Unaudited Condensed Consolidated Interim Financial Statements of

# EGI FINANCIAL HOLDINGS INC.

For the quarters ended June 30, 2013 and 2012

**EGI FINANCIAL HOLDINGS INC.**
**Consolidated Balance Sheets**
(Unaudited, in thousands of Canadian dollars)

| | Note | June 30 2013 | December 31 2012 |
|---|---|---|---|
| **Assets** | | | |
| Cash and short–term deposits | | 24,750 | 19,578 |
| Accounts receivable | | 48,471 | 35,577 |
| Investments | 6 | 424,144 | 412,728 |
| Due from insurance companies | | 1,723 | 3,326 |
| Deferred policy acquisition costs | | 28,011 | 21,588 |
| Income taxes recoverable | | 2,486 | – |
| Prepaid expenses and other assets | | 3,795 | 3,118 |
| Reinsurers' share – unearned premiums | | 12,983 | 9,169 |
| – provision for unpaid claims | 7 | 30,942 | 30,283 |
| Property and equipment | | 745 | 743 |
| Intangible assets | 9 | 6,213 | 5,568 |
| Deferred income taxes | | 5,904 | 5,350 |
| | | 590,167 | 547,028 |
| **Liabilities** | | | |
| Income taxes payable | | – | 663 |
| Accounts payable and accrued liabilities | | 17,957 | 13,078 |
| Payable to insurance companies | | 3,367 | 3,449 |
| Unearned premiums | | 118,128 | 94,085 |
| Unearned commission | | 2,257 | 1,770 |
| Provision for unpaid claims | 7 | 281,788 | 268,580 |
| | | 423,497 | 381,625 |
| **Equity** | | | |
| Share capital | | 66,897 | 68,244 |
| Contributed surplus | | 1,266 | 1,068 |
| Retained earnings | | 97,424 | 91,237 |
| Accumulated other comprehensive income | 13 | 2,280 | 6,054 |
| Equity attributed to shareholders of the Company | | 167,867 | 166,603 |
| Non–controlling interest | | (1,197) | (1,200) |
| Total equity | | 166,670 | 165,403 |
| | | 590,167 | 547,028 |

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

**EGI FINANCIAL HOLDINGS INC.**
**Consolidated Statements of Income and Comprehensive Income**
(Unaudited, in thousands of Canadian dollars)

| | Note | 3 months ended June 30 | | 6 months ended June 30 | |
|---|---|---|---|---|---|
| | | **2013** | **2012** | **2013** | **2012** |
| Revenue | | | | | |
| Gross written and assumed premiums | | 80,992 | 66,106 | 138,402 | 110,045 |
| Less: Premiums ceded to reinsurers | | (8,922) | (8,725) | (16,956) | (12,357) |
| Net written and assumed premiums | | 72,070 | 57,381 | 121,446 | 97,688 |
| (Increase) decrease in gross unearned premiums | | (20,341) | (17,362) | (23,345) | (15,163) |
| Increase (decrease) in unearned premiums, reinsurers' share | | 2,325 | 3,938 | 4,073 | 3,602 |
| Change in provision for unearned premiums | | (18,016) | (13,424) | (19,272) | (11,561) |
| Net earned premiums | | 54,054 | 43,957 | 102,174 | 86,127 |
| Other income | | 205 | 530 | 337 | 530 |
| Investment income | 6 | 5,584 | 2,501 | 10,649 | 8,461 |
| Total revenue | | 59,843 | 46,988 | 113,160 | 95,118 |
| Expenses | | | | | |
| Gross claims incurred | | 37,031 | 34,398 | 75,714 | 62,676 |
| Less: claims recoveries from reinsurers | | (6,113) | (3,084) | (9,641) | (3,646) |
| Net incurred claims | | 30,918 | 31,314 | 66,073 | 59,030 |
| Gross acquisition costs | | 16,939 | 12,168 | 30,918 | 22,966 |
| Less: acquisition cost recoveries from reinsurers | | (3,674) | (1,435) | (6,278) | (2,694) |
| Net acquisition costs | | 13,265 | 10,733 | 24,640 | 20,272 |
| Operating costs | | 6,910 | 6,713 | 13,080 | 12,604 |
| Total expenses | | 51,093 | 48,760 | 103,793 | 91,906 |
| Income (loss) before taxes and discount rate impact on claims | | 8,750 | (1,772) | 9,367 | 3,212 |
| Impact of change in discount rate on claims | 7 | 1,770 | (1,811) | – | (1,811) |
| Income (loss) before income taxes | | 10,520 | (3,583) | 9,367 | 1,401 |
| Income tax expense | 11 | 2,302 | (763) | 2,059 | 427 |
| Net income (loss) | | 8,218 | (2,820) | 7,308 | 974 |
| Attributed to: | | | | | |
| Shareholders of the Company | | 8,126 | (2,390) | 7,305 | 1,598 |
| Non–controlling interest | | 92 | (430) | 3 | (624) |
| | | 8,218 | (2,820) | 7,308 | 974 |
| Earnings per share attributable to shareholders of the Company | 14 | | | | |
| Net income (loss) per share – basic | | $0.69 | $(0.20) | $0.62 | $0.13 |
| Net income (loss) per share – diluted | | $0.68 | $(0.20) | $0.61 | $0.13 |
| Net income | | 8,218 | (2,820) | 7,308 | 974 |
| Other comprehensive income (loss), net of taxes that may be classified subsequently to net income | | | | | |
| Available-for-sale securities: | | | | | |
| Change in net unrealized gains | | (4,938) | (111) | (1,625) | 2,268 |
| Reclassification of net realized (gains) losses to net income | | (3,553) | 760 | (4,787) | (1,333) |
| Cumulative translation gain (loss) | | 508 | 325 | 712 | 4 |
| Tax impact | | 2,208 | 218 | 1,926 | (314) |
| Other comprehensive income (loss) | | (5,775) | 1,192 | (3,774) | 625 |
| Total comprehensive income (loss) | | 2,443 | (1,628) | 3,534 | 1,599 |
| Attributed to: | | | | | |
| Shareholders of the Company | | 2,351 | (1,198) | 3,531 | 2,223 |
| Non-controlling interest | | 92 | (430) | 3 | (624) |
| | | 2,443 | (1,628) | 3,534 | 1,599 |

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

**EGI FINANCIAL HOLDINGS INC.**
**Consolidated Statements of Changes in Equity**
(Unaudited, in thousands of Canadian dollars)

| | Share Capital | Contributed Surplus | Accumulated Other Comprehensive Income | Retained Earnings | Shareholders' Equity | Non–controlling interest | Total Equity |
|---|---|---|---|---|---|---|---|
| Balance at January 1, 2013 | 68,244 | 1,068 | 6,054 | 91,237 | 166,603 | (1,200) | 165,403 |
| Net income | – | – | – | 7,305 | 7,305 | 3 | 7,308 |
| Other comprehensive income (loss) | – | – | (3,774) | – | (3,774) | – | (3,774) |
| Total comprehensive income (loss) | – | – | (3,774) | 7,305 | 3,531 | 3 | 3,534 |
| Common shares repurchased | (1,375) | – | – | (1,118) | (2,493) | – | (2,493) |
| Common shares issued | 28 | – | – | – | 28 | – | 28 |
| Stock options – expense | – | 198 | – | – | 198 | – | 198 |
| Balance at June 30, 2013 | 66,897 | 1,266 | 2,280 | 97,424 | 167,867 | (1,197) | 166,670 |

| | Share Capital | Contributed Surplus | Accumulated Other Comprehensive Income | Retained Earnings | Shareholders' Equity | Non–controlling interest | Total Equity |
|---|---|---|---|---|---|---|---|
| Balance at January 1, 2012 | 69,133 | 724 | 13,766 | 71,410 | 155,033 | (213) | 154,820 |
| Net income (loss) | – | – | – | 1,598 | 1,598 | (624) | 974 |
| Other comprehensive income (loss) | – | – | 625 | – | 625 | – | 625 |
| Total comprehensive income (loss) | – | – | 625 | 1,598 | 2,223 | (624) | 1,599 |
| Common shares repurchased | (342) | – | – | – | (342) | – | (342) |
| Stock options – expense | – | 163 | – | – | 163 | – | 163 |
| Balance at June 30, 2012 | 68,791 | 887 | 14,391 | 73,008 | 157,077 | (837) | 156,240 |

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

**EGI FINANCIAL HOLDINGS INC.**
**Consolidated Statements of Cash Flows**
(Unaudited, in thousands of Canadian dollars)

| | 6 months ended June 30, 2013 | 6 months ended June 30, 2012 |
|---|---|---|
| Cash provided by (used in): | | |
| Operating activities | | |
| Net income | 7,308 | 974 |
| Items not involving cash: | | |
| Reinsurers' share of unearned premiums | (3,814) | (269) |
| Reinsurers' share of unpaid claims | (659) | 1,789 |
| Provision for unpaid claims | 13,208 | 11,334 |
| Unearned premiums | 24,043 | 12,699 |
| Deferred income taxes | (554) | 36 |
| Unearned commissions | 487 | 534 |
| Deferred policy acquisition costs | (6,423) | (3,831) |
| Amortization on property plant equipment and intangible assets | 1,399 | 1,779 |
| Amortization of premiums on bonds | 1,202 | 659 |
| Fair value change on FVTPL investments | 1,175 | (77) |
| Options expense | 198 | 163 |
| Currency translation | 712 | 4 |
| Prepaid expenses & other assets | (677) | (2,046) |
| Other | (2) | – |
| | 30,295 | 22,772 |
| Cash flow from changes in | | |
| Accounts receivable | (12,894) | (6,042) |
| Net realized (gains) losses | (5,044) | (2,040) |
| Income taxes payable/recoverable | (1,222) | (1,580) |
| Due to related parties | 1,521 | (2,172) |
| Other liabilities | 4,879 | 3,700 |
| Cash provided by operating activities | 17,537 | 14,638 |
| Financing activities | | |
| Issue of common shares | 28 | – |
| Share repurchase | (2,493) | (342) |
| Cash provided by (used in) financing activities | (2,465) | (342) |
| Investing activities | | |
| Purchases of property and equipment and intangible assets | (2,046) | (1,777) |
| Purchase of investments | (386,294) | (259,502) |
| Sale/maturity of investments | 371,134 | 235,031 |
| Cash (used in) investing activities | (17,206) | (26,248) |
| Increase in cash and short-term deposits | 5,172 | (10,978) |
| Cash and short-term deposits, beginning of year | 19,578 | 30,839 |
| Cash and short-term deposits, end of year | 24,750 | 19,861 |
| Supplementary information | | |
| Operating activities | | |
| Income taxes paid | 4,644 | 2,483 |

The accompanying notes are an integral part of these condensed interim consolidated financial statements.

## 1 Organization and basis of presentation

The organization and nature of business are substantially the same as at the end of 2012. Refer to Note 1 of the annual 2012 consolidated financial statements.

EGI Financial Holdings Inc. (the Company) was incorporated on August 18, 1997, under the Business Corporations Act (Ontario) and is incorporated and domiciled in Canada. The Company is principally engaged, through its subsidiaries, in property and casualty insurance in Canada, U.S. and Europe. The Company's head office is located at 2680 Matheson Blvd. East, Suite 300, Mississauga, Ontario.

The Company's wholly–owned subsidiaries are EGI Insurance Managers Inc., Echelon General Insurance Company (Echelon), EGI Insurance Services, Inc., American Colonial Insurance Company (ACIC), EGI Insurance Services (Florida), Inc., CIM Reinsurance Company Ltd. (CIM Re) and CUISA Managing General Agency Corporation ("CUISA MGA"). The Company also owns all of the preferred shares plus 51% of common shares of QIC Holdings ApS, which owns 100% of Qudos Insurance A/S.

## 2 Basis of preparation

These condensed consolidated interim financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) applicable to the preparation of interim financial statements, including IAS 34, Interim Financial Reporting. The condensed consolidated interim financial statements should be read in conjunction with the annual financial statements for the year ended December 31, 2012, which have been prepared in accordance with IFRS.

These consolidated financial statements have been authorized for issue by the Board of Directors, on August 8, 2013.

Prior period figures have been reclassified to conform to the current period presentation.

## 3 Summary of significant accounting policies

The accounting policies adopted are consistent with those of the previous financial year end and the Company has consistently applied the same accounting policies through all periods presented except as described below.

### *Income taxes*

Taxes on income in the interim periods are accrued using the estimated annual tax rate that would be applicable to expected total annual income.

### *Amendment to IAS 1 Presentation of Financial Statements*

In June 2011, the IASB issued an amendment to IAS 1 that changes the presentation of items in the consolidated statements of comprehensive income. This amendment requires the components of other comprehensive income to be presented in two separate groups, based on whether or not the components may be recycled to the consolidated statements of earnings in the future. Companies will continue to have a choice of whether to present components of OCI before or after tax. Those that present components of OCI before tax will be required to disclose the amount of tax related to the two groups separately. This amendment is effective for annual periods beginning on or after July 1, 2012, is applied retrospectively, with early adoption permitted.

The Company assessed its presentation of financial statements conclusions on January 1, 2013, and determined that the adoption of IAS 1 did not result in any change in the presentation of financial status of the Company.

***IFRS 10, Consolidated Financial Statements***

IFRS 10, Consolidated Financial Statements, replaces the guidance on control and consolidation in IAS 27, Consolidated and Separate Financial Statements, and SIC-12, Consolidation – Special Purpose Entities. IFRS 10 requires consolidation of an investee only if the investor possesses power over the investee, has exposure to variable returns from its involvement with the investee and has the ability to use its power over the investee to affect its returns. Detailed guidance is provided on applying the definition of control. The accounting requirements for consolidation have remained largely consistent with IAS 27.

The Company assessed its consolidation conclusions on January 1, 2013, and determined that the adoption of IFRS 10 did not result in any change in the consolidation status of any of its subsidiaries and investees.

***IFRS 12 Disclosure of Interests in Other Entities***

IFRS 12 sets out the disclosure requirements under IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements and IAS 28 Investments in Associates and Joint Ventures. The enhanced disclosures in the new standard are intended to help financial statement readers evaluate the nature, risks and financial effects of an entity's interests in subsidiaries, associates, joint arrangements and unconsolidated structured entities. Entities are permitted to incorporate any of the disclosure requirements in IFRS 12 into their financial statements without early adopting IFRS 12.

The Company assessed its disclosure of interest in other entities conclusions on January 1, 2013, and determined that the adoption of IFRS 12 did not result in any change in the disclosure of interest in other status of any of its subsidiaries and investees.

***IFRS 13, Fair Value Measurement***

IFRS 13, Fair Value Measurement, provides a single framework for measuring fair value. The measurement of the fair value of an asset or liability is based on assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk. The Company adopted IFRS 13 on January 1, 2013, on a prospective basis. The adoption of IFRS 13 did not require any adjustments to the valuation techniques used by the Company to measure fair value and did not result in any measurement adjustments as at January 1, 2013.

(Unaudited, in thousands of Canadian dollars, except per share amounts)

## 4 Critical accounting estimates and assumptions

The preparation of the Company's condensed consolidated interim financial statements requires management to use estimates and judgements that affect the amounts reported in the financial statements. These estimates and judgements principally relate to the establishment of reserves for claims and expenses, impairments of investment securities, amounts recoverable from reinsurers and income taxes. As more information becomes known, these estimates and judgements could change and impact future results.

In preparing these condensed consolidated interim financial statements, the significant judgements made by management in applying accounting policies and the key sources of estimation uncertainty were the same as those applied to the annual 2012 consolidated financial statements.

## 5 Seasonality

The P&C insurance business is seasonal in nature. While net earned premiums are generally stable from quarter to quarter, net underwriting income is driven mainly by weather conditions which may vary significantly by quarter.

## 6 Investments

The investment policies adopted are consistent with those of the previous financial year end and the Company has consistently applied the same investment policies through all periods presented.

| | Carrying and fair values | |
|---|---|---|
| **Available-for-sale** | **As at June 30, 2013** | **As at December 31, 2012** |
| Bonds | | |
| Government | 169,008 | 192,540 |
| Corporate | 202,686 | 178,101 |
| Total bonds | 371,694 | 370,641 |
| Commercial Mortgages | 2,000 | – |
| Common shares | 22,756 | 16,941 |
| Total available-for-sale | 396,450 | 387,582 |
| **Fair value through profit or loss** | | |
| Preferred shares | 27,694 | 25,146 |
| **Total investments** | 424,144 | 412,728 |

### Fair value

The Company is responsible for determining the fair value of its investment portfolio by utilizing market-driven fair value measurements from active markets, where available, by considering other observable and unobservable inputs and by employing valuation techniques which make use of current market data. The Company uses a fair-value hierarchy to categorize the inputs used in valuation techniques to measure fair value. A description of the inputs used in the valuation of financial instruments is as follows:

(Unaudited, in thousands of Canadian dollars, except per share amounts)

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

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

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

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

There have been no significant changes in the business circumstance that affect the fair value of the financial assets. The economic circumstances that affect the fair value of the Company's financial assets has changed in the period with the increasing interest rates. There has been no transfer between the fair value hierarchy investments.

The following table provides the classification of the Company's investments within the fair value hierarchy, as outlined above, as at June 30, 2013, and December 31, 2012:

| **June 30, 2013** | **Investments at fair value** | | | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Bonds | – | 371,694 | – | 371,694 |
| Commercial Mortgages | – | – | 2,000 | 2,000 |
| Common Shares | 22,756 | – | – | 22,756 |
| Preferred Shares | 27,694 | – | – | 27,694 |
| | 50,450 | 371,694 | 2,000 | 424,144 |

(Unaudited, in thousands of Canadian dollars, except per share amounts)

| **December 31, 2012** | **Investments at fair value** | | | |
|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Bonds | – | 370,157 | 484 | 370,641 |
| Common Shares | 16,941 | – | – | 16,941 |
| Preferred Shares | 25,146 | – | – | 25,146 |
| | 42,087 | 370,157 | 484 | 412,728 |

**Impaired assets and provisions for losses**

Management has reviewed currently available information regarding those investments where estimated fair values are less than carrying values. For those investments that are considered impaired, the Company has recorded the difference between the cost, or amortized cost, of the investment and its fair value as an impairment, which reduces investment income recorded in the period.

A provision for impairments on investments of $901 was recognized in 2013 (June 30, 2012 – $2,186). A remaining gross unrealized loss of $1,660 on AFS investments held as at June 30, 2013 (June, 2012 – $1,266) is recorded, net of tax, in the amount of $1,239 (June 30, 2012 – $926) as Accumulated Other Comprehensive Loss.

**Investment income**

Investment income was derived from the following:

| | **3 months ended June 30** | | **6 months ended June 30** | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Interest income | 3,462 | 3,198 | 6,508 | 6,373 |
| Dividend income | 463 | 448 | 930 | 948 |
| Net realized gains (losses) | 4,635 | 1,305 | 5,945 | 4,226 |
| Impairment loss | (896) | (1,947) | (901) | (2,186) |
| Fair value change on FVTPL investments | (1,466) | (44) | (1,175) | 77 |
| Realized and unrealized foreign exchange gains (losses) | (291) | (47) | 1 | (151) |
| Investment expenses | (323) | (412) | (659) | (826) |
| | 5,584 | 2,501 | 10,649 | 8,461 |

## 7 Provision for unpaid claims

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

The Company discounts its best estimate of claim provisions at a rate of interest of 2.65% (December 31, 2012 – 2.65%) for all lines of business. The Company determines the discount rate based on the expected return on its investment portfolio of assets with appropriate assumptions for interest rates relating to reinvestment of maturing investments.

(Unaudited, in thousands of Canadian dollars, except per share amounts)

The Company recorded a $3,655 reduction to the net provision for unpaid claims relating to redundancies in prior years' estimates (June 30, 2012 – $2,256).

To recognize the uncertainty in establishing these best estimates, to allow for possible deterioration in experience, and to provide greater comfort that the actuarial liabilities are adequate to pay future claims, the Company includes provisions for adverse deviations (PFADs) in some assumptions relating to claims development, reinsurance recoveries and future investment income. The PFADs selected are in the mid-range of those recommended by the Canadian Institute of Actuaries. The aggregate impact of the provision for adverse deviation is to increase the provision for unpaid claims on a gross basis by $26,848as at June 30, 2013 (December 31, 2012 – $27,282).

**Claims development**

| Provision for unpaid claims analysis | June 30, 2013 | June 30, 2012 |
|---|---|---|
| Unpaid claims, beginning of year, net | 238,297 | 221,250 |
| Change in undiscounted estimates for losses of prior years | (1,112) | (2,864) |
| Change in discount rate | – | 1,811 |
| Change in PFADs | (5,114) | (3,899) |
| Interest cost | 2,571 | 2,696 |
| Provision for claims occurring in current period | 69,728 | 63,097 |
| Paid on claims occurring during | | |
| Current year | (19,356) | (16,621) |
| Prior year | (34,168) | (31,097) |
| Unpaid claims, end of period, net | 250,846 | 234,373 |
| Reinsurers' share | 30,942 | 31,480 |
| | 281,788 | 265,853 |

The development of insurance liabilities provides a measure of the Company's ability to estimate the ultimate value of claims.

Assumptions used to develop the provision estimate for unpaid claims and adjustment expenses are selected by class of business and geographic location. Consideration is given to the characteristics of the risks, historical trends, and the amount of data available on individual claims, inflation and any other pertinent factors. Some assumptions require a significant amount of judgment such as the expected impacts of future judicial decisions and government legislation. The diversity of these considerations results in it not being practical to identify and quantify all individual assumptions that are more likely than others to have a significant impact on the measurement of the Company's insurance contracts. There were no new assumptions identified in the period as having a potential or identifiable material impact on the overall claims estimate.

## 8 Risk management

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

These condensed consolidated interim financial statements do not include all financial risk management information and disclosures required in the annual financial statements and should be read in conjunction with the Company's annual financial statements as at December 31, 2012.

The Company has written principles for overall risk management, as well as written policies covering specific areas such as underwriting, reinsurance, foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non–derivative financial instruments and investment of excess liquidity. There has been no significant change in risk management since year end.

### *Insurance risk*

The risk under any one insurance contract is the possibility that the event occurs and the uncertainty of the amount of the resulting claim. By the very nature of an insurance contract, the risk is random and therefore unpredictable. The principal risk that the Company faces under its insurance contract is that the actual claims payments exceed the carrying amount of the insurance liabilities. This could occur because the frequency or the severity of the claims is greater than estimated. Insurance events are random and the actual number and amount of claims will vary from year to year from the estimate.

The concentration of insurance risk by product line, country, province or state, and underlying currency, will also impact financial results depending on the nature and location of events.

Compared to year end there was no material change to insurance risk.

### Interest rate risk

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

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

(Unaudited, in thousands of Canadian dollars, except per share amounts)

| | As at June 30, 2013 | | | As at December 31, 2012 | | |
|---|---|---|---|---|---|---|
| **Change in interest rates** | **Fair value of fixed income portfolio** | **Hypothetical change on fair value** | **Effect on OCI** | **Fair value of fixed income portfolio** | **Hypothetical change on fair value** | **Effect on OCI** |
| 200 basis point rise | 346,008 | (7%) | (18,622) | 312,522 | (8%) | (20,558) |
| 100 basis point rise | 358,433 | (4%) | (9,614) | 326,041 | (4%) | (10,689) |
| No change | 371,694 | – | – | 340,684 | – | – |
| 100 basis point decline | 385,804 | 4% | 10,230 | 356,633 | 5% | 11,643 |
| 200 basis point decline | 399,589 | 7% | 20,224 | 372,660 | 9% | 23,342 |

### Liquidity risk

Liquidity risk is the risk that the Company may not have sufficient liquid financial resources to meet its obligations when they fall due, or would have to incur excessive costs to do so. The Company's liquidity management strategy is to ensure that there is sufficient cash to meet its financial commitments as they become due. To manage cash flow requirements, the Company maintains a portion of invested assets in liquid investments.

The maturity profile of bonds as at June 30, 2013, and December 31, 2012, are as follows:

| June 30, 2013 | Less than 1 year | 1 – 3 years | 3 – 5 years | Greater than 5 years | Total |
|---|---|---|---|---|---|
| Bonds | 41,578 | 97,213 | 147,515 | 85,388 | 371,694 |
| Percentage of total | 11% | 26% | 40% | 23% | 100% |

| December 31, 2012 | Less than 1 year | 1 – 3 years | 3 – 5 years | Greater than 5 years | Total |
|---|---|---|---|---|---|
| Bonds | 28,342 | 81,864 | 120,066 | 140,369 | 370,641 |
| Percentage of total | 8% | 22% | 32% | 38% | 100% |

(Unaudited, in thousands of Canadian dollars, except per share amounts)

The following tables summarize the expected timing of cash flows arising from insurance obligations, on an undiscounted basis, as at June 30, 2013, and December 31, 2012:

| June 30, 2013 | Less than 1 year | 1 – 3 years | 3 – 5 years | Greater than 5 years | Total |
|---|---|---|---|---|---|
| Actuarial liabilities (undiscounted) | 81,487 | 98,951 | 53,597 | 37,815 | 271,850 |
| Less: Reinsurance recoverable | 12,144 | 9,649 | 4,685 | 2,889 | 29,367 |
| Net actuarial liabilities | 69,343 | 89,302 | 48,912 | 34,926 | 242,483 |

| December 31, 2012 | Less than 1 year | 1 – 3 years | 3 – 5 years | Greater than 5 years | Total |
|---|---|---|---|---|---|
| Actuarial liabilities (undiscounted) | 76,651 | 92,256 | 52,211 | 35,980 | 257,098 |
| Less: Reinsurance recoverable | 11,782 | 9,592 | 4,747 | 2,605 | 28,726 |
| Net actuarial liabilities | 64,869 | 82,664 | 47,464 | 33,375 | 228,372 |

All other financial liabilities are for duration of one year or less. The contractual maturities for lease commitments are listed in note 12.

**Equity price risk**

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

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

The table below summarizes the potential impact of a 10% change in the value of the equity securities (common and preferred shares) on net income and OCI for the quarter ended June 30, 2013, and the year ended December 31, 2012. Certain shortcomings are inherent in the method of analysis presented, as the analysis is based on the assumption that all equity holdings increased/decreased by 10% with all other variables held constant.

| Change in equity holdings | Effect on Net Income | | Effect on OCI net of tax | |
|---|---|---|---|---|
| | June 30, 2013 | December 31, 2012 | June 30, 2013 | December 31, 2012 |
| 10% rise | 2,022 | 1,836 | 1,661 | 1,237 |
| 10% decline | (2,022) | (1,836) | (1,661) | (1,237) |

(Unaudited, in thousands of Canadian dollars, except per share amounts)

**Credit risk**

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

The company participates in a securities lending program managed by a federally regulated financial institution whereby the Company lends securities it owns to other financial institutions to allow them to meet their delivery commitments. The Company receives collateral for securities loaned. At June 30, 2013, securities, which are included in invested assets, with a fair value of $88,045 (December 31, 2012 – Nil) have been loaned. Securities with a fair value of $92,829 (December 31, 2012 – nil) were received as collateral. The collateral received has not been recorded on the Company's consolidated balance sheet.

The Company is exposed to risk from reinsurers' inability to cover balances. 92.0% of the Company's reinsurance balances are from registered reinsurers. The Company holds sufficient collateral to cover the 8.0% of reinsurance balances from unregistered reinsurers.

The following table sets forth the Company's fixed income securities portfolio by credit quality as at June 30, 2013, and December 31, 2012.

**Fixed income portfolio**

| | As at June 30, 2013 | | As at December 31, 2012 | |
|---|---|---|---|---|
| | **Fair value** | **Fair value** | **Fair value** | **Fair value** |
| AAA | 128,772 | 35% | 134,855 | 37% |
| AA | 74,824 | 20% | 76,636 | 21% |
| A | 105,891 | 28% | 108,801 | 29% |
| BBB | 37,434 | 10% | 39,718 | 10% |
| BB | 17,560 | 5% | 6,626 | 2% |
| B | 802 | – | 455 | – |
| CCC | 2,075 | 1% | 277 | – |
| Unrated | 4,336 | 1% | 3,273 | 1% |
| Total | 371,694 | 100% | 370,641 | 100% |

**Preferred share portfolio**

| | As at June 30, 2013 | | As at December 31, 2012 | |
|---|---|---|---|---|
| | **Fair value** | **Fair value** | **Fair value** | **Fair value** |
| P1 | 5,829 | 21% | 9,179 | 36% |
| P2 | 17,856 | 65% | 9,766 | 39% |
| P3 | 4,009 | 14% | 6,201 | 25% |
| Total | 27,694 | 100% | 25,146 | 100% |

(Unaudited, in thousands of Canadian dollars, except per share amounts)

## 9 Intangible assets

| | Opening cost | Purchases | Sales | End of period cost | Accumulated amortization | Net |
|---|---|---|---|---|---|---|
| **Software** | | | | | | |
| June 30, 2013 | 10,403 | 1,781 | – | 12,184 | 6,566 | 5,618 |
| December 31, 2012 | 7,412 | 2,991 | – | 10,403 | 5,430 | 4,973 |
| **Goodwill** | | | | | | |
| June 30, 2013 | 595 | – | – | 595 | – | 595 |
| December 31, 2012 | 195 | 400 | – | 595 | – | 595 |
| **Total intangible assets** | | | | | | |
| June 30, 2013 | 10,998 | 1,781 | – | 12,779 | 6,566 | 6,213 |
| December 31, 2012 | 7,607 | 3,391 | – | 10,998 | 5,430 | 5,568 |

## 10 Related party transactions

The Co–operators Group Limited and Co–operators General Insurance Company (collectively Co–operators), significant shareholders of the Company, provide services to the Company, including but not limited to product distribution and investment management services under arms-length contracts. Direct written premiums derived from Co–operators' agents were $4,721 (June 30, 2012 – $5,826), commissions paid were $543 (June 30, 2012 – $670) and investment management fees were $227 (June 30, 2012 – $190).

The Company has a 100% Quota Share reinsurance treaty with Co–operators General Insurance Company for policies written in 2001 and 2002. Reinsurers share of unpaid claims includes a recoverable of $316 (June 30, 2012 – $316) from Co-operators General Insurance Company. The payable to insurance companies balance includes amounts due to Co-operators General Insurance Company of $96 (June 30, 2012 – $50).

## 11 Income taxes

Income tax expense is recognized based on managements estimate of the weighted annual income tax rate expected for the full financial year. The estimated annual tax rate used for the three and six months ended June 30, 2013, was 27%. The estimated tax rate for the three and six months ended June 30, 2012, was 27.5%.

The income tax expense (recovery) is as follows:

| | 3 months ended June 30 | | 6 months ended June 30 | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Current | 2,544 | (764) | 2,584 | 463 |
| Deferred | (242) | 1 | (524) | (36) |
| | 2,302 | (763) | 2,059 | 427 |

(Unaudited, in thousands of Canadian dollars, except per share amounts)

## 12 Lease commitments

The Company is committed under lease agreements for office premises and computer equipment with minimum lease payments of $5,962 as follows:

| Lease commitments | |
|---|---|
| 2013 | 735 |
| 2014 | 1,324 |
| 2015 | 1,238 |
| 2016 | 1,223 |
| 2017 | 1,093 |
| 2018 and thereafter | 349 |
| | 5,962 |

## 13 Accumulated other comprehensive income

| | 6 months ended June 30 | |
|---|---|---|
| | **2013** | **2012** |
| Beginning Balance that may subsequently be classified to profit and loss | 6,054 | 13,766 |
| Unrealized gains (losses) on fixed maturities and equity investments arising during the period | (1,625) | 2,268 |
| Reclassification adjustment for (gains) losses included in net income | (4,787) | (1,333) |
| Foreign currency translation adjustments | 712 | 4 |
| Tax impact | 1,926 | (314) |
| Ending balance | 2,280 | 14,391 |

| | **As at June 30, 2013** | **As at December 31, 2012** |
|---|---|---|
| Gross unrealized gains (losses) | 2,192 | 8,604 |
| Foreign currency translation adjustments | 753 | 41 |
| Tax impact | (665) | (2,591) |
| Ending balance | 2,280 | 6,054 |

## 14 Earnings per share

| | 3 months ended June 30 | | 6 months ended June 30 | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Basic earnings per share: | | | | |
| Net income available to shareholders | 8,126 | (2,390) | 7,305 | 1,598 |
| Average number of common shares (in thousands) | 11,789 | 12,049 | 11,800 | 12,049 |
| Basic earnings per share | $0.69 | $(0.20) | $0.62 | $0.13 |
| Diluted earnings per share: | | | | |
| Average number of common shares (in thousands) | 11,789 | 12,049 | 11,800 | 12,049 |
| Average number of dilutive common shares under employee stock option plan (in thousands) | 194 | 128 | 192 | 81 |
| Average number of diluted common shares (in thousands) | 11,983 | 12,177 | 11,992 | 12,130 |
| Diluted earnings per share | $0.68 | $(0.20) | $0.61 | $0.13 |

## 15 Subsequent Event

On August 8, 2013, the Company entered into a definitive stock purchase agreement to sell EGI Insurance Services, Inc. and all its subsidiary companies, including American Colonial Insurance Company, a Florida domiciled insurance company, and EGI Insurance Services (Florida), Inc., a Florida based managing general agency. The transaction will result in a reduction of book value of $5,700, before tax, on closing and the U.S. segment will be classified as a discontinued operation, which will be reflected in the third quarter financial statements.

The transaction is expected to close in the fall, subject to regulatory approval.

## 16 Segmented information

The Company operates through four segments: Personal Lines and Specialty Programs divisions in Canada, non–standard automobile markets in the U.S. division and specialty business in the International division. Through its Personal Lines division, the Company is engaged primarily in the underwriting of high premium, non–standard automobile insurance.

Through its Specialty Programs division, the Company designs and underwrites specialized non–auto insurance programs, such as higher premium property, primary and excess liability, legal expense, accident and health insurance and warranty coverage. Through the U.S. division, the Company underwrites high premium, non-standard automobile insurance. Through the International division the Company underwrites European property, automobile and other niche and specialty insurance products.

The effect of reinsurance is reflected in the revenue and results of each segment. The investment activities consist of managing the investment portfolio for the Company as a whole. Investment income is shown net of investment expenses. The corporate and other activities include holding company expenses not attributable to a division.

**EGI FINANCIAL HOLDINGS INC.**
**Notes to the Condensed Consolidated Interim Financial Statements**
**For the three and six months ended June 30, 2013 and 2012**
**(continued)**
(Unaudited, in thousands of Canadian dollars, except per share amounts)

| | **3 months ended June 30** | | **6 months ended June 30** | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Revenue | | | | |
| Earned premiums | | | | |
| Canada – Personal Lines | 30,299 | 31,427 | 59,601 | 62,904 |
| – Specialty Programs | 8,201 | 8,242 | 16,500 | 16,623 |
| | 38,500 | 39,669 | 76,101 | 79,527 |
| U.S. | 3,607 | 3,115 | 7,161 | 5,265 |
| International | 11,947 | 1,173 | 18,912 | 1,335 |
| Total earned premium | 54,054 | 43,957 | 102,174 | 86,127 |
| Net claims Incurred | | | | |
| Canada – Personal Lines | 16,926 | 17,669 | 38,978 | 39,222 |
| – Specialty Programs | 5,066 | 8,646 | 10,752 | 12,207 |
| | 21,992 | 26,315 | 49,730 | 51,429 |
| U.S. | 3,274 | 4,237 | 6,405 | 6,722 |
| International | 5,652 | 762 | 9,938 | 879 |
| Total net claims incurred | 30,918 | 31,314 | 66,073 | 59,030 |
| Net expenses | | | | |
| Canada – Personal Lines | 8,862 | 9,600 | 17,262 | 18,386 |
| – Specialty Programs | 3,835 | 3,986 | 7,749 | 7,764 |
| | 12,697 | 13,586 | 25,011 | 26,150 |
| U.S. | 1,248 | 1,145 | 2,603 | 2,384 |
| International | 5,280 | 1,285 | 8,292 | 2,133 |
| Corporate Expenses | 745 | 900 | 1,477 | 1,679 |
| Total net expenses | 19,970 | 16,916 | 37,383 | 32,346 |
| Income (loss) before income taxes | | | | |
| Canada – Personal Lines | 4,511 | 4,158 | 3,361 | 5,296 |
| – Specialty Programs | (700) | (4,390) | (2,001) | (3,348) |
| | 3,811 | (232) | 1,360 | 1,948 |
| U.S. | (915) | (2,267) | (1,847) | (3,841) |
| International | 1,015 | (874) | 682 | (1,677) |
| Corporate and other | (745) | (900) | (1,477) | (1,679) |
| Underwriting (loss) income | 3,166 | (4,273) | (1,282) | (5,249) |
| Impact of change in net claims discount rate | 1,770 | (1,811) | – | (1,811) |
| Investment income | 5,584 | 2,501 | 10,649 | 8,461 |
| Total income before income taxes | 10,520 | (3,583) | 9,367 | 1,401 |

(Unaudited, in thousands of Canadian dollars, except per share amounts)

***Segmented long-term assets***

| | **June 30** | **December 31** |
|---|---|---|
| | **2013** | **2012** |
| Canada – Personal Lines | 5,847 | 5,362 |
| – Specialty Programs | 852 | 816 |
| | 6,699 | 6,178 |
| U.S | 15 | 20 |
| International | 254 | 118 |
| Total segmented long-term assets | 6,968 | 6,316 |