



For wherever life leads you. The Economical Insurance Group
2010 ANNUAL REPORT

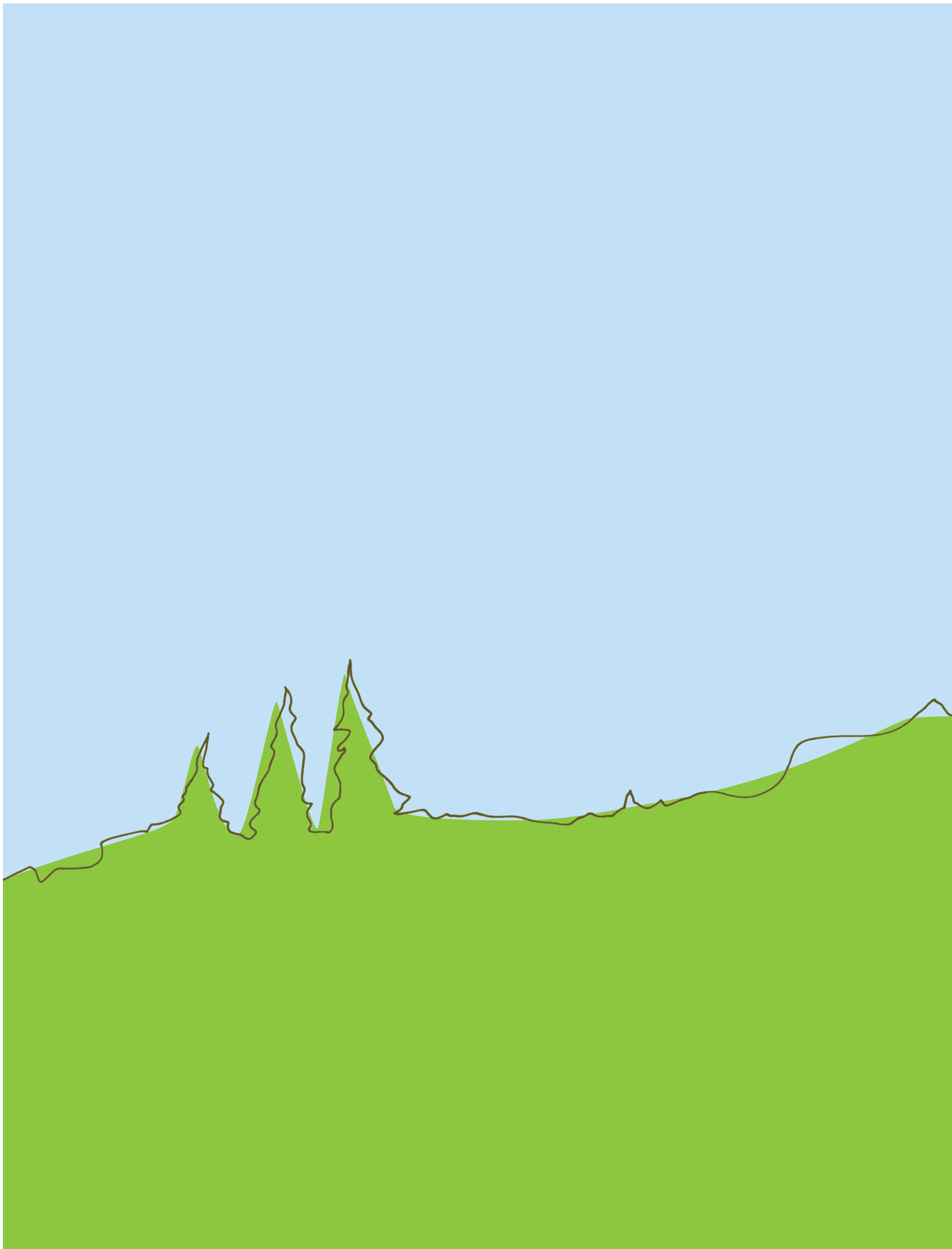




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A Message from Gerald Hooper, Chairman of the Board of Directors

2011 MARKS ECONOMICAL'S 140TH YEAR PROVIDING FOR THE INSURANCE NEEDS OF CANADIANS.

Since our founding in 1871, our organization has positively emerged through many challenging circumstances, always by the strength of our employees and our values. Over our long history of service to Canadians, we have weathered deep recessions and the Great Depression, we have adapted to changes in our regulatory and business environments and we have become one of Canada's leading property and casualty ("P&C") insurers. We are proud of our commitment to financial stability and service excellence, and we are proud to provide over one million Canadians with the security and peace of mind they deserve.

This record of excellence was built upon the core values we at The Economical Insurance Group® ("The Group", "Economical") believe in. And it was these core values of integrity, collaboration and achievement that guided us through this last year.

In 2010, management sustained and executed the decisions that enabled Economical's comparatively speedy recovery from the global financial crisis, and transformed that recovery into a phase of rejuvenation.

During the past year, The Group:

- implemented our new web-based underwriting platform, designed to drive productivity, enhance customer experience and better support our distribution partners;
- embraced the power of predictive analytics as the basis for our risk-selection strategy; and
- launched a comprehensive leadership training program to build leadership skills and enhance employee engagement.

Most importantly, Economical dramatically improved its operating performance, achieving an \$88.2 million reduction in underwriting losses, a marked decline in combined ratio, and increased pre-tax net income to more than \$85 million.

Poor underwriting results in 2008 and 2009 necessitated strong corrective action to restore profitability. The strategy focused on reducing exposure to higher risk lines and regions, particularly Ontario personal automobile insurance, where underwriting losses could not be sustained. Improving operating performance meant focusing on profitability rather than the number of policies in force and the related revenues, which both declined during the year. We believe that we have taken the appropriate action and the Company is now well positioned for growth and further profitability.

Economical ended the year with a minimum capital test ("MCT") ratio of 234%. The MCT is an industry measure of financial strength, monitored by the Office of the Superintendent of Financial Institutions, or OSFI. This is one of the strongest capital positions in the history of The Group and far in excess

of the minimum ratio of 150% required by OSFI. During the reporting period, the surplus of The Group increased by \$87.4 million to \$1.26 billion. This performance was achieved due to the strength of our organizational culture and the efforts of our employees, demonstrating the value of our ongoing strategic investment in employee training and development.

In December, the Board made public its most important decision of the year, one that is truly historic for Economical and our industry as a whole. We announced that the Company will pursue demutualization.

Our mutual business model has served our organization well throughout our history. It has permitted us to achieve an impressive level of financial stability and has encouraged us to remain focused on the long-term viability and competitiveness of the Company. However, the mutual structure also places limits on our ability to raise capital and access new funds – resources that have the power to unleash Economical's true growth potential.

I am pleased to report that we have appointed an outstanding chief executive to lead our organization through this exciting period of transition.

Economical took a deliberative and strategic approach to recruiting our new president. Over eighteen months, our Board collaborated with a wide cross-section of stakeholders and conducted a global search to identify the right person to lead our organization. We set out to find a candidate with extensive experience in the P&C insurance business and a strong reputation as a team builder.

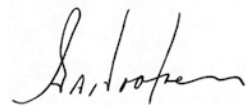
I was most pleased in late 2010 to announce the appointment of Katherine Mabe to the position of President and Chief Executive Officer of Economical Mutual Insurance Company. Kathy has over three decades' experience and a remarkable record of achievement within the North American P&C insurance industry, in addition to her long-standing commitment to community service. Kathy is bringing a fresh perspective and an energizing, collaborative leadership style to the Company's executive team.

Kathy's executive leadership team and the Board of Directors are committed to a demutualization process that respects the needs of our stakeholders, and will ensure that Economical can capitalize on opportunities to accelerate our strategic vision and secure our ongoing success.

Together with our executive leadership, our network of supportive and skilled broker partners and our invaluable employees, Economical will soon write a new chapter in our story.

And we intend to write it well.

Sincerely,



Gerald Hooper, FCA

Chairman of the Board

A Message from Kathy Mabe, President and CEO

I AM HONORED TO SHARE THIS MESSAGE WITH YOU AS THE NEW PRESIDENT AND CHIEF EXECUTIVE OFFICER OF ECONOMICAL MUTUAL INSURANCE COMPANY.

Since transitioning into my new role in January 2011, I have been impressed with the vital work underway within The Group, and energized by the opportunities that our organization intends to seize in this milestone year.

It is a milestone year for several reasons. Our Company engaged in an historic transformation, unique in the history of Canada's property and casualty insurance sector, and this year marks Economical's 140th year of service to Canadians.

For Economical, 2010 was a year of accelerated recovery from the global financial crisis, which continues to jeopardize many economies and businesses around the world.

Through disciplined execution in underwriting, pricing and claims performance, our team, in partnership with our brokers, achieved a continued and meaningful reduction to the Company's combined ratio and more than doubled Economical's net income from 2009. Our profitability indicators continued to strengthen through the reporting period, laying an excellent foundation for profitable growth in the future.

At Economical, one of our core values is learning. I am pleased to report that in early 2011, Economical placed second in *Training Magazine's* global ranking of 125 organizations that excel in organizational learning and development. In a similar testament to our employee development focus, we were recognized by *ELearning! Media Group* as a leader in providing web-based learning opportunities to employees.

Also in 2010, Economical earned the APEX Award at the World Conference on Disaster Management for our pandemic preparedness plans, and we were named best insurer by the readers of Economical's hometown newspaper *The Waterloo Region Record*.

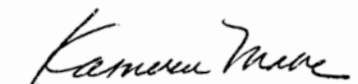
It was from this position of financial strength and positive recognition that the Board of Directors announced, in December, the Company's intention to pursue demutualization and embark upon a new era for Economical. In response, we organized our team to have a dedicated focus on the work streams associated with demutualization, while the balance of our team focuses on serving our customers and achieving our operating plan for 2011 and beyond.

These and other changes demonstrate our commitment to the exciting opportunities that lie ahead and showcase the exceptional quality of our employees, whose hard work and professionalism are the ultimate source of our Company's success.

As I look forward to 2011, I remain grateful for the strong partnerships we continue to build with our national team of independent brokers. These collaborative business relationships ensure that we provide the products and services consumers need, and they are the foundation of our policyholders' positive customer experience.

On behalf of all my colleagues in our organization, thank you for your continued support of Economical Mutual Insurance Company and its bright future.

Sincerely,



Kathy Mabe, CPCU, CLU, ChFC, MBA

President and CEO

Management Discussion and Analysis

Introduction

MARCH 29, 2011

The following management discussion and analysis (“MD&A”), which was approved by the Board of Directors for the year ended December 31, 2010, is intended to enable the reader to assess The Economical Insurance Group’s results from operations and its financial condition for the year ended December 31, 2010, compared to the corresponding information for 2009. It should be read in conjunction with the consolidated financial statements and accompanying notes for the fiscal year ended December 31, 2010.

The Group uses both generally accepted accounting principles (“GAAP”) and certain non-GAAP measures to assess performance. Non-GAAP measures do not have any standardized meaning prescribed by GAAP and are unlikely to be comparable to any similar measures presented by

other companies. The Group analyzes performance based on underwriting ratios such as combined, expense and claims ratios. These measures are outlined in the list of definitions included in the MD&A.

Certain totals, subtotals and percentages may not agree due to rounding. An increase/decrease column has been provided showing the variation between 2010 and 2009 for certain financial analyses.

This document contains forward-looking statements that involve risks and uncertainties. The Group’s actual results could differ materially from these forward-looking statements as a result of various factors, including those discussed hereinafter. Please read the cautionary note at the end of this document.

Section 1 – Overview

ABOUT THE ECONOMICAL INSURANCE GROUP

Founded in 1871, The Economical Insurance Group (“The Group”) is one of the largest property and casualty insurance groups in Canada, providing security and support to customers and broker partners from coast to coast. The Group’s approximately 2,600 employees are committed to providing quality home, automobile and commercial insurance products to over one million policyholders across Canada.

Canadian owned and operated, The Group provides a wide range of personal and commercial insurance products to customers in all provinces across Canada. Unlike many insurance companies operating in Canada, The Group is not a subsidiary of a foreign-owned company. The Group’s head office is located in Waterloo, Ontario, with 19 branches and member companies across the continent providing service to policyholders and brokers. In Canada, The Group partners with approximately 900 independent insurance brokers who work with customers to assess their insurance needs and choose with them the right products and coverage.

The financial stability of The Group is demonstrated by assets of over \$4.6 billion and policyholders’ equity of approximately \$1.3 billion reflecting the combined strength of its member companies. 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;
- Westmount Financial Inc., including Family Insurance Solutions Inc. (managing general agent) and The Mattei Companies (U.S.-based subsidiary and managing general underwriter).

CORPORATE STRATEGY

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

The Group will achieve this vision by:

- Delivering a customer experience and overall value proposition that is superior to our competitors as measured by our customers;
- Being recognized by our distribution partners as their preferred partner to do business with;
- Building and executing industry-leading capabilities in pricing, underwriting, claims and risk management;
- Being the preferred place to work with an emphasis on learning, personal growth, diversity and commitment to our communities and our environment; and
- Maintaining the trust and confidence of our customers, employees, brokers and regulators through consistent top-quartile operating performance.

In 2010, we made great strides toward our strategic vision. Some examples include:

- We completed the implementation of Energie Auto, our web-based platform, across all provinces except Quebec. Quebec implementation is scheduled for 2011. Energie will enable faster speed to market and create the foundation for better support of our distribution partners, enhancing our customer experience and improving productivity across the organization.
- We designed and built our new Multivariate Ontario Auto product that will be launched in 2011. This product continues our advancement in pricing analytics to more accurately match the right price to each customer and better support our broker partners.

- We launched our Leadership 2010 People and Performance Program for everyone in a leadership role to continue our focus on engagement, leadership development and high performance.
- We significantly improved our operating performance by:
 - Achieving an \$88.2 million reduction in underwriting losses (61.3%) resulting from proactive rate management and underwriting discipline;
 - Reducing the combined ratio from 107.9% to 103.3%, including a 7.5 point improvement in the claims ratio; and
 - Significantly increasing net income before taxes, generating a total of \$85.5 million for the year.

Improving our operating performance came at a cost as we saw a decline in both revenue and policies in force. We believe we have taken the appropriate action and The Group is well positioned for profitability and growth.

In 2011, we will continue to execute on our strategic vision by:

- Executing the Board's mandate to demutualize the Company and capitalize on the opportunities that this brings to accelerate our strategic vision;
- Capitalizing on our investment in technology with Energie Auto and our Broker Connectivity initiatives to continue to enhance our customer and broker experience;
- Developing Energie Property to expand our web-based capabilities to this critical product to better serve customer and distribution partners;
- Expanding our use of analytics in pricing and risk selection;
- Implementing our corporate sustainability strategy; and
- Continuing our focus on disciplined processes in underwriting and claims to ensure top-quartile performance.

DEFINITIONS

Policies in force ("PIF")

The number of insurance policies for which the company is on risk at a specified date.

Gross written premiums ("GWP")

The total premiums from the sale of insurance during a specified period.

Net premiums written ("NPW")

GWP less the cost of reinsurance coverage.

Net earned premiums ("NEP")

The portion of NPW equal to the expired period of time an insurance policy is in effect.

Claims ratio

Claims and adjustment expenses during a defined period, expressed as a percentage of net premiums earned for the same period.

Expense ratio

Underwriting expenses including commissions, operating expenses and premium taxes during a defined period, expressed as a percentage of net premiums earned for the same period.

Combined ratio

The sum of the claims ratio and the expense ratio.

Underwriting profit

The excess of net earned premiums over the sum of claim and adjustment expenses, commissions, operating expenses and premium taxes.

Return on equity ("ROE")

Net income after tax for the 12 months ended at a specified date divided by the average retained earnings over the same 12-month period.

Minimum capital test ("MCT")

A regulatory formula defined by the Office of the Superintendent of Financial Institutions ("OSFI") that is a risk-based test of capital available relative to capital required.

Provision for adverse deviation

An amount that is added to the discounted claims and adjustment expenses to reduce the potential adverse effect of the uncertainty that is inherent in the assumptions and data used to estimate such liabilities.

Section 2 – Industry Outlook

THE ECONOMY AND THE INDUSTRY

Generally speaking, financial markets and economic indicators improved during 2010, but the Canadian economy has not fully recovered from the effects of 2008 and 2009. Capital markets are likely to remain volatile in 2011 due to lingering uncertainty regarding the strength of the global recovery. The P&C insurance industry traditionally lags recovery in the financial markets, and therefore, it may take until the end of 2011 before improving economic conditions translate directly into improved financial performance for the insurance industry.

The low interest rate environment continues to place significant pressure on the ability of P&C insurers to generate adequate investment returns. The general consensus amongst economists is that interest rates will remain low for the next 12 to 24 months and, as a result, it is unlikely that there will be significant upward momentum for investment yields in the near-term. When it is more difficult to generate investment income, producing an underwriting profit becomes even more critical.

Personal insurance continues to present challenges for the industry. Personal insurance premiums continue to increase with inflationary pressure on the rebuilding cost of homes a major contributing factor. Significant increases to bodily injury and accident benefit claims in Ontario were experienced in 2010, and claims ratios on Ontario personal auto exceeded 100%, particularly in the Greater Toronto Area (“GTA”). Results continued to deteriorate before legislative changes took effect in September. The reforms

were not in place for a sufficient time to have a meaningful impact on 2010 results but the insurance industry is anticipating significant reductions in such claims costs in the coming years. As well, environmental changes continue to have significant impacts on property claims. There have continued to be more frequent and severe storms across the country which have resulted in significant amounts of large claims.

The pricing environment in the commercial insurance marketplace remains competitive and there is unlikely to be any meaningful increase in rates during the course of 2011. In order to achieve profitable growth in the near-term, it appears that companies will have to explore niche markets and focus even further on targeting the most profitable segments of business and appropriate cost management.

Despite the challenges of the current economic environment, The Group is well positioned to continue the significant progress toward enhanced results achieved in 2010. The Group’s excellent capital strength is demonstrated by an increased MCT ratio of 234.2% (its highest since 2005). The Group also maintained its prudent investment strategy focused on high-quality assets. In addition, there has also been significant progress made on The Group’s pricing and underwriting activities, as demonstrated by a 61.3% reduction in underwriting losses compared to the prior year. The Group is ideally placed for continued success in 2011 and beyond.

REGULATORY ENVIRONMENT

The P&C industry is subject to the oversight of several regulatory bodies such as OSFI, provincial regulators such as the Financial Services Commission of Ontario (“FSCO”) and federal and provincial taxation authorities, amongst others. There are a number of developments that have impacted the P&C insurance industry in 2010.

In 2003, along with certain reforms, the Ontario legislature amended the Insurance Act to include a requirement that FSCO undertake a review of the auto insurance regulations with a minimum frequency of once every five years. Following the 2003 reforms, claim costs fell in 2004 but savings have since eroded to the point that the affordability of the product was jeopardized once again, posing a serious threat to market stability. Premium rate increases approved by FSCO in recent years were signs that the mounting pressure of loss costs were significantly affecting premiums. As a result, with the most recent five-year review completed, the Government of Ontario implemented further auto

CAPITAL REQUIREMENTS

The P&C insurance industry requires adequate capital to cover insurance risks while simultaneously providing protection against exposure to credit and liquidity risks. Strict rules implemented by OSFI define and regulate the minimum amount of capital that companies are required to

insurance reforms effective September 1, 2010. This reform is aimed at reducing costs and improving market stability through a number of measures intended to contain certain costs and reduce the incidence of claim inflation or fraud, including:

- Capping medical/rehabilitation costs for minor injury claims at \$3,000;
- Capping assessments at \$2,000;
- Eliminating rebuttal examinations; and
- Creating a definition for “incurred expenses” among other improvements.

Taken in their entirety, the industry’s cost savings from the above-mentioned measures will help to close the sizeable gap that has arisen between rising claim costs and premium levels. The reforms will reduce cost pressures in the short-term and should remedy some of the core reasons for recurring instability in the system.

maintain in order to provide adequate protection for policyholders. The Group is well positioned in this regard, demonstrating a strengthened capital position and regulatory capital significantly in excess of the OSFI minimum capital requirement.

Section 3 – The Year in Review

FINANCIAL HIGHLIGHTS FOR THE YEAR INCLUDE:

Underwriting loss	\$88.2 million reduction in underwriting losses (a 61.3% improvement) as a result of proactive rate management and underwriting discipline.
Combined ratio	Improvement in the combined ratio from 107.9% to 103.3%, including a 7.5 point improvement in the claims ratio.
Net income	Significant increase in net income before taxes to \$85.5 million, a \$65.7 million improvement over 2009.

RESULTS FROM OPERATIONS

Figure 1 (in millions of dollars, except as otherwise noted)	Year ended December 31		Increase (Decrease)
	2010	2009	
Gross written premiums	1,722.0	1,826.3	(104.3)
Net premiums written	1,626.4	1,747.5	(121.1)
Net premiums earned	1,676.4	1,813.3	(136.9)
Claims and adjustment expenses	1,167.9	1,400.3	(232.4)
Other underwriting expenses	564.2	556.8	7.4
<i>Underwriting loss</i>	<i>(55.7)</i>	<i>(143.9)</i>	88.2
Interest and dividend income	114.4	125.2	(10.8)
Recognized gains on investments	33.3	40.5	(7.2)
Other expenses	(6.5)	(2.0)	(4.5)
<i>Net income before income taxes</i>	<i>85.5</i>	<i>19.8</i>	65.7
Income tax expense / (recovery)	21.1	(4.3)	25.4
Net income	64.4	24.1	40.3
Claims ratio	69.7%	77.2%	(7.5%)
Expense ratio	33.6%	30.7%	2.9%
Combined ratio	103.3%	107.9%	(4.6%)
Return on equity	5.3%	2.0%	3.3%
Policies in force (in thousands)	1,074.8	1,188.0	(113.2)

CLAIM AND ADJUSTMENT EXPENSES

Figure 2 (in millions of dollars, except as otherwise noted)	Year ended December 31		Increase (Decrease)
	2010	2009	
Net incurred losses:			
Current year claims	1,251.1	1,444.2	(193.1)
Prior year claim development (favourable)	(83.2)	(43.9)	(39.3)
Total	1,167.9	1,400.3	(232.4)

COMMISSION AND OTHER EXPENSES

Figure 3 (in millions of dollars, except as otherwise noted)	Year ended December 31		Increase (Decrease)
	2010	2009	
Commissions	349.6	348.8	0.8
Operating expenses	155.7	145.3	10.4
Premium taxes	58.9	62.7	(3.8)
Total	564.2	556.8	7.4

GROSS WRITTEN PREMIUMS

Policies in force (“PIF”) and gross written premiums (“GWP”) decreased 9.5% and 5.7%, respectively, during the year, reflecting the implementation of The Group’s initiatives to restore profitability. PIF and GWP were also affected by intense competition within the industry as insurers vied to retain

profitable business. However, rate increases achieved across most lines of business and a planned increase in the proportion of business from more profitable commercial lines resulted in an increase in average written premium per policy of 4.2%.

CLAIM AND ADJUSTMENT EXPENSES

The Group’s combined ratio has improved significantly due to a number of strategic actions taken during the year including proactive risk and broker management, rate increase activity and targeting the most profitable business segments while maintaining pricing and underwriting discipline. Claim costs continue to trend in a positive direction as demonstrated by a 7.5% reduction in the claims ratio representing a \$232.4 million reduction in claim and adjustment expenses incurred

year-over-year. This significant reduction reflects a number of factors, including more positive underwriting results for the current accident year, favourable development on prior year claims, fewer weather-related events in the year and the reduced impact of claim discounting. The Group continues to maintain its strong focus on claim management while ensuring it provides the highest levels of service and support to its policyholders.

COMMISSION AND OTHER EXPENSES

Commission expense remained steady in 2010. Higher contingent profit commissions due to more profitable business offset decreases in regular commissions and expense overrides due to the decline in GWP. Operating expenses increased year-over-year due primarily to an increase in the accrual for incentives resulting from improved

underwriting results and resulting profitability. The Group continues to invest in leading-edge technology including broker connectivity tools that make it easier for brokers to partner with The Group. The decrease in premium taxes is directly correlated to the decrease in premiums year-over-year.

INVESTMENT INCOME

Despite challenging capital markets, The Group generated a healthy return on its investment portfolio, realizing \$114.4 million in interest and dividends throughout the year. This return was notwithstanding an intentional decision to reduce The Group's exposure to preferred shares, as part of The Group's prudent and balanced risk and capital management strategies, and despite the historically low interest rate environment. Net gains of \$33.3 million on

investments were also recognized in the year, despite impairment losses of \$23.1 million being incurred on The Group's available-for-sale ("AFS") portfolio. While recognizing the risk appetite and challenging market conditions, The Group continues to compare favourably to investment benchmarks, and the specialist in-house investment management team has generated significant long-term returns for the organization.

INCOME TAX EXPENSE

Income tax expense increased by \$25.4 million year-over-year as a result of the significantly higher 2010 pre-tax income of \$85.5 million (2009: \$19.8 million). The Group was also in

a tax recovery position in 2009 as prior year tax losses were utilized to reduce taxes payable. This situation did not recur in 2010.

NET INCOME

The Group achieved net income of \$64.4 million in 2010, compared with \$24.1 million in the prior year. This represents the highest level of net income generated by The Group since 2007. The Group has successfully implemented a number of measures that are beginning to positively impact the bottom line including increasing rates across most regions and lines of business, working with brokers to ensure a focus on profitable growth and reducing exposure in less desirable markets such as the GTA.

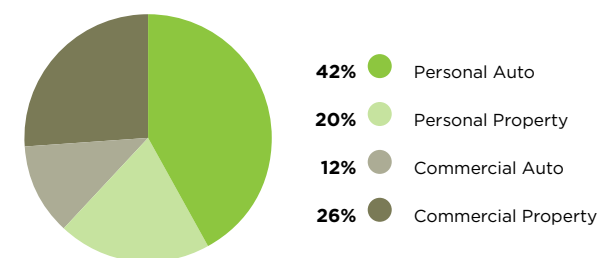
The Group ended the year in an excellent position of financial strength, with an MCT of 234.2%, the second highest MCT ratio in The Group's history. The Group's focus on profitable growth, significantly improved underwriting results and solid investment performance in a challenging environment for financial markets have all contributed to a highly successful year in 2010.

Section 4 - Results by Line of Business

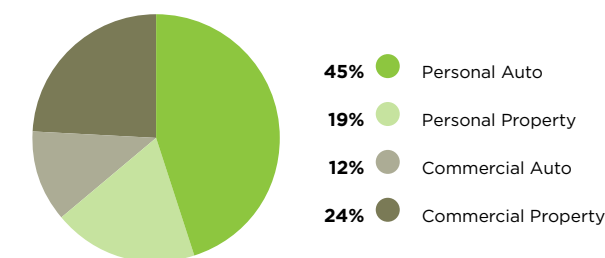
The Group provides a wide range of P&C insurance products that are divided into two broad lines of business: personal and commercial insurance. Within each of these lines is a further breakdown between the auto, property, liability

and - in the case of commercial - more specialized books of business. The following charts illustrate The Group's gross written premiums split on this basis:

2010 GWP BY LINE OF BUSINESS



2009 GWP BY LINE OF BUSINESS



As illustrated, the mix of business between personal and commercial lines has shifted slightly in comparison to the prior year. Furthermore, the percentage of business represented by personal auto has fallen from 45% of The Group's revenue to 42% in the current year. This change is a direct result of The Group's strategy to reduce its exposure

to unprofitable personal auto business, particularly in Ontario and more specifically in the GTA, while seeking to focus and grow its higher-profit areas, specifically in commercial lines. The increase in personal property is due to introducing rate increases and Insurance to Value initiatives to increase profitability on this line.

UNDERWRITING - PERSONAL LINES

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

	Year ended December 31		Increase (Decrease)	
	2010	2009	\$	%
Policies in force (in thousands)				
Auto	487.7	545.3	(57.6)	(10.6)
Property	407.8	458.1	(50.3)	(11.0)
Total	895.5	1,003.4	(107.9)	(10.8)
Gross written premiums				
Auto	715.2	819.9	(104.7)	(12.8)
Property	341.0	355.8	(14.8)	(4.2)
Total	1,056.2	1,175.7	(119.5)	(10.2)
Net premiums earned				
Auto	750.4	862.5	(112.1)	(13.0)
Property	323.8	342.9	(19.1)	(5.6)
Total	1,074.2	1,205.4	(131.2)	(10.9)
Underwriting profit (loss)				
Auto	(71.1)	(101.4)	30.3	29.9
Property	18.6	(42.0)	60.6	144.3
Total	(52.5)	(143.4)	90.9	63.4

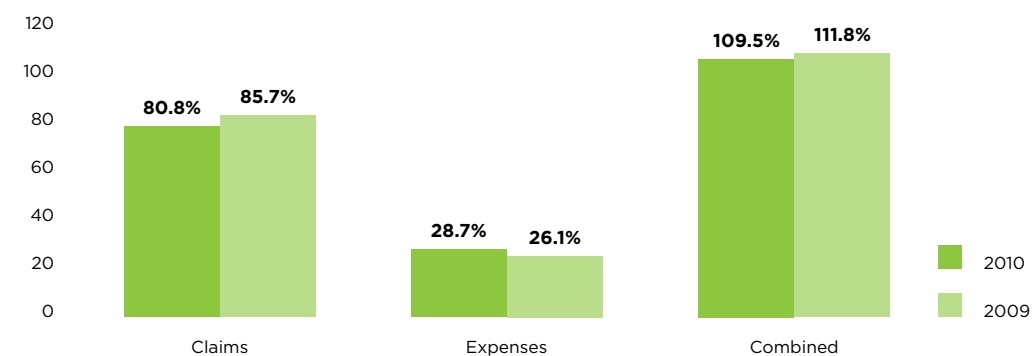
PERSONAL LINES

GWP for personal automobile business in Ontario as a percentage of the total GWP for personal automobile has fallen from 71.1% in 2009 to 68.8% in 2010. This demonstrates The Group's successful implementation of its strategy to strengthen underwriting in this poorer performing geographic area. Excluding the Ontario region, the personal automobile combined ratio for The Group is a healthy 92.6%. As a result of the actions taken, The Group has been able to stabilize the overall combined ratio for its personal automobile business and has reduced the underwriting loss in absolute terms by \$90.9 million (or 63.4%). Poor personal automobile underwriting results have plagued the entire industry, and particularly those companies with significant market shares in Ontario auto. The Group expects more favourable results in 2011 and beyond due to the reduction of its exposure to Ontario, as well as the positive impact of the most recent Ontario auto reforms.

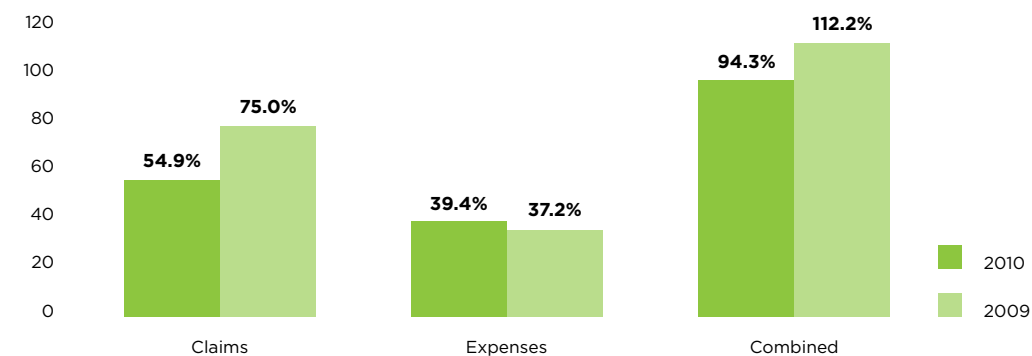
The Group experienced a \$14.8 million (4.2%) drop in personal property GWP due to a significant decline in PIF (11.0%), somewhat offset by an increase in the average rate per policy of 7.6%. The reduction in PIF resulted from lower retention as a result of rate increases and underwriting discipline. These actions have also, however, resulted in significantly improved underwriting performance, with a dramatic 20.1 point reduction in the claims ratio. The Group has successfully returned the personal property line of business to profitability.

Through these strategic actions, The Group has successfully reduced its dependence on personal auto while addressing pricing inadequacy, resulting in a significant improvement in the underwriting performance of this division.

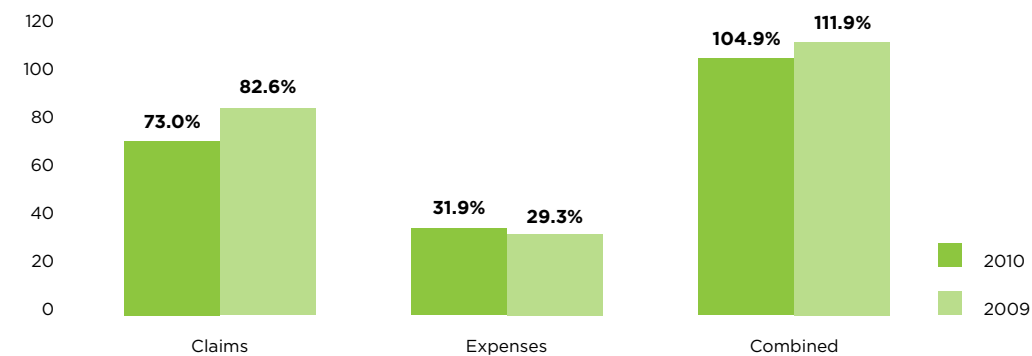
PERSONAL AUTOMOBILE RATIOS



PERSONAL PROPERTY RATIOS



TOTAL PERSONAL LINES RATIOS



UNDERWRITING - COMMERCIAL LINES

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

	Year ended December 31		Increase (Decrease)	
	2010	2009	\$	%
Policies in force (in thousands)				
Auto	53.4	55.9	(2.5)	(4.5)
Property	125.9	128.6	(2.7)	(2.1)
Total	179.3	184.5	(5.2)	(2.8)
Gross written premiums				
Auto	220.2	213.9	6.3	2.9
Property	443.4	436.7	6.7	1.5
Total	663.6	650.6	13.0	2.0
Net premiums earned				
Auto	204.4	207.3	(2.9)	(1.4)
Property	397.7	400.6	(2.9)	(0.7)
Total	602.1	607.9	(5.8)	(1.0)
Underwriting profit (loss)				
Auto	(9.3)	22.0	(31.3)	(142.3)
Property	6.1	(22.5)	28.6	127.1
Total	(3.2)	(0.5)	(2.7)	(540.0)

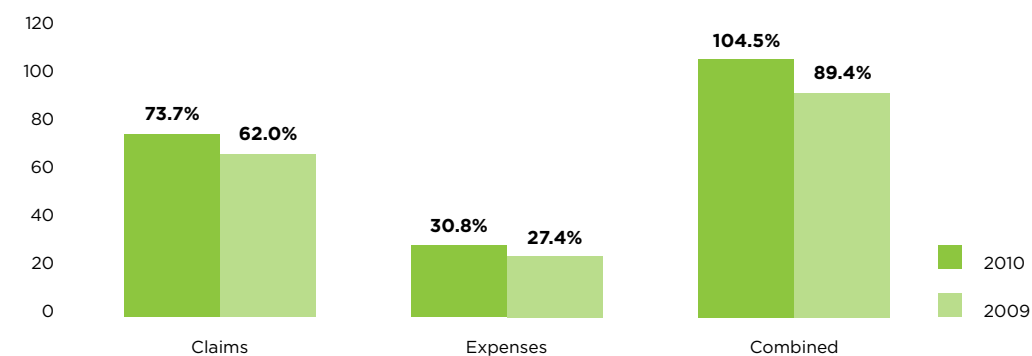
COMMERCIAL LINES

Overall, the commercial lines business has performed well throughout the year, generating higher levels of GWP while maintaining a stable combined ratio of 100.5%.

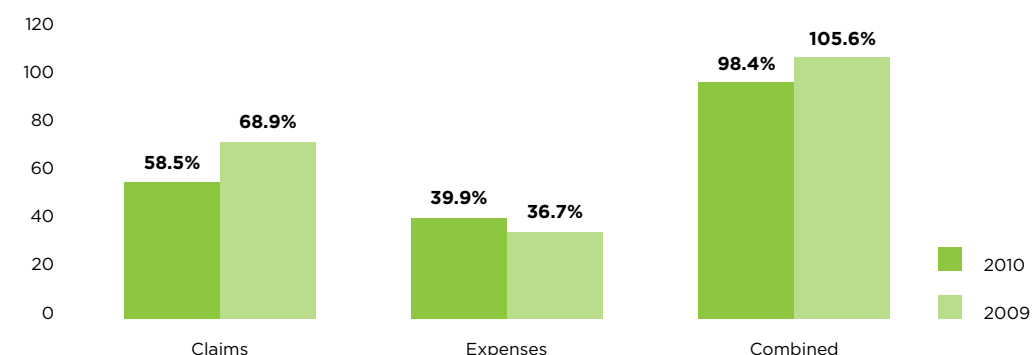
GWP for the commercial automobile segment increased by 2.9% over the prior year, as rate increases more than offset a small decline in PIF. Underwriting results were disappointing, due primarily to an unexpected increase in large losses, resulting in a combined ratio of 104.5%. Despite the current year's result, The Group continues to believe the quality of the underlying business remains strong, as demonstrated by the consistent track record of profits for this business.

Premium levels for the commercial property and liability segment were also strong, with The Group experiencing GWP growth of 1.5%, similarly as a result of improved pricing. Underwriting performance has shown a significant improvement compared to the prior year, with a 10.4 point improvement in the claims ratio. This improved performance was the result of specific underwriting actions, a change in the mix of business and higher rates, and was assisted by more favourable weather conditions experienced in 2010.

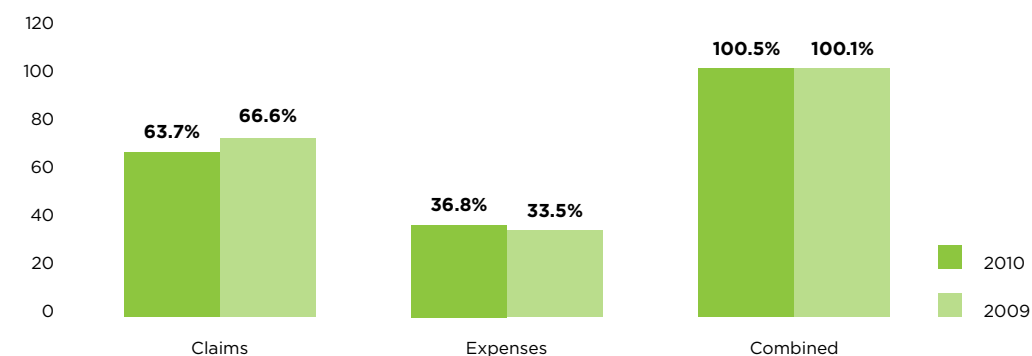
COMMERCIAL AUTOMOBILE RATIOS



COMMERCIAL PROPERTY RATIOS



TOTAL COMMERCIAL LINES RATIOS



Section 5 – Key Performance Indicators

KEY PERFORMANCE INDICATORS

Figure 6

(in millions of dollars, except as otherwise noted)	Year ended December 31				
	2010	2009	2008	2007	2006
Policies in force (in thousands)	1,074.8	1,188.0	1,341.5	1,387.2	1,396.6
Gross written premiums	1,722.0	1,826.3	1,939.7	1,906.1	1,921.0
Claims ratio	69.7%	77.2%	81.5%	69.2%	68.9%
Expense ratio	33.6%	30.7%	29.9%	30.6%	30.7%
Combined ratio	103.3%	107.9%	111.4%	99.8%	99.6%
Underwriting (loss) profit	(55.7)	(143.9)	(210.4)	3.4	6.3
Net income (loss)	64.4	24.1	(102.4)	117.6	130.0
Return on equity	5.3%	2.0%	(8.4%)	9.7%	12.0%
Investments at cost*	3,539.5	3,459.8	3,243.4	3,195.0	2,950.5
Investments at fair value*	3,554.0	3,443.2	3,151.8	3,167.3	2,999.8
Retained earnings	1,255.9	1,191.5	1,167.4	1,269.8	1,151.6
Policyholders' equity	1,258.0	1,170.7	1,079.0	1,255.7	1,151.6
Total assets	4,633.2	4,603.8	4,441.2	4,341.2	4,100.9

*does not include cash and cash equivalents

The Management Discussion and Analysis to this point focuses on the changes from 2009 to 2010. The information below provides some insight into the movement in key performance indicators and trends experienced between 2006 and 2010.

GWP and PIF levels declined steadily since 2006 reflecting competitive pressures, and more recently, specific actions taken by The Group to refocus on profitable underwriting. The Group's focus remains one of profitable growth and as such, The Group is carefully managing its underwriting risks to ensure that underwriting performance is not sacrificed to achieve top-line growth.

The claims ratio has rebounded dramatically from an historical high in 2008 of 81.5% back to a more normalized position consistent with the profitable underwriting years of 2007 and 2006. This has been achieved despite a negative impact from discounting of claims liabilities due

to continuing low investment yields. As the interest rate environment changes and Ontario automobile reforms take hold, further favourable developments in the claims ratio should become evident.

The expense ratio increased in 2010 to a level approximately three points higher than the historical norm. This was the result of several factors, including increased commissions and incentive expense related to The Group's improved combined ratio, the impact of lower net earned premiums as a result of The Group's realignment of its book of business, and continued investment in the future of the organization.

The combined impact of the claims and expense ratios resulted in the best underwriting year since 2007, and it exemplifies a dramatic turnaround from the difficult years of 2009 and 2008. This improvement is also reflected in the highest levels of net income and policyholders' equity since 2007.

Section 6 – Investments

CASH AND INVESTMENTS

Figure 7

(in millions of dollars, except as otherwise noted)	As at December 31, 2010		As at December 31, 2009	
	Fair Value	% @ Fair Value	Fair Value	% @ Fair Value
Cash and cash equivalents	94.9	2.6%	125.3	3.5%
Short-term investments	29.9	0.8%	40.0	1.1%
Bonds				
Federal	1,839.1	50.4%	1,596.1	44.7%
Provincial	334.2	9.2%	479.9	13.5%
Corporate	824.4	22.6%	789.0	22.1%
	2,997.7	82.2%	2,865.0	80.3%
Canadian preferred stocks	114.9	3.1%	163.9	4.6%
Common stocks				
Canadian	208.8	5.7%	178.2	5.0%
Foreign	138.8	3.8%	118.1	3.3%
	462.5	12.6%	460.2	12.9%
Canadian income trusts	12.2	0.4%	9.0	0.3%
Commercial loans	51.7	1.4%	69.0	1.9%
	3,648.9	100.0%	3,568.5	100.0%

The Group maintains a balanced but low-risk investment strategy, which seeks to generate a satisfactory return while protecting the policyholders' equity and effectively managing The Group's capital. The strategy 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 become evident. 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.

The fair value of investments in bonds increased \$132.7 million year-over-year. In 2009, The Group transitioned the

portfolio into a more conservative position in light of expected market volatility. This strategy continued in 2010 as the bond mix continued to change, with a 1.9% increase in the mix of bond holdings.

Preferred stocks have been volatile for several years, and The Group has been strategically reducing its preferred stock holdings through redemptions and sales.

Based on a forecast of improved capital market conditions, The Group made the decision to recommence investing in common stocks in 2010.

The fair value of commercial loans decreased \$17.3 million year-over-year as principal repayments received in 2010 exceeded the amount of new loans issued.

INTEREST AND DIVIDEND INCOME

Figure 8
(in millions of dollars, except as otherwise noted)

	Year ended December 31		Increase (Decrease)
	2010	2009	
Interest income	96.2	99.8	(3.6)
Dividend income	18.2	25.4	(7.2)
Total	114.4	125.2	(10.8)

Interest income decreased slightly year-over-year due primarily to a higher concentration of lower-interest yielding Government bonds in the investment portfolio. Dividend income declined 28.3% from the prior year as the preferred share portfolio was reduced in keeping with The Group's

strategy to reduce risk and maintain statutory capital. The level of investment income generated remains strong, despite the de-risking strategies undertaken and the weak interest rate environment.

RECOGNIZED GAIN ON INVESTMENTS

Figure 9
(in millions of dollars, except as otherwise noted)

	Year ended December 31		Increase (Decrease)
	2010	2009	
Realized gains on sale of bonds	40.1	60.6	(20.5)
Realized gains on sale of equities	21.6	24.3	(2.7)
Unrealized losses on bonds held for trading	(5.3)	(20.9)	15.6
Impairment loss	(23.1)	(23.5)	0.4
Total	33.3	40.5	(7.2)

A subset of the bond portfolio, which is matched in quantum and duration to the claim reserves, is designated as held for trading ("HFT"). Changes in the market value of HFT instruments flows through the consolidated statement of income. The balance of the bond portfolio along with The Group's equity portfolio is designated as available for sale ("AFS"). Changes in the fair value of AFS instruments flows through other comprehensive income.

Recognized gain on investments, comprised of unrealized losses on the HFT portfolio, realized gains on the disposal

of investments and the impairment loss declined \$7.2 million in the current year. Realized gains on the sale of bonds and equities were down due to lower turnover of assets in the portfolio. Unrealized losses on bonds in the HFT portfolio declined as bond prices increased during the course of the year.

The Group has maintained a high-quality and diversified portfolio despite very challenging capital market conditions over the past couple of years. Investment write-downs represented less than 1% of total invested assets in 2010.

INVESTMENT CREDIT QUALITY

The Group continuously monitors the credit ratings of investments within the portfolio to ensure that a high level of quality is maintained. This resulted in 98.9% (2009: 99.1%) of The Group's bonds being rated "A-" or better and 100.0% (2009: 100.0%) of the preferred stocks being rated "P2" or better.

The following tables illustrate the excellent credit quality of The Group's fixed income securities and preferred shares portfolios.

Figure 10
(in millions of dollars, except as otherwise noted)

	As at December 31, 2010		As at December 31, 2009	
	Fair Value	% @ Fair Value	Fair Value	% @ Fair Value
AAA	1,977.6	66.0%	1,924.0	67.2%
AA	396.8	13.2%	389.2	13.6%
A	591.5	19.7%	524.3	18.3%
BBB or BB	31.8	1.1%	27.5	0.9%
Total	2,997.7	100.0%	2,865.0	100.0%

Figure 11
(in millions of dollars, except as otherwise noted)

	As at December 31, 2010		As at December 31, 2009	
	Fair Value	% @ Fair Value	Fair Value	% @ Fair Value
P1	69.9	60.8%	138.1	84.3%
P2	45.0	39.2%	25.8	15.7%
Total	114.9	100.0%	163.9	100.0%

The Group focuses its investments on high-quality and highly liquid investments, which are generally supported by quoted market prices or other observable inputs.

The Group has reviewed its portfolio to identify investments determined to be impaired due either 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.

The Group 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 debtors and pledged collateral indicates that there is reasonable assurance of timely collection of the full amount of principal and interest.

Section 7 – Financial Strength

FINANCIAL HIGHLIGHTS FOR THE YEAR INCLUDE:

Investments	\$111.1 million growth in invested assets during the year, reflecting the investment of cash generated by the profitable performance of The Group.
Total assets	Total assets increased by \$29.4 million compared to the prior year.
Premium-related balances	Premium-related assets and liabilities decreased as expected in line with reduced GWP levels.
Claim liabilities	Claim liabilities remained consistent, reflecting improved claims ratios and claim management.
Policyholders' equity	Total policyholders' equity increased by \$87.3 million, or 7.5%, to an historical high, demonstrating The Group's excellent financial position and strength.

FIGURE 12 SHOWS THE SIGNIFICANT BALANCE SHEET LINE ITEMS.

Figure 12 (in millions of dollars, except as otherwise noted)	As at December 31		
	2010	2009	Increase (Decrease)
Cash and cash equivalents	94.9	125.3	(30.4)
Investments	3,556.8	3,445.7	111.1
Premiums receivable	482.8	516.5	(33.7)
Reinsurance receivables	93.1	122.9	(29.8)
Deferred policy acquisition expenses	173.3	179.6	(6.3)
Goodwill and intangible assets	77.3	71.0	6.3
Other assets	155.0	142.8	12.2
Total Assets	4,633.2	4,603.8	29.4
Claim liabilities	2,372.7	2,360.4	12.3
Unearned premiums	858.2	904.0	(45.8)
Other liabilities	144.3	168.7	(24.4)
Total Liabilities	3,375.2	3,433.1	(57.9)
Retained earnings	1,255.9	1,191.5	64.4
Accumulated other comprehensive income (loss)	2.1	(20.8)	22.9
Policyholders' equity	1,258.0	1,170.7	87.3
	4,633.2	4,603.8	29.4

UNPAID CLAIM AND ADJUSTMENT EXPENSES

Claim liabilities represent an estimate of the amount required to settle all outstanding claims and any 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 discounted claim liabilities are best estimates.

The discount rate used to determine the actuarial value of claim liabilities is based on the fair value yield of The Group's HFT bond portfolio, which was 2.39% (2009: 2.50%).

FIGURE 13 SHOWS THE CHANGE IN THE GROUP'S CLAIM LIABILITIES FOR THE PAST TWO YEARS.

Figure 13 (in millions of dollars, except as otherwise noted)	Year ended December 31	
	2010	2009
Net unpaid claim liabilities at the beginning of the year	2,265.6	2,188.1
Change in estimated losses and expenses for claims occurring in prior years:		
Core lines of business	(51.4)	(57.6)
Industry pools	(18.9)	2.0
Impact of discounting	(12.9)	11.7
Losses and expenses on claims occurring in the current year	1,251.1	1,444.2
Paid on claims occurring during:		
Current year	(541.8)	(659.5)
Prior years	(597.0)	(663.3)
Net unpaid claim liabilities at the end of the year	2,294.7	2,265.6

Figure 14 (in millions of dollars, except as otherwise noted)	Year ended December 31				
	2010	2009	2008	2007	2006
Net unpaid claim liabilities, beginning of year	2,265.6	2,188.1	1,912.3	1,771.3	1,514.0
(Favourable)/adverse development on prior year claims, undiscounted	(70.2)	(55.7)	(43.7)	(38.2)	11.7
Impact of discounting	(13.0)	11.8	42.6	(4.1)	(14.8)
Beneficial change in claims occurring in prior years	(83.2)	(43.9)	(1.1)	(42.3)	(3.1)

As illustrated, these favourable trends demonstrate The Group's prudent approach to its claim reserving, and further support the excellent financial strength of the organization

and its capacity to meet its claim obligations. In all but 2006, The Group's claim liabilities have been conservative when compared to actual development.

POLICYHOLDERS' EQUITY

FIGURE 15 ILLUSTRATES THE CHANGE IN THE GROUP'S POLICYHOLDERS' EQUITY OVER THE LAST FIVE YEARS.

Figure 15 (in millions of dollars, except as otherwise noted)	As at December 31				
	2010	2009	2008	2007	2006
Retained earnings	1,255.9	1,191.5	1,167.4	1,269.8	1,151.6
Accumulated other comprehensive income (loss)	2.1	(20.8)	(88.4)	(14.1)	—
Policyholders' equity	1,258.0	1,170.7	1,079.0	1,255.7	1,151.6

The Group's retained earnings increased by \$64.4 million (2009: \$24.1 million) during the year, and policyholders' equity increased 7.5% year-over-year. Policyholders' equity

ended the year at the highest level in the 139-year history of The Group and it is poised to grow in the coming years as the strategy of profitable growth takes hold.

CAPITAL MANAGEMENT

Management develops the capital strategy for The Group and oversees the capital management processes. As a group of federally regulated property and casualty insurance companies, The Group's capital position is monitored by OSFI. OSFI evaluates the Company's financial strength primarily through the minimum capital test ("MCT"), which measures available capital against required risk-weighted capital. Available capital comprises total policyholders' equity subject to adjustments prescribed by OSFI. Capital required is calculated by applying risk factors to assets and liabilities. As of December 31, 2010, The Group's available

capital exceeds the minimum capital of 150% required by OSFI, and significantly exceeds a higher and more stringent target as set by The Board of Directors.

Management actively monitors the MCT and the effect that external and internal forces and actions have on the capital base of The Group. 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.

FIGURE 16 SHOWS THE MCT FOR THE GROUP OVER THE PAST FIVE YEARS.

Figure 16	As at December 31				
	2010	2009	2008	2007	2006
MCT	234.2%	222.6%	200.2%	231.9%	220.6%

The MCT has improved significantly in 2010, and The Group is in one of the strongest positions from a capital standpoint in its history. The Group has capital in excess of the 150% minimum demanded by OSFI. Management regularly monitors the MCT ratio, including the performance of annual dynamic capital adequacy stress testing, to ensure that The Group maintains a strong regulatory capital position, and is ready to take corrective actions as necessary.

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

NET RISK RATIO

Another ratio used to measure the financial strength of insurers is the net risk ratio ("NRR"). The NRR measures the leverage employed by The Group, expressing net written

premiums for a 12-month period as a ratio to policyholders' equity. The OSFI guideline for NRR is 3:1 or less.

FIGURE 17 SHOWS THE GROUP'S NRR FOR THE PAST FIVE YEARS.

Figure 17	As at December 31				
	2010	2009	2008	2007	2006
NRR	1.3	1.5	1.7	1.5	1.6

OFF BALANCE SHEET LIABILITIES AND CONTINGENCIES

In common with the insurance industry, 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 does not and will not have a significant impact on the financial position, results from operations or the 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 is less than 1.0% 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 expire within the next twelve months. The swaps experienced an increase in fair value of \$0.2 million in 2010 (2009: \$3.4 million). The Group does not actively trade in derivatives for either hedging or speculative purposes.

COMMITMENTS

The Group operates throughout Canada in order to service its customers and support its broker distribution chain in an effective manner. As a result, The Group has committed to leasing premises, automobiles and equipment in support of these operations. Annual commitments are as follows.

YEAR	
2011	\$19.4 million
2012	\$15.6 million
2013	\$12.9 million
2014	\$11.4 million
2015	\$10.8 million
Thereafter	\$22.4 million

The Group participates in a securities lending program managed by a major Canadian financial institution whereby The Group lends securities it owns to other financial institutions in order to allow them to meet delivery commitments. The Canadian financial institution involved must provide sufficient collateral to support the value of the securities lent. At December 31, 2010, securities with an estimated fair value of \$337.7 million (2009: \$386.8 million) have been lent and securities with an estimated fair value of \$349.1 million (2009: \$399.4 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 Group retains the risks and rewards of ownership. The financial compensation The Group receives in exchange for securities lending is reflected in the consolidated statement of income in "Interest".

Section 8 – Accounting and Internal Controls

INTERNAL CONTROLS AND PROCEDURES

The Group has designed internal controls and procedures to ensure that accurate financial information is available internally to senior management and externally, to regulators and policyholders, in a timely and appropriate 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. The Group continues to monitor, assess and improve its system of internal controls and procedures.

CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

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, 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 most significant estimates and assumptions used in the preparation of the consolidated financial statements are summarized below.

POLICY LIABILITIES

Policy liabilities consist of claim liabilities and unearned premium liabilities net of reinsurance. In accordance with Canadian accepted actuarial practice, future investment income has been considered in the determination of policy liabilities and, 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 in 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 claim expenses. They are determined by taking into account the consistency of The Group's claim 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 claim 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 judicial interpretation of contracts or significant changes in severity or frequency of claims that diverge from past trends. Changes in the market yield of the HFT bond portfolio also affect the estimates as the policy liabilities are discounted based on the yield of this portfolio. 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 might be revised. Any 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 (“DPAE”). 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 DPAE 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 insured parties. 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 in Canadian unlisted markets. Impairment of invested securities results in a charge to earnings when a decline in the market value of an AFS investment to below cost is other-than-temporary. Members of the investment and finance departments meet regularly

to assess the impairments, and to 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.

GOODWILL AND INTANGIBLE ASSETS

The establishment of goodwill and intangible assets and the ongoing review of these assets for possible impairment require management to make estimations and exercise judgement.

Upon initial recognition of goodwill, The Group analyzes the purchase price 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’s 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 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.

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 of the asset. 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 Group are recognized as intangible assets when specific accounting capitalization criteria are met. Other development expenditures that do not meet the capitalization criteria are recognized as an expense as incurred.

INCOME TAXES

The Group operates in various tax jurisdictions, each subject to different income tax laws. 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, which are currently closed to new entrants, provide pension benefits based on length of service and an average of the highest 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 the expected 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 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 other factors such as: expected plan salary escalation, expected retirement age of employees, and expected health care costs. All assumptions are determined by management and are reviewed annually by The Group’s external actuarial advisors. Actual experience that differs from the assumptions will affect the amounts of the benefit obligation and the expense.

FUTURE ACCOUNTING AND REPORTING CHANGES

INTERNATIONAL FINANCIAL REPORTING STANDARDS (“IFRS”)

The Group will first report under IFRS for the year ended December 31, 2011 with 2010 comparative information generally 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 updated quarterly on the progress and results of the IFRS project. A detailed timetable has been prepared and the project is on schedule, with the activities required for the changeover to IFRS substantially now completed. To date, the team has analyzed the IFRS standards expected to be in effect for 2011 and identified the accounting policy changes to be made.

In general, an entity is required to apply IFRS principles on a retrospective basis; however, certain optional exemptions from retrospective application are permitted under the transition standard. The Group has provisionally determined its transition choices and policy elections. Under IFRS 1 – “First Time Adoption of IFRS”, The Group has elected not to restate prior business combinations and instead intends to apply the IFRS requirements prospectively to any

acquisitions completed after January 1, 2010. Elections have also been made in respect of The Group’s accounting for its defined benefit plans, as outlined hereafter. No changes have been made in respect of the measurement of The Group’s property and equipment, or the classification of its financial instruments, upon transition.

In addition to measurement differences discussed hereafter, there will be numerous presentation and disclosure changes required to ensure that the 2011 financial statements comply with IFRS. The Group is currently in the process of drafting and reviewing these presentation and disclosure changes.

The initial adoption of IFRS will have no significant impact on The Group’s internal controls and procedures, information technology systems or business activities. Staff training has been provided and will continue as new standards are issued.

The Group has identified the following significant accounting policy differences between existing Canadian GAAP and IFRS, which are expected to have measurement impacts on the financial statements at transition.

A) EMPLOYEE FUTURE BENEFIT PLANS

First-time adopters can elect to recognize all cumulative actuarial gains and losses at the date of transition as an adjustment to opening retained earnings. Alternatively, entities may elect an IFRS “corridor” approach to leave some actuarial gains and losses unrecognized, as if an IFRS “corridor” approach had always been applied.

The Group has elected to recognize all cumulative actuarial losses at the date of transition as an adjustment to opening

B) FINANCIAL INSTRUMENTS

First-time adopters can also choose to reclassify their financial assets and financial liabilities at the transition date. The Group has elected not to change its current investments classification.

On transition to IFRS, The Group is also required to reassess its AFS financial assets for impairment under IFRS. IFRS does not include the “other-than-temporary impairment” rule which is applicable under Canadian GAAP and, as such, impairment losses on AFS financial assets may be recorded more quickly in the future.

The Group is currently completing its assessment of the impact of IFRS transition on its AFS financial assets.

retained earnings. The Group has estimated the January 1, 2010 transition impact on retained earnings to be a reduction of approximately \$32.6 million, net of tax. This adjustment represents the only significant transition adjustment to policyholders’ equity. Post-transition to IFRS, The Group has elected to recognize ongoing actuarial gains or losses immediately in other comprehensive income.

Retrospective application of IFRS impairment rules on transition will likely require a reclassification from accumulated other comprehensive income (“AOCI”) to retained earnings. This reclassification will have no overall impact on The Group’s policyholders’ equity or its reported MCT ratio.

Further changes to the IFRS accounting standards are possible and have the potential to introduce additional significant accounting differences. The Group continues to actively monitor developments with IFRS and assess their potential impact on the organization.

Section 9 – Risk Management

The Group is engaged in the business of gauging, assuming and managing risk. Effective risk management relies on recognizing risk, developing risk management 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 the Internal Audit process, 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. A summary of the most significant risks faced

by The Group and the processes for managing them is outlined below.

As part of The Group's continuing involvement and its focus on best practice governance processes, The Group is currently in the process of recruiting a Chief Risk Officer ("CRO"). The CRO will report directly to the Chief Executive Officer. Once established, the CRO will enhance and build on the existing risk management practices of The Group and facilitate integration with The Group's existing compliance and risk management functions, while ensuring that The Group continues its long track record of compliance with the provincial and federal regulatory bodies overseeing its activities. The CRO will also help The Group stay abreast of best practices related to enterprise risk management.

INSURANCE RELATED RISKS

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 claim frequency, severity trends, product line expense ratios, special risk factors, capital requirements and investment income. These factors are reviewed and adjusted as needed to ensure they are reflective of current trends and market conditions.

For automobile insurance, certain elements of pricing must be submitted to various provincial regulators. It is possible that decisions or delays by provincial regulators may restrict automobile rate changes or other actions that The Group wishes to take.

When there is intense competition in the marketplace for any product line, The Group's competitors may price their products at rates that appear to be below the level required 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. As demonstrated in 2010, 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

The Group's performance depends on the ability to reduce financial loss resulting from the selection of risks to be insured and the management of contract clauses.

Unfavourable results in these areas can lead to deviations from the estimates based on actuarial assumptions. The Group has adopted underwriting policies that set out the

underwriting risk appetite and criteria of the organization, together with specifying 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 future claims as they arise. Management monitors the solvency of The Group by requiring compliance with strict solvency standards based on the risks assumed. The Board of Directors has established a minimum solvency standard well above that required by OSFI. On an annual basis, the Appointed Actuary must present a report to the Audit Committee on The Group's current and future solvency. In

addition, The Group is required to submit quarterly reports to OSFI regarding solvency.

The Group actively monitors the MCT ratio and the affect that external and internal forces and 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 for claims. The Group is exposed to credit risk with respect to the amounts ceded to

its reinsurers. With the assistance of its reinsurance broker, The Group regularly assesses the financial soundness of the reinsurers it deals with, including, but not limited to, the monitoring of reinsurers' credit ratings.

INVESTMENT RELATED RISKS

Management is responsible for the establishment of, and ongoing adherence to, Investment Policies which ensure The Group's investments are prudently managed to protect policyholders' equity, while maximizing long-term returns. The Board of Directors oversees this through an Investment Committee that reviews and recommends approval of the Investment Policies and monitors compliance with those policies on a regular basis.

The Group has established detailed Investment Policy Statements which, as noted above, are subject to regular review and approval, for both the matched and non-matched

investment portfolios. These policy statements set out The Group's philosophy to its investment management, which is to maximize the long-term returns to The Group while effectively managing risk, and include specific guidelines over such items as asset mix, concentration levels in specific investments, required quality of the underlying investments, the use of derivatives and exposure to foreign currencies. Compliance with these guidelines, and the requirements of the Insurance Companies Act, is routinely monitored and reported on to the Investment Committee.

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 this situation 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 or negatively impact the equity markets and consequently, the equity investments of The Group.

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 in order to extinguish a liability. Credit risk is concentrated in the bond and preferred share investment portfolios, reinsurance receivable and recoverable and the amounts owing from brokers and policyholders in the form of premium payments.

FOREIGN EXCHANGE RISK

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

USE OF DERIVATIVES RISK

Generally, The Group's investment policies limit the use of derivative instruments, without prior Investment Committee approval. As such, The Group's current use of derivative instruments is limited to the credit default swaps noted earlier in the MD&A. There were no purchases or sales of

In addition to ensuring compliance with The Group's asset mix requirements, The Group actively monitors the sensitivity of its investment portfolio to changes in the interest rate environment and equity markets. As illustrated in Note 6 to the consolidated financial statements, The Group is most exposed to changes in interest rates as a result of its significant bond portfolio.

The Group's risk management strategy is to invest in fixed-income instruments and preferred shares of high-credit quality issuers and to limit the amount of credit exposure with respect to any one issuer by imposing limits based upon credit quality. Please refer to Figures 10 and 11 for more information. In addition, The Group sets limits on the total credit exposure across all asset classes. These limits are specifically outlined in The Group's Investment Policy Statements, as discussed above.

In accordance with The Group's investment policies, there is minimal exposure to this risk as of December 31, 2010.

credit default swaps during 2010. In addition, The Group conducts a search for embedded derivatives on an annual basis, and found no material embedded derivatives that required bifurcation.

OTHER RELATED RISKS**LIQUIDITY RISK**

Liquidity risk is the risk that The Group will encounter difficulty in raising funds to meet obligations associated with financial liabilities, particularly those related to claim payments. An appropriate portion of invested assets is maintained in short-term (less than one year) highly liquid

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 ongoing monitoring and follow-up on risks and controls through regular reporting by the Control and Risk

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 in the manner 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

money market securities, which are used to manage The Group's operational requirements. A large portion of invested assets are held in highly liquid federal and provincial government debt to protect against any unanticipated large cash requirements.

Management Committee to the Audit Committee and to the Corporate Governance and Conduct Review Committee.

Internal Audit creates 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.

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 affect 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.

Section 10 – Other Matters

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain of the statements in this MD&A regarding The Group's current and future plans, expectations and intentions, results, levels of activity, performance, goals or achievements, or any other future events or developments constitute forward-looking statements. The words "may", "will", "would", "should", "could", "expects", "plans", "intends", "trends", "indications", "anticipates", "believes", "estimates", "predicts", "likely" or "potential" or the negative or other variations of these words or other similar or comparable words or phrases, are intended to identify forward-looking statements.

Forward-looking statements are based on estimates and assumptions made by management based on management's experience and perception of historical trends, current conditions and expected future developments, as well as other factors that management believes are appropriate in the circumstances. Many factors could cause The Group's actual results, performance, achievements, future events or developments to differ materially from those expressed or implied by the forward-looking statements, including, without limitation, the following factors: The Group's ability to implement its strategy or operate its business as management currently expects; its ability to accurately assess the risks associated with the insurance policies that it

writes; unfavourable capital market developments or other factors which may affect The Group's investments and funding obligations under its pension plans; the cyclical nature of the P&C industry; management's ability to accurately predict future claims frequency or severity; government regulations; litigation and regulatory actions; periodic negative publicity regarding the insurance industry; intense competition; The Group's reliance on information technology and telecommunications systems; The Group's dependence on key employees; general economic, financial and political conditions; and The Group's dependence on the results of operations of its member companies.

All of the forward-looking statements included in this MD&A are qualified by these cautionary statements and those made in the "Risk Management" section of the MD&A for the year ended December 31, 2010. These factors are not intended to represent a complete list of the factors that could impact The Group; however, these factors should be considered carefully, and readers should not place undue reliance on forward-looking statements made herein. The Group and management have no intention and undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

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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.

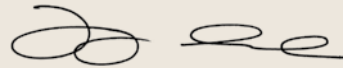
Management is responsible for ensuring that these statements, which include amounts based on estimates and judgement, are consistent with other information and operating data contained in the Annual Report, and reflect the company's business transactions and financial position.

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

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

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

The Board of Directors annually appoints an Audit Committee 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.



Jorge Arruda
Senior Vice President, Operations, for 2010



Bharat Kannan
Vice President, Finance and Controller

Waterloo, Canada
February 24, 2011

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, 2010, and their change in the consolidated statement of income for the year then ended in accordance with accepted actuarial practice in Canada, including selection of appropriate assumptions and methods.

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



Linda M. Goss
Fellow, Canadian Institute of Actuaries

Waterloo, Canada
February 24, 2011

Independent Auditor's Report

To the Members of Economical Mutual Insurance Company

We have audited the accompanying consolidated financial statements of Economical Mutual Insurance Company, which comprise the consolidated balance sheet as at 31 December 2010 and the consolidated statements of income, comprehensive income, changes in policyholders' equity and cash flows for the year then ended and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Economical Mutual Insurance Company as at 31 December 2010 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

Chartered Accountants

Licensed Public Accountants

Kitchener, Canada
February 24, 2011

Consolidated Balance Sheet

(in thousands of dollars)	Year ended December 31	
	2010	2009
ASSETS		
Cash and cash equivalents	\$ 94,896	\$ 125,294
Investments (note 5)	3,556,784	3,445,743
Accrued investment income	18,897	16,945
Premiums receivable	482,776	516,536
Reinsurance receivable and recoverable (notes 7 and 11)	93,088	122,862
Deferred policy acquisition expenses (note 7)	173,256	179,575
Property and equipment (note 9)	27,635	29,004
Future income tax asset	36,104	28,168
Other assets	72,442	68,665
Goodwill and intangible assets (note 10)	77,338	71,016
	\$ 4,633,216	\$ 4,603,808
LIABILITIES AND POLICYHOLDERS' EQUITY		
Unearned premiums (note 7)	\$ 858,248	\$ 903,984
Provision for unpaid claims (note 7)	2,372,682	2,360,440
Accounts payable and other liabilities	140,674	120,216
Income, premium and other taxes payable	3,595	48,508
	3,375,199	3,433,148
POLICYHOLDERS' EQUITY		
Retained earnings	1,255,869	1,191,460
Accumulated other comprehensive income (loss)	2,148	(20,800)
Total policyholders' equity (note 18)	1,258,017	1,170,660
	\$ 4,633,216	\$ 4,603,808

Commitments and contingent losses (notes 15 and 16).

See accompanying notes.

On behalf of the Board:

G.A. Hooper
Director

T.J. Reidel
Director

Consolidated Statement of Income

(in thousands of dollars)	Year ended December 31	
	2010	2009
Gross premiums written (note 11)	\$ 1,722,030	\$ 1,826,333
Net premiums written (note 11)	\$ 1,626,378	\$ 1,747,468
Net premiums earned (note 11)	\$ 1,676,369	\$ 1,813,256
Underwriting expenses (notes 7 and 11):		
Claims and adjustment expenses	1,167,893	1,400,291
Commissions	349,563	348,830
Operating expenses	155,698	145,282
Premium taxes	58,896	62,710
	1,732,050	1,957,113
Underwriting loss	(55,681)	(143,857)
Investment income (note 5):		
Interest	96,175	99,752
Dividends	18,194	25,449
Recognized gain on investments	33,338	40,474
	147,707	165,675
Other expense	(6,544)	(2,004)
Income before income taxes	85,482	19,814
Income tax expense (recovery) (note 4)		
Current	29,009	(3,851)
Future	(7,936)	(402)
	21,073	(4,253)
Net income	\$ 64,409	\$ 24,067

See accompanying notes.

Consolidated Statement of Comprehensive Income

(in thousands of dollars)	Year ended December 31	
	2010	2009
Net income	\$ 64,409	\$ 24,067
Other comprehensive income (note 14)	22,948	67,585
Comprehensive income	\$ 87,357	\$ 91,652

See accompanying notes.

Consolidated Statement of Changes in Policyholders' Equity

(in thousands of dollars)	Year ended December 31					
	2010			2009		
	Retained earnings	Accumulated other comprehensive income (loss)	Total policyholders' equity	Retained earnings	Accumulated other comprehensive income (loss)	Total policyholders' equity
Balance, beginning of the year	\$ 1,191,460	\$ (20,800)	\$ 1,170,660	\$ 1,167,393	\$ (88,385)	\$ 1,079,008
Net income	64,409	—	64,409	24,067	—	24,067
Other comprehensive income	—	22,948	22,948	—	67,585	67,585
Balance, end of the year	\$ 1,255,869	\$ 2,148	\$ 1,258,017	\$ 1,191,460	\$ (20,800)	\$ 1,170,660

See accompanying notes.

Consolidated Statement of Cash Flows

(in thousands of dollars)	Year ended December 31	
	2010	2009
Operating activities:		
Receipts:		
Premiums collected	\$ 1,660,075	\$ 1,799,847
Investment income received	136,518	154,977
Income, premium and other taxes received	—	59,193
	1,796,593	2,014,017
Payments:		
Claims paid (note 7)	1,138,774	1,322,853
Expenses paid	466,021	487,204
Income, premium and other taxes paid	146,040	—
	1,750,835	1,810,057
Net cash provided by operating activities	45,758	203,960
Investing activities:		
Investments purchased	(3,108,521)	(3,518,678)
Investments sold, redeemed or matured	3,048,200	3,342,403
Other assets purchased	(17,294)	(10,712)
Business dispositions, net of cash	1,459	5,365
Net cash used in investing activities	(76,156)	(181,622)
Cash and cash equivalents:		
Net (decrease) increase during the year	(30,398)	22,338
Balance, beginning of the year	125,294	102,956
Balance, end of the year	\$ 94,896	\$ 125,294
Cash	\$ 92,896	\$ 123,294
Cash equivalents	2,000	2,000
Total cash and cash equivalents	\$ 94,896	\$ 125,294
Supplemental cash flow information:		
Income taxes paid	\$ 84,694	\$ —

See accompanying notes.

Notes to the Consolidated Financial Statements

December 31, 2010

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”). 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 Westmount Financial Inc. (collectively the “Company”). The consolidated financial statements of the Company also include the TEIG Investment Partnership, which manages the investment portfolio for all insurance 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 any 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.

(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 timeframe, 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 or observable market inputs. 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" ("OCI") in the consolidated statement of comprehensive income until the disposal of the financial instrument or an other than temporary impairment is identified. When the financial instrument is disposed of, the gain or loss is reclassified from "Accumulated other comprehensive income (loss)" ("AOCI") to "Recognized gain on 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 "Recognized gain on 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 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 – *Financial Instruments – Recognition and Measurement*. The Company voluntarily designates certain items as HFT with reference to the criteria outlined in OSFI 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 financial assets. Changes in fair values of HFT financial instruments are recorded in "Recognized gain on investments" 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 "Recognized gain on 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 financial liabilities 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 "Recognized gain on investments".

(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 the 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 as follows:

	BASIS	RATES
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 the individual 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	5-20 years
Other intangible assets	7 years

(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 unit credit 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 applicable to 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 sheet 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**Business Combinations, Consolidated Financial Statements and Non-controlling Interests**

Effective for business combinations on or after January 1, 2010, the Company adopted CICA 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 an expense in the periods they are incurred, except for

costs incurred to issue debt or share capital. 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. Section 1601 and Section 1602 must be adopted concurrently with Section 1582. The change aligns CICA standards with international financial reporting standards ("IFRS"). The adoption of these changes in accounting policies had no impact on the consolidated financial statements.

3. FUTURE ACCOUNTING AND REPORTING CHANGES**International Financial Reporting Standards ("IFRS")**

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 expected to be in effect for 2011 and identified accounting policy changes to be made.

Further changes to the IFRS accounting standards are possible and have the potential to introduce additional significant accounting differences.

4. INCOME TAX EXPENSE (RECOVERY)

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

(in thousands of dollars)	2010	2009
Income tax expense based upon statutory tax rates	\$ 26,004	\$ 6,370
Adjustments to income tax expense (recovery) related to:		
Canadian dividend income not subject to tax	(4,680)	(7,254)
Non-deductible expenses	699	1,423
Effect of change in substantively enacted tax legislation	—	(5,615)
Rate differential on AFS-recognized gains	(2,732)	(205)
Other	1,782	1,028
Income tax expense (recovery) reflected in the consolidated statement of income	\$ 21,073	\$ (4,253)

5. INVESTMENTS**(a) Investment income and balances**

Investment income by financial instrument classification is as follows:

(in thousands of dollars)	2010			Total
	HFT	AFS	Loans and receivables	
Interest	\$ 59,610	\$ 33,203	\$ 3,362	\$ 96,175
Dividends	—	18,194	—	18,194
Realized gain on sale of investments	23,995	37,759	—	61,754
Impairment loss on AFS investments	—	(23,079)	—	(23,079)
Unrealized loss on HFT financial instruments	(5,337)	—	—	(5,337)
Recognized gain on investments	18,658	14,680	—	33,338
	\$ 78,268	\$ 66,077	\$ 3,362	\$ 147,707

(in thousands of dollars)	2009			Total
	HFT	AFS	Loans and receivables	
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)
Recognized gain on investments	32,881	7,593	—	40,474
	\$100,825	\$ 61,250	\$ 3,600	\$ 165,675

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

(in thousands of dollars)	2010			
	HFT	AFS	Loans and receivables	Total
Short-term investments	\$ —	\$ 29,916	\$ —	\$ 29,916
Bonds	2,186,493	811,252	—	2,997,745
Preferred stocks	—	114,902	—	114,902
Common stocks	—	347,603	—	347,603
Income trust units	—	12,154	—	12,154
Commercial loans (note 12)	—	—	54,464	54,464
	\$ 2,186,493	\$ 1,315,827	\$ 54,464	\$ 3,556,784

(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

The commercial loans have an amortized cost of \$54.5 million (2009: \$0.3 million) and the gross unrealized gains of \$69.0 million, which reflects the gross unrealized gains of \$51.7 million (2009: \$0.2 million) and the gross unrealized losses of \$3.1 million (2009: \$2.7 million).

The unrealized gains (losses) on AFS investments are detailed below. The cost of all AFS investments, except AFS bonds, is the purchase price less impairment losses, if applicable. The cost of all AFS bonds is the amortized cost adjusted for impairment losses or recoveries.

(in thousands of dollars)	2010			
	Cost/amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Canadian short-term investments	\$ 29,916	\$ —	\$ —	\$ 29,916
Bonds:				
Federal	218,392	—	(1,220)	217,172
Provincial	186,194	877	(1,817)	185,254
Corporate	409,683	5,252	(6,109)	408,826
	814,269	6,129	(9,146)	811,252
Canadian preferred stocks	114,148	3,478	(2,724)	114,902
Common stocks:				
Canadian	202,854	8,146	(2,239)	208,761
Foreign	138,288	554	—	138,842
	341,142	8,700	(2,239)	347,603
Canadian income trust units	12,598	56	(500)	12,154
	\$ 1,312,073	\$ 18,363	\$ (14,609)	\$ 1,315,827

(in thousands of dollars)	2009			
	Cost/amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Canadian short-term investments	\$ 39,970	\$ —	\$ —	\$ 39,970
Bonds:				
Federal	306,153	—	(7,043)	299,110
Provincial	230,187	1,647	(1,279)	230,555
Corporate	245,317	871	(9,786)	236,402
	781,657	2,518	(18,108)	766,067
Canadian preferred stocks	163,861	6,774	(6,687)	163,948
Common stocks:				
Canadian	172,796	16,200	(10,826)	178,170
Foreign	141,720	—	(23,613)	118,107
	314,516	16,200	(34,439)	296,277
Canadian income trust units	8,417	1,263	(636)	9,044
	\$ 1,308,421	\$ 26,755	\$ (59,870)	\$ 1,275,306

(b) Financial instruments measured at fair value

The Company categorizes its fair value measurements according to a three-level hierarchy, which 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 fair value measurements 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 with a fair value of \$462.5 million (2009: \$460.2 million) and income trust units with a fair value of \$12.2 million (2009: \$9.0 million).

(ii) Level 2 fair value measurements use 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 with a fair value of \$2,997.7 million (2009: \$2,865.0 million) and short-term investments with a fair value of \$29.9 million (2009: \$40.0 million).

(iii) Level 3 fair value measurements use significant non-market observable inputs, including assumptions about risk or liquidity. This category is comprised of credit default swaps with a negligible fair value (2009: \$0.2 million).

There were no transfers of financial instruments between levels during the year.

(c) Term to maturity

(in thousands of dollars)	2010				Total
	Less than 1 year	1-5 years	6-10 years	10 years +	
Canadian short-term investments	\$ 29,916	\$ —	\$ —	\$ —	\$ 29,916
Bonds:					
HFT					
Federal	40,646	1,581,239	—	—	1,621,885
Provincial	—	148,908	—	—	148,908
Corporate	15,186	369,149	31,365	—	415,700
	55,832	2,099,296	31,365	—	2,186,493
AFS					
Federal	—	96,223	120,949	—	217,172
Provincial	—	—	185,254	—	185,254
Corporate	40,289	144,912	203,239	20,386	408,826
	40,289	241,135	509,442	20,386	811,252
Canadian preferred stocks	52,012	54,791	8,099	—	114,902
Canadian commercial loans	6,403	33,563	14,498	—	54,464
Total, at carrying value	\$ 184,452	\$ 2,428,785	\$ 563,404	\$ 20,386	\$ 3,197,027

(in thousands of dollars)	2009				Total
	Less than 1 year	1-5 years	6-10 years	10 years +	
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

The fair value yield at December 31 for the HFT bond portfolio was 2.39% (2009: 2.50%) and for the AFS bond portfolio was 3.77% (2009: 5.96%).

(d) Impairment review

During the year, the Company reclassified unrealized losses of \$25.8 million (2009: \$25.9 million) for impaired AFS stocks from AOCI to net income. The Company also recorded a \$2.7 million recovery (2009: \$2.4 million recovery) in net income for the increase in fair value of a previously impaired AFS bond due to a change in circumstances arising during the year related to the issuer.

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 participates in a securities lending program managed by a major Canadian financial institution whereby the Company lends securities it owns to other financial institutions to allow them to meet delivery commitments. The Canadian financial institution assumes all the risk associated with the lending activity. At December 31, securities with an estimated fair value of \$337.7 million (2009: \$386.8 million) have been loaned and securities with an estimated fair value of \$349.1 million (2009: \$399.4 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 notional amount of \$45.0 million (2009: \$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 negligible liability as at December 31 (2009: \$0.2 million liability) and has been accrued in "Accounts payable and other liabilities" on the consolidated balance sheet. A \$0.2 million gain (2009: \$3.4 million gain) as a result of the change in the fair value of the credit default swaps has been included in "Recognized gain on investments" in the consolidated statement of income. Credit default swaps with a notional amount of \$30.0 million (2009: nil) matured during the year. The remaining credit default swaps mature in March 2011. 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 within its significant contracts. No significant 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' equity. 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 financial assets 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)	2010		2009	
	+ 1%	- 1%	+ 1%	- 1%
Impact on:				
Fair value of HFT bonds and net income before tax	\$ (65,551)	\$ 65,551	\$ (59,573)	\$ 59,573
Fair value of AFS bonds and OCI before tax	\$ (45,817)	\$ 45,817	\$ (48,494)	\$ 48,494

The estimated impact on taxes would be calculated at the statutory rate of 30.42% (2009: 32.15%).

(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 does not dispose of the stocks during the year, is as follows:

(in thousands of dollars)	2010		2009	
	+ 10%	- 10%	+ 10%	- 10%
Impact on:				
Fair value of Canadian stocks and OCI before tax	\$ 30,563	\$ (30,563)	\$ 30,658	\$ (30,658)
Fair value of foreign stocks and OCI before tax	\$ 13,884	\$ (13,884)	\$ 11,811	\$ (11,811)

The estimated impact on taxes would be calculated at the statutory rate of 30.42% (2009: 32.15%).

(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 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 that require closer monitoring of the credit risk. Of the bonds held at December 31, 98.9% (2009: 99.1%) were rated "A-" or better and 100.0% (2009: 100.0%) of the preferred stocks were rated "P2" or better. Of the corporate bonds held, 90.1% (2009: 96.3%) are concentrated in the financial services industry and 9.9% (2009: 3.7%) in other industries.

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

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 significant. The Company's broker appointment process ensures a full financial review of each broker before they are granted a contract. This review includes an assessment of the ability of the broker 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 insignificant as overdue receivables are negligible. 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. The Company has recorded

an allowance for losses on reinsurance receivable and recoverable of \$1.0 million (2009: \$1.0 million).

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 \$229.2 million (2009: \$203.8 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)	2010		2009	
Impact on:	+ 1%	- 1%	+ 1%	- 1%
Fair value of foreign stocks and OCI before tax	\$ 1,388	\$ (1,388)	\$ 1,181	\$ (1,181)

The estimated impact on taxes would be calculated at the statutory rate of 30.42% (2009: 32.15%).

A 1% change in the value of the United States dollar, relative to the Canadian dollar, would have a negligible impact on the net investment in foreign-based insurance operations and net income. The exchange gain on the net investment in foreign-based insurance operations included in "Other expense" was \$0.4 million for the year (2009: \$0.1 million loss).

(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, 2010, the Company has \$94.9 million (2009: \$125.3 million) of cash and cash equivalents and short-term investments of \$29.9 million (2009: \$40.0 million). The Company also has a highly liquid investment portfolio. As at December 31, Canadian fixed-income investments issued or guaranteed by domestic governments, investment-grade corporate bonds and publicly traded Canadian and foreign equities have a fair value of \$3,453.1 million (2009: \$3,430.2 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 obligations of the Company on account of policies effective on or before December 31, 2010 and consist of premium and claim liabilities. Policy liabilities are not covered by CICA Handbook Section 3862 – *Financial Instruments – Disclosures* disclosures as the Company has elected to maintain CICA Handbook 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, 2010. The unearned premium amounts as at December 31, 2010 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 amount 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 of deferred policy acquisition expenses is required for the year ended December 31, 2010 (2009: 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 significant 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 opposite 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 three-quarters 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)	2010			2009		
	Gross	Ceded	Net	Gross	Ceded	Net
Long settlement-term lines of business						
Automobile – bodily injury and accident benefits	\$ 1,755,191	\$ 36,884	\$ 1,718,307	\$ 1,686,208	\$ 38,118	\$ 1,648,090
General liability	322,960	16,191	306,769	349,014	22,379	326,635
	2,078,151	53,075	2,025,076	2,035,222	60,497	1,974,725
Short settlement-term lines of business						
Automobile	52,403	2,867	49,536	51,501	5,053	46,448
Property	194,267	22,049	172,218	221,476	29,318	192,158
	246,670	24,916	221,754	272,977	34,371	238,606
Facility Association and other residual pools	47,861	—	47,861	52,241	—	52,241
	\$ 2,372,682	\$ 77,991	\$ 2,294,691	\$ 2,360,440	\$ 94,868	\$ 2,265,572

(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 \$68.0 million (2009: \$67.1 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)	2010	2009
Net unpaid claim liabilities at the beginning of the year	\$ 2,265,572	\$ 2,188,134
Change in estimated losses and expenses for claims occurring in prior years	(83,201)	(43,923)
Losses and expenses on claims occurring in the current year	1,251,094	1,444,214
Paid on claims occurring during:		
Current year	(541,820)	(659,490)
Prior years	(596,954)	(663,363)
Net unpaid claim liabilities at the end of the year	\$ 2,294,691	\$ 2,265,572

(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 and 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)	2010	2009
Undiscounted net unpaid claim liabilities	\$ 2,219,996	\$ 2,200,095
Impact of the time value of money	(151,591)	(157,491)
Provision for adverse deviation	226,286	222,968
Fair value of net unpaid claim liabilities	\$ 2,294,691	\$ 2,265,572

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 45.2%

(2009: 48.5%) 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. Prior approval rate regulation on individually rated vehicles.
New Brunswick	New Brunswick Insurance Board	
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)	2010		
	Cost	Accumulated amortization	Net book value
Buildings	\$ 35,559	\$ 17,206	\$ 18,353
Furniture and equipment	19,122	15,381	3,741
Computer equipment	10,503	6,201	4,302
	65,184	38,788	26,396
Land	1,239	—	1,239
	\$ 66,423	\$ 38,788	\$ 27,635

(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

Amortization charged to operating expenses amounted to \$3.3 million (2009: \$2.9 million).

10. GOODWILL AND INTANGIBLE ASSETS

Goodwill is subject to an impairment test that is performed at least annually. The goodwill impairment testing for the current year determined that there was no evidence of impairment. In 2009, annual impairment testing 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 Company incurring an impairment of goodwill as noted in the table below. In 2010, this wholly-owned subsidiary was sold and the remaining goodwill of \$1.8 million was disposed of for cash proceeds of \$1.0 million and a note payable of \$4.0 million.

During the year, a subsidiary of the Company wrote down the cost of software that was identified as impaired.

These adjustments for impairment 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:

(in thousands of dollars)	2010			
	Goodwill	Software	Other intangible assets	Total
Cost:				
Balance, beginning of the year	\$ 38,057	\$ 70,361	\$ 2,955	\$ 111,373
Additions	—	15,003	—	15,003
Disposals	(1,814)	(198)	(110)	(2,122)
Impairment	—	(3,459)	—	(3,459)
Balance, end of the year	\$ 36,243	\$ 81,707	\$ 2,845	\$ 120,795
Accumulated amortization:				
Balance, beginning of the year	\$ —	\$ 38,875	\$ 1,482	\$ 40,357
Amortization expense	—	2,946	154	3,100
Balance, end of the year	\$ —	\$ 41,821	\$ 1,636	\$ 43,457
Net book value, end of the year	\$ 36,243	\$ 39,886	\$ 1,209	\$ 77,338

(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

Included in software is \$9.8 million (2009: \$10.2 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 (2009: \$1.0 million) in the event of a property claim, and an amount of \$3.0 million (2009: \$2.5 million) in the event of a liability claim. In addition, the Company has obtained reinsurance having an upper amount of \$1.3 billion (2009: \$1.0 billion), which limits the Company's net retention to \$20.0 million (2009: \$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)	2010	2009
Reinsurance assumed		
Assumed premiums written	\$ 17,889	\$ 17,322
Premiums earned	\$ 17,566	\$ 18,661
Claims and adjustment expenses	\$ 12,217	\$ 8,155
Reinsurance ceded		
Ceded premiums written	\$ 95,652	\$ 78,865
Premiums earned	\$ 91,396	\$ 78,888
Claims and adjustment expenses	\$ 7,973	\$ 28,829
Reinsurance receivable	\$ 15,097	\$ 27,994

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 \$6.5 million (2009: \$3.7 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 except as otherwise noted)	Pension plans		Other benefit plans	
	2010	2009	2010	2009
Accrued benefit obligation	\$ (158,017)	\$ (126,916)	\$ (51,442)	\$ (37,360)
Fair value of plan assets	155,510	147,074	—	—
Plan surplus (deficit)	\$ (2,507)	\$ 20,158	\$ (51,442)	\$ (37,360)
Funded status on an accounting basis				
Plan surplus (deficit)	\$ (2,507)	\$ 20,158	\$ (51,442)	\$ (37,360)
Unamortized actuarial loss	56,472	33,232	10,855	707
Unamortized transitional asset	(3,451)	(4,229)	—	—
Unamortized past service cost	—	—	(1,018)	(1,189)
Accrued benefit asset (liability)	\$ 50,514	\$ 49,161	\$ (41,605)	\$ (37,842)
Actuarial assumptions				
Discount rate	5.5%	6.5%	5.5%	6.5%
Expected long-term return on plan assets	7.0%	6.8%	—	—
Rate of compensation increase	3.5%	3.5%	—	—
Health care cost increase	—	—	8.5%	9.0%
Average remaining service life of employees (in years)	10	11	19	19
Other information				
Employer contributions	\$ 1,869	\$ 5,768	\$ —	\$ —
Employee contributions	\$ 455	\$ 507	\$ —	\$ —
Benefits paid	\$ 4,785	\$ 4,395	\$ 616	\$ 704
Net expense for benefit plans	\$ 517	\$ 675	\$ 4,381	\$ 3,109

Pension plan assets:

The table below shows the allocation of defined benefit pension plan assets as at December 31, 2010:

	% of plan assets	
	2010	2009
Cash	1.4%	1.3%
Fixed income securities		
Canadian	41.9	41.0
Foreign	—	2.7
Equity securities		
Canadian	31.7	30.0
Foreign	24.6	24.6
Other	0.4	0.4
	100.0%	100.0%

Under the defined contribution pension plan, the Company contributes a fixed percentage of employees' pensionable earnings to the plan. Contributions under

the defined contribution pension plan totalled \$8.2 million (2009: \$7.8 million).

14. OTHER COMPREHENSIVE INCOME

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

(in thousands of dollars)	2010	2009
Net unrealized gain during the year on AFS investments, net of income tax expense of \$15,753 (2009: \$35,424)	\$ 35,795	\$ 72,048
Less:		
Net realized gain on sale of AFS investments reclassified to net income during the year, net of income tax expense of \$9,382 (2009: \$10,227)	28,377	20,862
Impairment loss on AFS investments reclassified to net income during the year, net of income tax recovery of \$7,549 (2009: \$7,097)	(15,530)	(16,399)
Other comprehensive income	\$ 22,948	\$ 67,585

15. COMMITMENTS

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

YEAR	
2011	\$19.4 million
2012	\$15.6 million
2013	\$12.9 million
2014	\$11.4 million
2015	\$10.8 million
Thereafter	\$22.4 million

16. 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.

17. DEMUTUALIZATION

On December 14, 2010, the Company announced its intention to demutualize. This involves converting from its current mutual form of ownership to a stock company. At this time, there are a number of future decisions to be made with respect to the demutualization, including determining the structure of the demutualization transaction, and approval of the transaction by mutual policyholders and government

regulators. Regulation, and potentially legislation, will also need to be enacted to permit the demutualization of a property and casualty insurance company. This announcement had no significant impact on the financial results as presented in these consolidated financial statements.

18. 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' equity 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, 2010 and 2009, the Company's available capital exceeds the minimum capital ratio 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. In accordance with regulatory requirements and the Company's capital management policies, the Board of Directors has set internal targets at levels higher than OSFI's minimum requirements, which further reduces the level of available capital.

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 Financial Information

(in millions of dollars, except as otherwise noted)	Year ended December 31				
	2010	2009	2008	2007	2006
Gross premiums written	1,722.0	1,826.3	1,939.7	1,906.1	1,921.0
Net premiums written	1,626.4	1,747.5	1,862.7	1,833.0	1,839.4
Net premiums earned	1,676.4	1,813.3	1,844.8	1,829.6	1,767.6
Claims and adjustment expenses	1,167.9	1,400.3	1,501.9	1,265.6	1,218.1
Other underwriting expenses	564.2	556.8	553.3	560.6	543.2
Total underwriting expenses	1,732.1	1,957.1	2,055.2	1,826.2	1,761.3
Underwriting profit (loss)	(55.7)	(143.9)	(210.4)	3.4	6.3
Interest and dividend income	114.4	125.2	136.4	130.3	109.9
Recognized gain (loss) on investments	33.3	40.5	(52.7)	44.3	74.5
Total investment income	147.7	165.7	83.7	174.6	184.4
Other income (expense)	(6.5)	(2.0)	(15.2)	(3.6)	3.9
Income (loss) before income taxes	85.5	19.8	(141.9)	174.4	194.7
Income tax expense (recovery)	21.1	(4.3)	(39.5)	56.8	64.7
Net income (loss)	64.4	24.1	(102.4)	117.6	130.0
Investments at carrying value	3,556.8	3,445.7	3,153.4	3,170.1	2,950.5
Investments at market value	3,554.0	3,443.2	3,151.8	3,167.3	2,999.8
Total assets	4,633.2	4,603.8	4,441.2	4,341.2	4,100.9
Policyholders' equity	1,258.0	1,170.7	1,079.0	1,255.7	1,151.6

(in millions of dollars, except as otherwise noted)	Year ended December 31				
	2005	2004	2003	2002	2001
Gross premiums written	1,778.0	1,696.9	1,522.8	1,342.7	1,191.1
Net premiums written	1,703.4	1,639.6	1,449.6	1,235.1	1,101.6
Net premiums earned	1,665.6	1,555.4	133.3	1,158.9	1,068.0
Claims and adjustment expenses	1,070.8	941.8	965.4	876.7	855.3
Other underwriting expenses	510.2	490.2	430.5	358.8	332.6
Total underwriting expenses	1,581.0	1,432.0	1,395.9	1,235.5	1,187.9
Underwriting profit (loss)	84.6	123.4	(62.6)	(76.6)	(119.9)
Interest and dividend income	91.9	82.1	81.2	80.0	86.3
Recognized gain (loss) on investments	71.1	27.2	23.7	14.0	38.1
Total investment income	163.0	109.3	104.9	94.0	124.4
Other income (expense)	9.3	9.2	5.2	3.1	(2.9)
Income (loss) before income taxes	256.8	241.9	47.5	20.5	1.6
Income tax expense (recovery)	84.7	80.1	12.6	(3.1)	(2.0)
Net income (loss)	172.1	161.8	34.9	23.6	3.6
Investments at carrying value	2,572.3	2,234.4	1,859.4	1,688.5	1,506.3
Investments at market value	2,644.6	2,335.1	1,939.2	1,736.0	1,566.1
Total assets	3,645.6	3,292.1	2,869.4	2,564.3	2,397.2
Policyholders' equity	1,021.5	849.4	687.6	652.7	655.1

Board of Directors

Mary N. Bales (2, 3, 6, 7)

A. Scott Carson (1, 2, 6)

Karen L. Gavan (1, 5, 7)

Gerald A. Hooper, Chairman (1, 2, 3, 4, 5, 6, 7)

Katherine A. Mabe (4)

David A. MacIntosh (4, 5, 7)

Charles M.W. Ormston (2, 3, 6, 7)

Terry J. Reidel (1, 3, 6)

Michael P. Stramaglia (4, 5)

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Douglas W. Brown

Ralph A. Forbes

William D. McGregor

John H. Panabaker

Brian J. Ruby

Harold E. Seegmiller

Peter H. Sims

COMMITTEES

1. Audit

2. Corporate Governance and Conduct Review

3. Human Resources and Compensation

4. Investment

5. Pension

6. Selection

7. Special

Senior Management Team

Katherine Mabe, CPCU, CLU, ChFC, MBA
President and Chief Executive Officer

Jorge Arruda, BComm
Senior Vice President, SBU and Delivery Management

Dean Bulloch, MBA, CHRP
Senior Vice President and Chief Human Resources Officer

Catherine Coulson, BA (Hons), FCIP
Vice President, Personal Insurance

David Crozier, BA (Hons), CIP, CRM
Senior Vice President, Operations

Louis Durocher, BSc, FCIA, FCAS, ASA
Regional Vice President, Quebec Region

David Fitzpatrick, BA
Vice President, Sales and Westmount Financial

Linda Goss, BSc (Hons), FCIA, FCAS
Senior Vice President and Chief Actuary

Bharat Kannan, BMath, CA, CFA
Vice President, Finance and Controller

Katherine Kipper, BA, CHRP
Vice President, Marketing and Communications

Scott Lennox, BMath, ASA, FCAS, FCIA
Vice President, Pricing and Research and Development

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

Chris Van Kooten, FCIA, FCAS
Vice President, Corporate Actuarial

Robert Gow, CCLA, CFE
Regional Vice President, Western Region

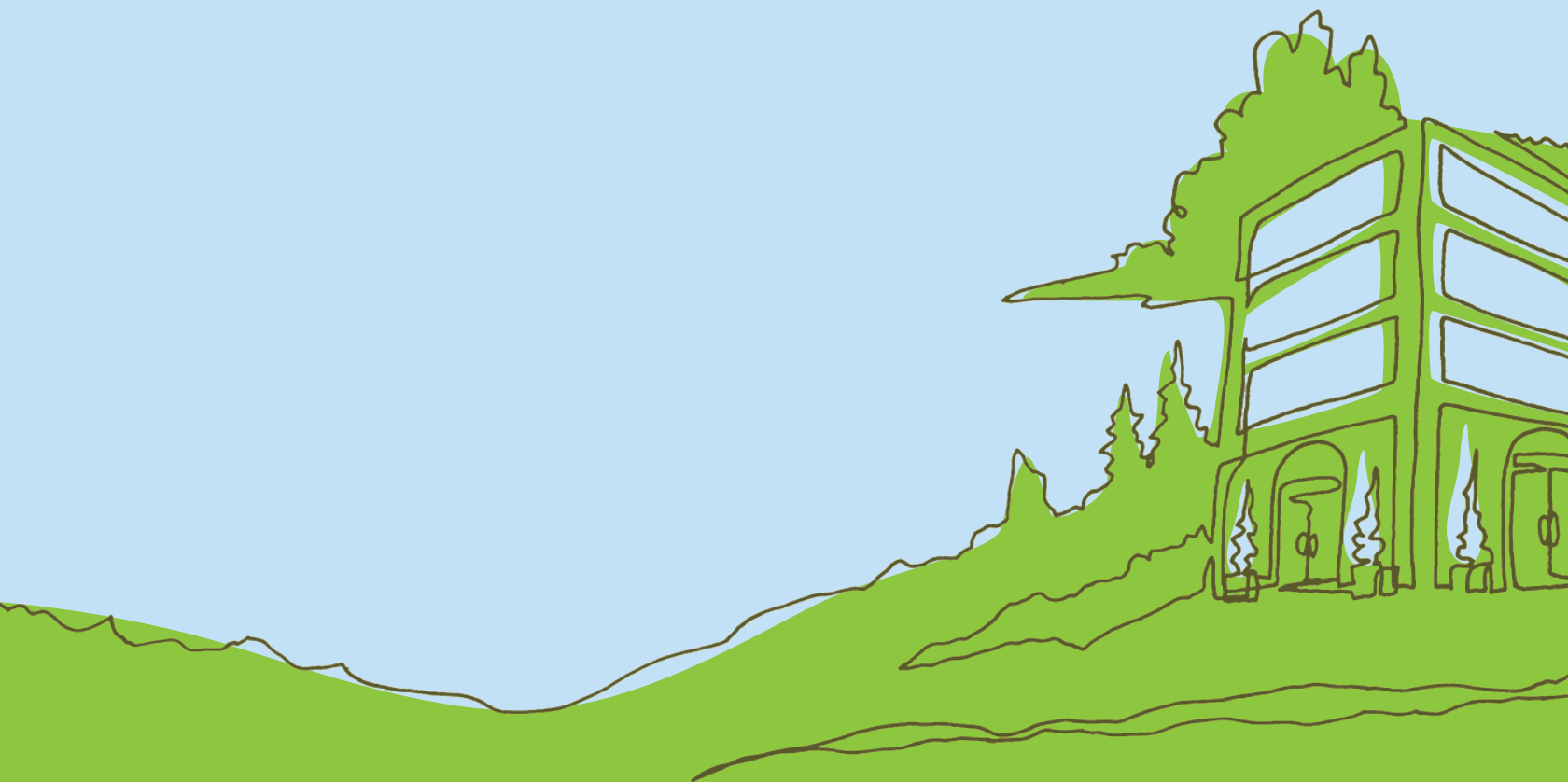
Walter Leszkowicz, BA, CIP
Regional Vice President, Ontario Region

Dan Spears, FCIP
Regional Vice President, Atlantic Region

Ian Wismer, BA, LLB
Corporate Secretary

Member Companies





The Economical Insurance Group
2010 ANNUAL REPORT

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The Economical Insurance Group

Founded in 1871, Economical is one of the largest property and casualty insurance companies in Canada. Built upon a strong foundation of broad experience, earned trust and long-term financial stability, we are proud to provide security and support for our customers and broker partners from coast to coast.