriate. The market value of the bond portfolio compared to book value improved greatly in 2009 as a result of declining interest rates and The Group was able to realize significant gains.

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. For 2009, \$20.9 million of unrealized losses (2008: \$43.3 million unrealized gains) on the HFT bond portfolio were included in investment income. The significant change was a result of the strategy to extend the HFT portfolio's duration to more closely match the duration of The Group's claims liabilities.

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.

Despite the improvement in investment markets, certain positions have not recovered in value requiring The Group to take a further impairment loss during the year of \$23.5 million (2008: \$124.0). Certain of the securities impaired in 2008 recovered in value by \$40.3 million resulting in \$22.2 million of realized gains and \$18.1 million of unrealized gains for The Group in 2009. For more

information, please refer to the 'Impairment and Valuation of Invested Assets' discussion.

#### Provision for Income Taxes

The Group has an income tax recovery due to a reduction of future income tax associated with new tax rules enacted into law in 2009.

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

#### Net Income

The Group achieved net income of \$24.1 million in 2009 compared to a loss of \$102.4 million in 2008. The Group has taken several measures including tightening the approach in underwriting and implementing focused cost containment measures to improve profitability. The Group has also increased rates across most regions and all lines of business and reduced its exposure to unprofitable policies and segments. From an investment standpoint, The Group has taken a more conservative approach on its portfolio, while at the same time, benefiting from the stronger investment markets in 2009.

#### Return on Equity

The Group achieved a 2.0% return on equity in 2009 despite the continuing challenging operating environment; this compared to a negative 8.4% return on equity experienced in 2008. As has been noted, The Group took concerted action to change its exposure to risk across all aspects of its operations and this has resulted in the \$24.1 million net income achieved in 2009. The Group has continued to increase its policyholders' surplus, ending the year close to the record high levels of 2007 with a balance of almost \$1.2 billion.

## Key Performance Indicators

**FIGURE 6**

(in millions of dollars, except as otherwise noted)

	Year ended December 31				
	2009	2008	2007	2006	2005
Policies in force (thousands)	1,188.0	1,341.5	1,387.2	1,396.6	1,333.2
Gross written premiums	1,826.3	1,939.7	1,906.1	1,921.0	1,778.0
Claims ratio	77.2%	81.5%	69.2%	68.9%	64.3%
Expense ratio	30.7%	29.9%	30.6%	30.7%	30.6%
Combined ratio	107.9%	111.4%	99.8%	99.6%	94.9%
Underwriting (loss) profit	(143.9)	(210.4)	3.4	6.3	84.6
Net (loss) income	24.1	(102.4)	117.6	130.0	172.1
Return on equity	2.0%	(8.4%)	9.7%	12.0%	18.4%
Investments at cost*	3,459.8	3,243.4	3,195.0	2,950.5	2,572.3
Investments at market value*	3,443.2	3,151.8	3,167.3	2,999.8	2,644.6
Operating surplus	1,191.5	1,167.4	1,269.8	1,151.6	1,021.5
Policyholders' surplus	1,170.7	1,079.0	1,255.7	1,151.6	1,021.5
Total assets	4,603.8	4,441.2	4,341.2	4,100.9	3,645.6

\* Does not include cash and cash equivalents

The Management Discussion and Analysis focuses on the changes from 2008 to 2009. The information above provides some insight to the movement in key performance indicators between 2005 and 2008.

The Group suffered a loss in 2008 compared to net income in 2007 as a result of many factors. A large underwriting loss transpired due to a substantial increase in claims frequency and severity relating to automobile claims, as well as a significant increase in weather-related catastrophic losses. There was also a \$124.0 million loss on impaired investments due to the unprecedented turmoil in financial markets.

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.

## Financial Strength

### Cash and Investments

**FIGURE 7**

(in millions of dollars, except as otherwise noted)	As at December 31, 2009			As at December 31, 2008		
	Cost*	Fair Value	% @ Fair Value	Cost*	Fair Value	% @ Fair Value
Cash and cash equivalents	125.3	125.3	3.5%	103.0	103.0	3.2%
Canadian short-term investments	40.0	40.0	1.1%	0.0	0.0	0.0%
Bonds						
Federal	1,601.2	1,596.1	44.7%	1,319.1	1,371.4	42.1%
Provincial	478.4	479.9	13.5%	298.7	306.1	9.4%
Corporate	781.8	789.0	22.1%	854.3	812.3	25.0%
	2,861.4	2,865.0	84.9%	2,472.1	2,489.8	79.7%
Canadian preferred stocks	163.9	163.9	4.6%	291.7	264.5	8.1%
Common stocks						
Canadian	172.8	178.2	5.0%	240.6	207.6	6.4%
Foreign	141.8	118.1	3.3%	160.7	113.5	3.5%
	478.5	460.2	12.9%	693.0	585.6	18.0%
Canadian income trusts	8.4	9.0	0.3%	9.9	9.5	0.3%
Canadian commercial loans	71.5	69.0	1.9%	68.4	66.9	2.0%
	3,585.1	3,568.5	100.0%	3,346.4	3,254.8	100.0%
Unrealized (losses)		(16.6)			(91.6)	

\* 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 Group took action in 2009 to transition the portfolio into a more conservative position in light of expected continued market volatility. At year-end, the fair value of cash and cash equivalents and short-term investments increased to \$165.3 million from \$103.0 million at the end of 2008. The Group continued its strategy to increase investments in both federal and provincial bonds as they provide a desirable risk and reward trade-off, while at the same time, reducing exposure to corporate bonds. The realignment of the bond portfolio allowed The Group to realize \$60.6 million in gains on bonds during 2009.

The Group's increased investment in the bond portfolio was partially funded by the disposition of over \$244.2 million in preferred and common equities during the course of the year. It is important to note that the improved equity markets allowed for \$24.3 million of realized gains to be taken in 2009. In addition, the market value deficit of the entire portfolio decreased by \$75.0 million during 2009.

The Group continued to monitor the credit ratings of the portfolio in order to maintain the high quality of investments. This resulted in 99.1% (2008: 99.5%) of The Group's bonds being rated "A-" or better and 100.0% (2008: 98.5%) of the preferred stocks being rated "P2" or better.

The Group continues to take a conservative approach to investment impairments. The Group has reviewed its portfolio to identify 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 while still maintaining a high-quality and diversified portfolio.

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

Development on prior years' claims for The Group's core lines of business continues to be strong on an undiscounted basis but the impact of discounting continued to affect the 2009 results.

### Unpaid Claims and Adjustment Expenses

Claim liabilities represent an estimate of the amount required to settle all outstanding and unreported claims incurred on or before year-end. 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 2009, 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 2.5% (2008: 3.0%).

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

**FIGURE 8**

(in millions of dollars, except as otherwise noted)

	Year ended December 31	
	2009	2008
Net unpaid claim liabilities at the beginning of the year	2,188.1	1,912.3
Change in estimated losses and expenses for claims occurring in prior years:		
Core lines of business	(57.6)	(42.0)
Industry pools	2.0	(1.7)
Impact of discounting	11.7	42.6
Losses and expenses on claims occurring in the current year	1,444.2	1,503.0
Paid on claims occurring during:		
Current year	(659.5)	(693.2)
Prior years	(663.3)	(532.9)
Net unpaid claim liabilities at the end of the year	2,265.6	2,188.1

Net unpaid claim liabilities rose 3.5% year over year. The primary causes included a 10.7% increase in claims severity, steadily increasing costs to settle personal automobile claims in Ontario and a provision of \$13.5 million for the anticipated impact of the HST. For more information regarding this impact, please refer to the 'Regulatory Environment' discussion in the 'Overview' section.

Development on prior years' claims for The Group's core lines of business continues to be strong on an undiscounted basis but the impact of discounting continued to affect the 2009 results.

For more information, please refer to Note 7 of the audited consolidated financial statements.

## Surplus

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

FIGURE 9 (in millions of dollars, except as otherwise noted)	Year ended December 31				
	2009	2008	2007	2006	2005
Operating Surplus	1,191.5	1,167.4	1,269.8	1,151.6	1,021.5
Accumulated other comprehensive loss	(20.8)	(88.4)	(14.1)	—	—
Policyholders' Surplus	1,170.7	1,079.0	1,255.7	1,151.6	1,021.5

The Group increased operating surplus due to the net income achieved in 2009. Operating surplus is over 16% higher than in 2005. Policyholders' surplus rose significantly due to a combination of

net income and healthier investment markets. Last year's large accumulated other comprehensive loss was a result of unprecedented turmoil in financial markets that led to significant unrealized losses.

## Minimum Capital Test

As a group of federally regulated P&C insurance companies, The Group's capital position is monitored by OSFI, who measures 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.

**FIGURE 10**

	Year ended December 31				
	2009	2008	2007	2006	2005
MCT	222.6%	200.2%	231.9%	220.6%	235.4%

The MCT has improved in 2009 due to a return to profitability and healthier investment markets. The Group has capital of \$343.8 million in excess of the 150% minimum required by OSFI and \$225.4 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 Net Risk Ratio (NRR). The NRR measures the financial leverage of The Group, expressing net written premiums for a 12-month period as a ratio of surplus. The OSFI guideline for NRR is 3:1 or less. The following table shows The Group's NRR for the past five years.

The MCT has improved in 2009 due to a return to profitability and healthier investment markets.

**FIGURE 11**

	Year ended December 31				
	2009	2008	2007	2006	2005
NRR	1.5	1.7	1.5	1.6	1.7

## 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 impact 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 notional amounts representing the entirety of the amount at risk represents less than 2.0% of The Group's total asset value.

The issuers of these obligations underlying the credit default swaps are rated "A-" or above by independent rating agencies. The default swaps are short term in nature and will all expire within the next 15 months. Although the swaps experienced a decrease in fair value in 2008 of \$3.6 million these have recovered by \$3.4 million in fair value in 2009. 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 related to 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 that 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 market decline in the 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 on any

impaired securities to the Investment Committee of the Board of Directors. Any impairment of these assets is written off against income in the period that such impairment becomes evident.

In 2009, The Group wrote down \$23.5 million (2008: \$124.0) of impaired securities.

### Goodwill

The establishment of goodwill and the continuing review of goodwill for possible impairment require management to make estimations and exercise judgement. Upon initial recognition of goodwill, The Group analyzes purchase price components of an acquisition and determines fair value 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 discounted cash flow models, a multiple of earnings, multiple of revenue or a multiple of book value approach. 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 its fair value, 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 related 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 the benefit obligation and the expense. The key assumptions are presented in Note 13 to the audited consolidated financial statements.

### **Future Accounting and Reporting Changes**

#### **Business Combinations, Consolidated Financial Statements, and Non-Controlling Interests**

In January 2009, the CICA issued three new accounting standards which are aligned with International Financial Reporting Standards (IFRS): Handbook Section 1582, Business Combinations, Section 1601, Consolidated Financial Statements and Section 1602, Non-controlling Interests.

For more information related to these Handbook Sections and the implications on the consolidated financial statements, please refer to Note 3 of the audited consolidated financial statements.

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

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 Group will first report under IFRS for the year-ended December 31, 2011, with 2010 comparative information restated and presented on a consistent basis.

The Group has established an IFRS project team to manage the transition to the new standards. The Audit Committee of the Board of Directors is being updated quarterly on the progress and results of the IFRS project. A detailed timetable has been prepared and the project is currently on schedule. To date, the team has analyzed the IFRS standards in effect for 2011 and identified accounting policy changes to be made. For more detail on how The Group plans to convert to IFRS, please refer to Note 3 of the audited consolidated financial statements.

## 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 most significant 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 price their products at rates that appear to be below the level to make a reasonable return in an effort to gain market share. In these instances, The Group may choose to adjust its 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 the desired 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 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 pre-determined schedule. This is 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 assumed. 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 the MCT ratio and the affect that external and internal actions have on its capital base. The Group determines the potential impact 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 the obligation to its policyholders. The Group is exposed to credit risk with respect to the amounts ceded to its reinsurers. With the assistance of a reinsurance broker, The Group regularly assesses the financial soundness of the reinsurers it deals with, including, but not limited to, the monitoring of reinsurers' credit ratings.

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. Falling 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 index holdings denominated in United States dollars as well as the net investment in foreign-based insurance operations.

More detail on the management of 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 and control self-assessments are performed

on all business units and functions. There is also on-going monitoring and follow-up on risks and controls through regular reporting from the Control and Risk Management Committee to the Audit Committee and the Corporate Governance and Conduct Review Committee.

Internal Audit conducts 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 refers to the impact of penalties, fines and restrictions on the ability to carry on business as a result of 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 in the future 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 that significant concerns are understood.





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## 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 judgment, 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 comprising 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  
Waterloo, Canada | February 19, 2010



**Sandeep Uppal**

Senior Vice President and  
Chief Financial Officer

## 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, 2009, 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 19, 2010

## 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, 2009 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, 2009 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

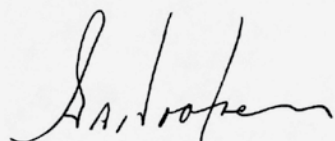
February 19, 2010.

## Consolidated Balance Sheet

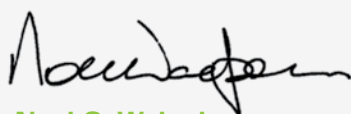
(in thousands of dollars)	As at December 31	
	2009	2008
<b>ASSETS</b>		
Cash and cash equivalents	\$ 125,294	\$ 102,956
Investments (note 5)	3,445,743	3,153,405
Premiums receivable	516,536	569,014
Accrued investment income	16,945	24,949
Income, premium and other taxes receivable	–	84,113
Reinsurance receivable and recoverable (notes 7 and 11)	122,862	111,871
Deferred policy acquisition expenses (note 7)	179,575	190,458
Property and equipment (notes 2 and 9)	29,004	27,608
Future income tax assets	28,168	44,432
Other assets	68,665	66,538
Goodwill and intangible assets (notes 2 and 10)	71,016	65,877
	\$ 4,603,808	\$ 4,441,221
<b>LIABILITIES AND POLICYHOLDERS' SURPLUS</b>		
Unearned premiums (note 7)	\$ 903,984	\$ 969,793
Provision for unpaid claims (note 7)	2,360,440	2,283,302
Accounts payable and other liabilities	120,216	109,118
Income, premium and other taxes payable	48,508	–
	3,433,148	3,362,213
<b>POLICYHOLDERS' SURPLUS</b>		
Operating surplus	1,191,460	1,167,393
Accumulated other comprehensive loss	(20,800)	(88,385)
Total policyholders' surplus	1,170,660	1,079,008
	\$ 4,603,808	\$ 4,441,221

See accompanying notes.

On behalf of the Board:



**Gerald A. Hooper**  
Director



**Noel G. Walpole**  
Director

## Consolidated Statement of Income

(in thousands of dollars)	For the Year Ended December 31	
	2009	2008
Gross premiums written (note 11)	\$ 1,826,333	\$ 1,939,673
Net premiums written (note 11)	\$ 1,747,468	\$ 1,862,711
Net premiums earned (note 11)	\$ 1,813,256	\$ 1,844,800
Underwriting expenses (notes 7 and 11):		
Claims and adjustment expenses	1,400,291	1,501,949
Commissions	348,830	346,058
Operating expenses	145,282	143,939
Premium taxes	62,710	63,285
	1,957,113	2,055,231
Underwriting loss	(143,857)	(210,431)
Investment income (note 5):		
Interest	99,752	111,405
Dividends	25,449	24,997
Realized gain on sale of investments	84,864	27,919
Impairment loss on available for sale investments	(23,496)	(123,955)
Unrealized gain (loss) on held for trading financial instruments	(20,894)	43,317
	165,675	83,683
Other expense	(2,004)	(15,150)
Income (loss) before income taxes	19,814	(141,898)
Income tax expense (recovery) (note 4)		
Current	(3,851)	(39,543)
Future	(402)	4
	(4,253)	(39,539)
Net income (loss)	\$ 24,067	\$ (102,359)

See accompanying notes.

## Consolidated Statement of Comprehensive Income

(in thousands of dollars)	For the Year Ended December 31	
	2009	2008
Net income (loss)	\$ 24,067	\$ (102,359)
Other comprehensive income (loss) (note 16)	67,585	(74,309)
Comprehensive income (loss)	\$ 91,652	\$ (176,668)

See accompanying notes.

## Consolidated Statement of Changes in Policyholders' Surplus

(in thousands of dollars)	For the Year Ended December 31					
	2009			2008		
	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	\$ 1,167,393	\$ (88,385)	\$ 1,079,008	\$ 1,269,752	\$ (14,076)	\$ 1,255,676
Net income (loss)	24,067	—	24,067	(102,359)	—	(102,359)
Other comprehensive income (loss)	—	67,585	67,585	—	(74,309)	(74,309)
Balance, end of the year	\$ 1,191,460	\$ (20,800)	\$ 1,170,660	\$ 1,167,393	\$ (88,385)	\$ 1,079,008

See accompanying notes.

## Consolidated Statement of Cash Flows

(in thousands of dollars)	For the Year Ended December 31	
	2009	2008
Operating activities:		
Receipts:		
Premiums collected	\$ 1,799,847	\$ 1,848,000
Investment income received	154,977	143,413
Income, premium and other taxes received	59,193	—
	2,014,017	1,991,413
Payments:		
Claims paid (note 7)	1,322,853	1,226,147
Expenses paid	487,204	503,755
Income, premium and other taxes paid	—	82,182
	1,810,057	1,812,084
Net cash provided by operating activities	203,960	179,329
Investing activities:		
Investments purchased	(3,518,678)	(2,478,778)
Investments sold, redeemed or matured	3,342,403	2,324,367
Other assets purchased	(10,712)	(7,284)
Business dispositions (acquisitions), net of cash	5,365	(3,687)
Net cash used in investing activities	(181,622)	(165,382)
Cash and cash equivalents:		
Net increase during the year	22,338	13,947
Balance, beginning of the year	102,956	89,009
Balance, end of the year	\$ 125,294	\$ 102,956
Cash	\$ 123,294	\$ 102,956
Cash equivalents	2,000	—
Total cash and cash equivalents	\$ 125,294	\$ 102,956
Income taxes paid	\$ —	\$ 18,742

See accompanying notes.

## Notes to the Consolidated Financial Statements

December 31, 2009

### | 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 reclassification of other financial instruments is not permitted 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 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, including indexed funds 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 "Accumulated other comprehensive income (loss)" ("AOCI") 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 preferred and common 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 AOCI to "Impairment loss on available for sale investments" in the consolidated statement of income in the year such criteria are met. Impairment losses on individual equities recognized in net income are not

reversed. Impairment losses recognized in prior periods on individual bonds are reversed through net income if the increase in fair value of the bond can be objectively related to an event occurring during the current year.

#### *Held for trading*

HFT financial assets 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 HFT 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 (loss) on held for trading financial instruments" in the consolidated statement of income with the related tax impact included in the current income tax line item.

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 classified as HFT and recorded at their fair value in the consolidated balance sheet in "Accounts payable and other liabilities". 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 in "Unrealized gain (loss) on held for trading financial instruments".

**(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 amortization, which is provided at rates sufficient to write off the costs over the estimated useful lives of the assets.

	<b>Basis</b>	<b>Rates</b>
Buildings	Declining balance	5%
Furniture and equipment	Declining balance	20%
Computer equipment	Straight-line	25%

**(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 CICA Handbook Section 3064 (Section 3064) - *Goodwill and Intangible Assets*, which requires goodwill impairment to be assessed at a reporting unit level. The Company has defined the reporting units to be the 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 are comprised of customer lists, brands and capitalized software costs where the software is not integral to the hardware on which it operates. Intangible assets that are determined to have a finite useful life are amortized on a systematic basis over the remaining useful life. Intangible assets that are determined to have an indefinite life are not amortized, but are tested at least annually for impairment. Intangible assets are carried at cost less accumulated amortization and accumulated impairment losses.

Costs that are directly attributable to the development and testing of identifiable and unique software products controlled by the Company are recognized as intangible assets when the criteria

specified in Section 3064 are met. Capitalized costs include employee costs for staff directly involved in software development and other direct expenditures related to the project. Other development expenditures that do not meet the capitalization criteria under Section 3064 are recognized as an expense as incurred.

The useful lives of the finite life intangible assets are as follows:

Software	7 – 20 years
Other intangible assets	7 years

During the year, the Company re-evaluated the estimated useful life of its computer software and determined that the maximum estimated useful life should be increased to twenty years from seven years based upon the demonstrated benefit of the software upon being placed into use by the Company. The impact of this change was applied on a prospective basis as this is a change in accounting estimate.

**(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 trustee 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 market-related value of the pension plan assets or accrued benefit obligation 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 operations 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. With the exception of amortization expense, revenues and expenses are translated at the rate at the transaction date, which is approximated by the weighted average rate prevailing during the year. Amortization expense is translated at the same historic rate as the related asset. The adjustments resulting from the translation of the balance sheets of the foreign operations 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) Goodwill and intangible assets

On January 1, 2009, the Company adopted Section 3064, replacing CICA Handbook Section 3062 (Section 3062) - *Goodwill and Other Intangible Assets*, and CICA Handbook Section 3450 (Section 3450) - *Research and Development Costs*. This standard introduces guidance for the recognition, measurement, presentation and disclosure of goodwill and intangible assets, including internally generated intangible assets. As a result of adopting Section 3064, the Company has reclassified the comparative balance of software with a net book value of \$21.7 million as at December 31, 2008 from "Property and equipment" to "Goodwill and intangible assets" on the Company's consolidated balance sheet. The accounting treatment for goodwill is unchanged from previous Section 3062.

### (b) Credit risk and the fair value of financial assets and financial liabilities

On January 1, 2009, the Company adopted EIC issued Abstract No. 173 ("EIC-173") - *Credit Risk and the Fair Value of Financial Assets and Financial Liabilities*. EIC-173 requires an entity to take into account its own credit risk and that of the relevant counterparties when determining the fair value of financial assets and financial liabilities, including derivative instruments. The impact of the new guidance is not material to the Company's consolidated financial position or results of operations.

### (c) Effective interest method and reversal of bond impairments

In 2009, the Company retroactively adopted amendments to Section 3855. These amendments provided a clarification with respect to the effective interest method. The effective interest method is a method of calculating the amortized cost of a financial asset or financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. These amendments also provide for the recovery through net income of bond impairment recognized in a prior period when the increase in the fair value of the individual bonds can be objectively related to an event occurring during the current year. There was no impact to the 2008 consolidated financial position or results of operations due to adopting these amendments.

### (d) Fair value and liquidity risk disclosure

In 2009, the Company adopted an amendment to CICA Handbook Section 3862 (Section 3862) - *Financial Instruments - Disclosures* that provides improvements to fair value and liquidity risk disclosures. The new disclosures are included in note 5. The amendment has not affected the Company's consolidated financial position or results of operations. Comparative information is not required in the year of adoption.

### | 3 | Future Accounting and Reporting Changes

#### (a) Business combinations, consolidated financial statements, and non-controlling interests

In January 2009, the CICA issued three new accounting standards which are aligned with International Financial Reporting Standards ("IFRS"): Handbook Section 1582 ("Section 1582") - *Business Combinations*, Section 1601 ("Section 1601") - *Consolidated Financial Statements* and Section 1602 ("Section 1602") - *Non-controlling Interests*. Section 1582 provides clarification as to what an acquirer must measure when it obtains control of a business, the basis of valuation and the date at which the valuation should be determined. Acquisition-related costs must be accounted for as expenses in the periods they are incurred, except for costs incurred to issue debt or share capital. This new standard will be applicable for acquisitions the Company completes on or after January 1, 2011, although adoption in 2010 is permitted to facilitate the transition to IFRS in 2011.

Section 1601 establishes standards for preparing consolidated financial statements after the acquisition date; Section 1602 establishes standards for the accounting and presentation of non-controlling interests. These new standards must be adopted concurrently with Section 1582.

#### (b) International Financial Reporting Standards

The Company will first report under IFRS for the year ended December 31, 2011, with 2010 comparative information restated and presented on a consistent basis.

The Company has established an IFRS project team to manage the transition to the new standards. The Audit Committee of the Board of Directors is being updated quarterly on the progress and results of the IFRS project. A detailed timetable has been prepared and the project is currently on schedule. To date, the team has analyzed the IFRS standards in effect for 2011 and identified accounting policy changes to be made.

Proposed changes to the IFRS accounting standards have the potential to introduce additional significant accounting differences. It is too early to comment on the impact of IFRS to the Company at transition, as it will depend on the IFRS standards in effect at the time, accounting elections that have not yet been made and the prevailing business and economic facts and circumstances.

#### | 4 | Income Tax Expense (Recovery)

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

(in thousands of dollars)	<b>2009</b>	2008
Income tax expense (recovery) based upon statutory tax rates	\$ 6,370	\$ (46,401)
Adjustments to income tax expense (recovery) related to:		
Canadian dividend income not subject to tax	(7,254)	(7,021)
Non-deductible expenses	1,423	1,853
Effect of change in substantively enacted tax legislation	(5,820)	(2,654)
Other	1,028	14,684
Income tax expense (recovery) reflected in the consolidated statement of income	\$ (4,253)	\$ (39,539)

## | 5 | Investments

### (a) Investment income and balances

Investment income by financial instrument classification is as follows:

(in thousands of dollars)	2009			
	HFT	AFS	Loans and receivables	Total
Interest	\$ 67,944	\$ 28,208	\$ 3,600	\$ 99,752
Dividends	–	25,449	–	25,449
Realized gain on sale of investments	53,775	31,089	–	84,864
Impairment loss on AFS investments	–	(23,496)	–	(23,496)
Unrealized loss on HFT financial instruments	(20,894)	–	–	(20,894)
	\$ 100,825	\$ 61,250	\$ 3,600	\$ 165,675

(in thousands of dollars)	2008			
	HFT	AFS	Loans and receivables	Total
Interest	\$ 78,164	\$ 30,035	\$ 3,206	\$ 111,405
Dividends	–	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 financial instruments	43,317	–	–	43,317
	\$ 134,069	\$ (53,592)	\$ 3,206	\$ 83,683

Investment balance carrying values by financial instrument classification are as follows:

(in thousands of dollars)	2009			
	HFT	AFS	Loans and receivables	Total
Short-term investments	\$ –	\$ 39,970	\$ –	\$ 39,970
Bonds	2,098,957	766,067	–	2,865,024
Preferred stocks	–	163,948	–	163,948
Common stocks	–	296,277	–	296,277
Income trust units	–	9,044	–	9,044
Commercial loans (note 12)	–	–	71,480	71,480
	\$ 2,098,957	\$ 1,275,306	\$ 71,480	\$ 3,445,743

(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

The commercial loans have an amortized cost of \$71.5 million (2008: \$68.5 million) and fair value of \$69.0 million (2008: \$66.9 million), which reflects the gross unrealized gains of \$0.2 million (2008: \$1.0 million) and the gross unrealized losses of \$2.7 million (2008: \$2.6 million).

The unrealized gains (losses) on AFS investments are detailed on page 55. 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 adjusted for impairment charges or recoveries.



**(b) Financial instruments measured at fair value**

In accordance with Section 3862, the Company categorizes its fair value measurements according to a three-level hierarchy. The hierarchy prioritizes the inputs used by the Company's valuation techniques. A level is assigned to each fair value measurement based on the lowest level input significant to the fair value measurement in its entirety. The three levels of the fair value hierarchy are defined as follows:

- (i) **Level 1** are fair value measurements that reflect unadjusted, quoted prices in active markets for identical assets and liabilities that the Company has the ability to access at the measurement date. If an instrument classified as Level 1 subsequently ceases to be actively traded, it is transferred out of Level 1 and into Level 2 or Level 3 as appropriate. Included in the Level 1 category are all stocks (\$460.2 million) and income trust units (\$9.0 million).
- (ii) **Level 2** are fair value measurements using inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in inactive markets, inputs that are observable but are not prices such as interest rates and credit risks and inputs that are derived from or corroborated by observable market data. Included in the Level 2 category are all bonds (\$2,865.0 million) and all short-term investments (\$40.0 million).
- (iii) **Level 3** are fair value measurements using significant non-market observable inputs, including assumptions about risk or liquidity. This category is comprised of credit default swaps (\$0.2 million).

## (c) Term to maturity

(in thousands of dollars)	2009				
	Less than 1 year	1-5 years	6-10 years	10 years +	Total
Canadian short-term investments	\$ 39,970	\$ –	\$ –	\$ –	\$ 39,970
Bonds:					
HFT					
Federal	65,924	1,231,076	–	–	1,297,000
Provincial	–	238,635	10,720	–	249,355
Corporate	72,115	460,965	19,522	–	552,602
	138,039	1,930,676	30,242	–	2,098,957
AFS					
Federal	–	35,062	205,652	58,396	299,110
Provincial	–	29,643	200,912	–	230,555
Corporate	28,009	78,151	121,855	8,387	236,402
	28,009	142,856	528,419	66,783	766,067
Canadian preferred stocks	107,450	56,498	–	–	163,948
Canadian commercial loans	7,915	47,367	16,198	–	71,480
Total, at carrying value	\$ 321,383	\$ 2,177,397	\$ 574,859	\$ 66,783	\$ 3,140,422

(in thousands of dollars)	2008					Total
	Less than 1 year	1-5 years	6-10 years	10 years +		
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
Canadian commercial loans	7,199	35,660	25,607	–		68,466
Total, at carrying value	\$ 375,773	\$ 2,097,131	\$ 314,719	\$ 35,148		\$ 2,822,771

The fair value effective interest rate at December 31 for the HFT bond portfolio was 2.50% (2008: 2.96%) and for the AFS bond portfolio was 5.96% (2008: 5.22%).

#### (d) Impairment review

During the year ended December 31, the Company reclassified unrealized losses of \$25.9 million (2008: \$110.5 million) for impaired AFS stocks from AOCI to net income. In 2008, the Company reclassified unrealized losses of \$13.5 million for impaired AFS bonds from AOCI to net income due to concerns

regarding the credit quality of the underlying issuer. Due to a change in circumstances during the year related to the issuer, a \$2.4 million recovery representing the increase in fair value was recorded in net income.

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.

#### **(e) Securities lending**

The Company has resumed participation 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 \$386.8 million (2008: \$629.4 million) have been loaned and securities with an estimated fair value of \$399.4 million (2008: \$640.7 million) have been received as collateral from the Canadian financial institution. The securities lent under this program have not been removed from "Investments" on the consolidated balance sheet because the Company retains the risks and rewards of ownership. The financial compensation the Company receives in exchange for securities lending is reflected in the consolidated statement of income in "Interest".

#### **(f) 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 "A" or above by independent rating agencies. In addition, 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 national amount of \$75.0 million (2008: \$75.0 million).

The fair value of the credit default swaps reflects the quoted price from the counterparty on a monthly basis. The fair value is a liability of \$0.2 million as at December 31 (2008: \$3.6 million liability) and has been accrued in "Accounts payable and other liabilities" on the consolidated balance sheet. A \$3.4 million gain (2008: \$4.0 million loss) as a result of the change in the fair value of the credit default swaps has been included in "Unrealized gain (loss) on held for trading financial instruments" in the consolidated statement of income. There were no purchases or sales of credit default swaps during the year.

#### **(g) Embedded derivatives**

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

## | 6 | Nature and Extent of Risks Arising from Financial Instruments

The Company's financial instruments, including investments, are exposed to interest rate risk, equity market price 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.

### (a) 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, the impact of an immediate hypothetical 1% change in interest rates with all other variables held constant is as follows:

(in thousands of dollars)	2009		2008	
	+ 1%	- 1%	+ 1%	- 1%
Impact on:				
Fair value of HFT bonds and net income (loss)	\$ (59,573)	\$ 59,573	\$ (47,048)	\$ 47,048
Fair value of AFS bonds and OCI	\$ (48,494)	\$ 48,494	\$ (24,661)	\$ 24,661

**(b) Equity market price 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 stocks that move with the Standard & Poor's 500 Index and the Morgan Stanley International Capital Europe, Australasia and Far East Index.

The impact of a change in the value of these stock market indices, with all other variables held constant, to the extent the Company did not dispose of the stocks during the year, is as follows:

**(c) 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

(in thousands of dollars)	<b>2009</b>		2008	
Impact on:	+ 10%	- 10%	+ 10%	- 10%
Fair value of Canadian stocks and OCI	\$ 30,658	\$ (30,658)	\$ 43,076	\$ (43,076)
Fair value of foreign stocks and OCI	\$ 11,811	\$ (11,811)	\$ 11,052	\$ (11,052)

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, 99.1% (2008: 99.5%) were rated "A-" or better and 100.0% (2008: 98.5%) of the preferred stocks were rated "P2" or better. Of the corporate bonds held, 96.3% (2008: 92.4%) are concentrated in the financial services industry and 3.7% (2008: 7.6%) in other industries.

As disclosed in note 5, the Company resumed participation 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.

For 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 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 2009 or 2008 related to the creditworthiness 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 \$203.8 million (2008: \$184.3 million).

#### (d) 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.

The impact of a change in the value of the United States dollar relative to the Canadian dollar is as follows:

(in thousands of dollars)	2009		2008	
Impact on:	+ 1%	- 1%	+ 1%	- 1%
Fair value of foreign stocks and OCI	\$ 1,181	\$ (1,181)	\$ 1,105	\$ (1,105)

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 loss on the net investment in foreign-based insurance operations included in "Other expense" was \$0.1 million for the year (2008: \$1.9 million gain).

**(e) 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 \$125.3 million (2008: \$103.0 million) of cash and cash equivalents and short-term investments of \$40.0 million (2008: nil). 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 \$3,430.2 million (2008: \$3,149.5 million).

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. Policy liabilities are not covered by Section 3862 disclosures as the Company has elected to maintain CICA Handbook Section 3861 ("Section 3861") - *Financial Instruments - Disclosure and Presentation disclosures*.

### (a) Premium liabilities

Premium liabilities are the liabilities associated with the unexpired portion of policies in-force as of December 31. The unearned premium amounts as at December 31 are based on monthly earnings of premiums written during the year. The amount of deferred policy acquisition expenses represents the brokers commission and premium taxes associated with the unearned portion of the premiums written during the year. The maximum deferrable is calculated as the difference between the unearned premiums less the estimated premium liabilities, plus unearned commission; 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 (2008: 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 the claims and adjustment expenses includes estimates that 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 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 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 below details the provision for unpaid claims 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)	2009			2008		
	Gross	Ceded	Net	Gross	Ceded	Net
Long settlement-term lines of business						
Automobile - bodily injury and accident benefits	\$ 1,686,208	\$ 38,118	\$ 1,648,090	\$ 1,580,234	\$ 40,638	\$ 1,539,596
General liability	349,014	22,379	326,635	352,946	26,073	326,873
	2,035,222	60,497	1,974,725	1,933,180	66,711	1,866,469
Short settlement-term lines of business						
Automobile	51,501	5,053	46,448	70,336	5,437	64,899
Property	221,476	29,318	192,158	230,330	23,020	207,310
	272,977	34,371	238,606	300,666	28,457	272,209
Facility Association and other residual pools	52,241	—	52,241	49,456	—	49,456
	\$ 2,360,440	\$ 94,868	\$ 2,265,572	\$ 2,283,302	\$ 95,168	\$ 2,188,134

**(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 (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 demonstrates that a 1% change in interest rates as at December 31 for the next twelve-month period results in an inverse change in claim liabilities of \$67.1 million (2008: \$60.6 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)	2009	2008
Net unpaid claim liabilities at the beginning of the year	\$ 2,188,134	\$ 1,912,332
Change in estimated losses and expenses for claims occurring in prior years	(43,923)	(1,087)
Losses and expenses on claims occurring in the current year	1,444,214	1,503,036
Paid on claims occurring during:		
Current year	(659,490)	(693,217)
Prior years	(663,363)	(532,930)
Net unpaid claim liabilities at the end of the year	\$ 2,265,572	\$ 2,188,134

**(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)	<b>2009</b>	2008
Undiscounted net unpaid claim liabilities	\$ 2,200,095	\$ 2,155,168
Impact of the time value of money	(157,491)	(144,314)
Provision for adverse deviation	222,968	177,280
Fair value of net unpaid claim liabilities	\$ 2,265,572	\$ 2,188,134

## | 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 48.5% (2008: 51.7%)

of the Company's total direct premiums written during the year.

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 there is no increase greater than 2% in rate for any insured per year; 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.
Quebec	Autorité des Marchés Financiers	Use and file rate regulation on individually rated private passenger, miscellaneous and commercial vehicles.

## | 9 | Property and Equipment

(in thousands of dollars)	2009		
	Cost	Accumulated amortization	Net book value
Buildings	\$ 35,861	\$ 16,124	\$ 19,737
Furniture and equipment	19,026	14,688	4,338
Computer equipment	9,626	5,944	3,682
	64,513	36,756	27,757
Land	1,247	–	1,247
	\$ 65,760	\$ 36,756	\$ 29,004

(in thousands of dollars)	2008		
	Cost	Accumulated amortization	Net book value
Buildings	\$ 35,770	\$ 15,031	\$ 20,739
Furniture and equipment	18,294	13,822	4,472
Computer equipment	8,443	7,293	1,150
	62,507	36,146	26,361
Land	1,247	–	1,247
	\$ 63,754	\$ 36,146	\$ 27,608

Amortization charged to operating expenses amounted to \$2.9 million (2008: \$2.6 million).

## | 10 | Goodwill and Intangible Assets

Annual impairment testing of goodwill 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 as

noted in the table on page 71. These amounts are included in the consolidated statement of income in "Other expense".

Goodwill and intangible assets, as presented on the consolidated balance sheet, is composed of the following items:

## Goodwill and intangible assets:

(in thousands of dollars)	2009			
	Goodwill	Software	Other intangible assets	Total
Cost:				
Balance, beginning of the year	\$ 42,243	\$ 56,920	\$ 3,202	\$ 102,365
Additions	–	13,441	130	13,571
Disposals	(1,186)	–	(377)	(1,563)
Impairment	(3,000)	–	–	(3,000)
Balance, end of the year	\$ 38,057	\$ 70,361	\$ 2,955	\$ 111,373
Accumulated amortization:				
Balance, beginning of the year	\$ –	\$ 35,262	\$ 1,226	\$ 36,488
Amortization expense	\$ –	3,613	256	3,869
Balance, end of the year	–	\$ 38,875	\$ 1,482	\$ 40,357
Net book value, end of the year	\$ 38,057	\$ 31,486	\$ 1,473	\$ 71,016

(in thousands of dollars)	2008			
	Goodwill	Software	Other intangible assets	Total
Cost:				
Balance, beginning of the year	\$ 47,246	\$ 47,232	\$ 12,208	\$ 106,686
Additions	–	9,688	220	9,908
Disposals	–	–	(229)	(229)
Impairment	(5,003)	–	(8,997)	(14,000)
Balance, end of the year	\$ 42,243	\$ 56,920	\$ 3,202	\$ 102,365
Accumulated amortization:				
Balance, beginning of the year	\$ –	\$ 31,070	\$ 3,970	\$ 35,040
Impairment	\$ –	\$ –	(5,030)	(5,030)
Amortization expense	–	4,192	2,286	6,478
Balance, end of the year	\$ –	\$ 35,262	\$ 1,226	\$ 36,488
Net book value, end of the year	\$ 42,243	\$ 21,658	\$ 1,976	\$ 65,877

Included in software is \$10.2 million (2008: \$5.3 million) that has not yet commenced being amortized as it is still under development.

## | 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 (2008: \$1.0 million) in the event of a property claim, and an amount of \$2.5 million (2008: \$2.5 million) in the event of a liability claim. In addition, the Company has obtained reinsurance having an upper amount of \$1.0 billion (2008: \$0.9 billion), which limits the Company's net retention to

\$20.0 million (2008: \$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)	2009	2008
<b>Reinsurance assumed</b>		
Assumed premiums written	\$ 17,322	\$ 17,861
Premiums earned	\$ 18,661	\$ 17,255
Claims and adjustment expenses	\$ 8,155	\$ 14,845
<b>Reinsurance ceded</b>		
Ceded premiums written	\$ 78,865	\$ 76,962
Premiums earned	\$ 78,888	\$ 77,345
Claims and adjustment expenses	\$ 28,829	\$ 18,190
<b>Reinsurance receivable</b>	\$ 27,994	\$ 16,703

## | 12 | Related Party Transactions

From time to time, the Company enters into transactions in the normal course of business, which are measured at the exchange amount, 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 \$3.7 million (2008: \$23.5 million) are due from companies subject to significant influence. The loans are included in "Investments" and are initially measured at the exchange amount. 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, 2009.

Information about the Company's defined benefit plans is as follows:

(in thousands of dollars, unless otherwise noted)	Pension plans		Other benefit plans	
	2009	2008	2009	2008
Accrued benefit obligation	\$ (126,916)	\$ (109,983)	\$ (37,360)	\$ (27,745)
Fair value of plan assets	147,074	131,361	—	—
Plan surplus (deficit)	\$ 20,158	\$ 21,378	\$ (37,360)	\$ (27,745)
<b>FUNDED STATUS ON AN ACCOUNTING BASIS</b>				
Plan surplus (deficit)	\$ 20,158	\$ 21,378	\$ (37,360)	\$ (27,745)
Unamortized actuarial loss (gain)	33,232	27,697	707	(6,332)
Unamortized transitional asset	(4,229)	(5,007)	—	—
Unamortized past service cost	—	—	(1,189)	(1,359)
Accrued benefit asset (liability)	\$ 49,161	\$ 44,068	\$ (37,842)	\$ (35,436)
<b>ACTUARIAL ASSUMPTIONS</b>				
Discount rate	6.5%	7.3%	6.5%	7.3%
Expected long-term return on plan assets	6.8%	6.8%	—	—
Rate of compensation increase	3.5%	3.5%	—	—
Health care cost increase	—	—	9.0%	7.5%
Average remaining service life of employees (in years)	11	12	19	19
<b>OTHER INFORMATION</b>				
(in thousands of dollars)	Pension plans		Other benefit plans	
	2009	2008	2009	2008
Employer contributions	\$ 5,768	\$ 6,184	\$ —	\$ —
Employee contributions	\$ 507	\$ 578	\$ —	\$ —
Benefits paid	\$ 4,395	\$ 4,608	\$ 704	\$ 578
Net expense for benefit plans	\$ 675	\$ 3,322	\$ 3,109	\$ 3,827

Pension plan assets:

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

	% of Plan assets	
	2009	2008
Cash	1.3%	1.0%
Fixed income securities		
Canadian	41.0	38.8
Foreign	2.7	7.9
Equity securities		
Canadian	30.0	26.4
Foreign	24.6	25.5
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 \$7.8 million (2008: \$7.2 million).

## | 14 | Commitments

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

Year	
2010	\$ 14.5 million
2011	\$ 11.4 million
2012	\$ 7.4 million
2013	\$ 6.2 million
2014	\$ 5.5 million
thereafter	\$ 12.6 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)	2009	2008
Net unrealized gain (loss) during the year on AFS investments, net of income tax expense of \$35,424 (2008: \$75,616 tax recovery)	\$ 72,048	\$ (144,611)
Less:		
Net realized gains on sale of AFS investments reclassified to net income during the year, net of income tax expense of \$10,227 (2008: \$5,348)	20,862	9,983
Impairment loss on AFS investments reclassified to net income during the year, net of income tax recovery of \$7,097 (2008: \$43,670)	(16,399)	(80,285)
Other comprehensive income (loss)	\$ 67,585	\$ (74,309)

## | 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 exceeds 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, as disclosed in note 11, 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 Consolidated Financial Information

(in millions of dollars)	2009	2008	2007	2006
Gross premiums written	\$ 1,826.3	\$ 1,939.7	\$ 1,906.1	\$ 1,921.0
Net premiums written	\$ 1,747.5	\$ 1,862.7	\$ 1,833.0	\$ 1,839.7
Net premiums earned	\$ 1,813.3	\$ 1,844.8	\$ 1,829.6	\$ 1,767.6
Claims and adjustment expenses	1,400.3	1,501.9	1,265.6	1,218.1
Other underwriting expenses	556.8	553.3	560.6	543.2
Total underwriting expenses	1,957.1	2,055.2	1,826.2	1,761.3
Underwriting profit (loss)	(143.9)	(210.4)	3.4	6.3
Interest and dividend income	125.2	136.4	130.3	109.9
Gain (loss) on investment	40.5	(52.7)	44.3	74.5
Total investment income	165.7	83.7	174.6	184.4
Other income (expense)	(2.0)	(15.2)	(3.6)	3.9
Goodwill amortization expense	—	—	—	—
Income (loss) before income tax	19.8	(141.9)	174.4	194.7
Income tax expense (recovery)	(4.3)	(39.5)	56.8	64.7
Net income (loss)	\$ 24.1	\$ (102.4)	\$ 117.6	\$ 130.0
Investments at carrying value	\$ 3,445.7	\$ 3,153.4	\$ 3,170.1	\$ 2,950.5
Policyholders' surplus	\$ 1,170.7	\$ 1,079.0	\$ 1,255.7	\$ 1,151.6
Total assets	\$ 4,603.8	\$ 4,441.2	\$ 4,341.2	\$ 4,100.9
Investments at market value	\$ 3,443.2	\$ 3,151.8	\$ 3,167.3	\$ 2,999.8

	2005	2004	2003	2002	2001	2000
	\$ 1,778.0	\$ 1,696.9	\$ 1,522.8	\$ 1,342.7	\$ 1,191.1	\$ 1,075.9
	\$ 1,703.4	\$ 1,639.6	\$ 1,449.6	\$ 1,235.1	\$ 1,101.6	\$ 943.1
	\$ 1,665.6	\$ 1,555.4	\$ 1,333.3	\$ 1,158.9	\$ 1,068.0	\$ 974.1
	1,070.8	941.8	965.4	876.7	855.3	787.2
	510.2	490.2	430.5	358.8	332.6	301.3
	1,581.0	1,432.0	1,395.9	1,235.5	1,187.9	1,088.5
	84.6	123.4	(62.6)	(76.6)	(119.9)	(114.4)
	91.9	82.1	81.2	80.0	86.3	90.3
	71.1	27.2	23.7	14.0	38.1	51.6
	163.0	109.3	104.9	94.0	124.4	141.9
	9.3	9.2	5.2	3.1	1.3	(3.4)
	–	–	–	–	4.2	4.2
	256.8	241.9	47.5	20.5	1.6	19.9
	84.7	80.1	12.6	(3.1)	(2.0)	0.3
	\$ 172.1	\$ 161.8	\$ 34.9	\$ 23.6	\$ 3.6	\$ 19.7
	\$ 2,572.3	\$ 2,234.4	\$ 1,859.4	\$ 1,688.5	\$ 1,506.3	\$ 1,436.5
	\$ 1,021.5	\$ 849.4	\$ 687.6	\$ 652.7	\$ 655.1	\$ 651.5
	\$ 3,645.6	\$ 3,292.1	\$ 2,869.4	\$ 2,564.3	\$ 2,397.2	\$ 2,280.2
	\$ 2,644.6	\$ 2,335.1	\$ 1,939.2	\$ 1,736.0	\$ 1,566.1	\$ 1,518.6

## BOARD OF DIRECTORS AND SENIOR MANAGEMENT

**Board  
of Directors**

Mary N. Bales (2,3)

A. Scott Carson (1,2)

Karen L. Gavan (1,5)

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

David A. MacIntosh (4,5)

Charles M. W. Ormston (2,3)

Terry J. Reidel (1,3)

Brian J. Ruby (1,4,5)

Noel G. Walpole (4)

**Committees**

| 1 | Audit

| 2 | Corporate Governance  
and Conduct Review

| 3 | Human Resources  
and Compensation

| 4 | Investment

| 5 | Pension

**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**  
Regional 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**  
Senior Vice President and Chief Information Officer

**William Stinson, BMath, FLMI**  
Vice President, Information Technology Operations

**Sandeep Uppal, BAdmin (Hons), 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.**



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