EGI Financial Holdings Inc.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF

# FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**For the period ending June 30, 2014**

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## For the period ending June 30, 2014

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*References to "EGI" or "Company" in this Management's Discussion and Analysis refer to EGI Financial Holdings Inc. on a consolidated basis, both now and in its predecessor forms.*

***Important Note:***

*The condensed consolidated interim financial statements for the quarters ended June 30, 2014, and 2013 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 policies applied in the condensed consolidated interim financial statements are based on IFRS and have been consistent with those of the previous financial year except for the ones explained in note 3 in the condensed financial statements.*

*The following discussion should be read in conjunction with EGI's unaudited condensed consolidated interim financial statements for the second quarter of fiscal 2014 and 2013, with the notes to the condensed consolidated interim financial statements, and with management's discussion and analysis (MD&A) and audited annual consolidated financial statements and accompanying notes in the Company's 2013 annual report. The financial data in this discussion has been prepared in accordance with IFRS and has been derived from the unaudited consolidated interim financial statements for the three months ended June 30, 2014, and 2013.*

*The following commentary is current as of August 7, 2014. Additional information relating to EGI is available on SEDAR at www.sedar.com. Certain totals, subtotals and percentages may not reconcile due to rounding.*

*EGI uses both IFRS and certain non-IFRS measures to assess performance. Securities regulators require that companies caution readers about non-IFRS measures that do not have a standardized meaning under IFRS and are unlikely to be comparable to similar measures used by other companies. EGI analyzes performance based on underwriting income and underwriting ratios such as combined, expense and loss ratios, which are non-IFRS measures. Underwriting income is defined as net earned premiums less net claims incurred, net acquisition expenses, general expenses, integration costs and excludes any impact of change in discount rate or foreign exchange rate on claims.*

*The following discussion contains forward-looking information that involves risk and uncertainties based on current expectations. This information includes, but is not limited to, statements about the operations, business, financial condition, priorities, targets, ongoing objectives, strategies and outlook of EGI for 2014 and subsequent periods.*

*This information is based upon certain material factors or assumptions that were applied in drawing a conclusion or making a projection as reflected in the forward-looking information. By its nature, this information is subject to inherent risks and uncertainties that may be general or specific. A variety of material factors, many of which are beyond EGI's control, affect the operations, performance and results of EGI and its business, and could cause actual results to differ materially from the expectations expressed in any of this forward-looking information.*

## COMPANY OVERVIEW

EGI operates in the property and casualty ("P&C") insurance industry in Canada and Europe. The Company underwrites non-standard automobile insurance and other specialty insurance products, with a focus on niche underserved markets.

EGI operates in Canada through Echelon General Insurance Company ("Echelon"), a federally-regulated P&C insurance company. It has two lines of insurance business – Personal Lines and Specialty Programs. Personal Lines focuses on the underwriting of EGI's non-standard automobile insurance and insurance for motorcycles, antique and classic vehicles, trailers, motor homes and recreational vehicles. Specialty Programs designs and underwrites specialized insurance programs, such as hard to place commercial property, primary and excess liability, and extended warranty.

The International division underwrites specialty insurance programs in Europe through Qudos Insurance A/S ("Qudos"), a majority-owned insurance company. Qudos is domiciled in Denmark and is regulated throughout the European Union by the Danish Financial Supervisory Authority. Products include motorcycle, taxi, non-standard auto and warranty insurance. It commenced writing premiums in 2012 and, to date, the majority of the business written is in the United Kingdom and Denmark.

On November 30, 2013, EGI completed a definitive stock purchase agreement with White Pine Insurance Company for the sale of its U.S. operations. The U.S. operations are discontinued and the division's results are excluded from any comparative results.

On March 28, 2014, EGI announced that it has entered into a definitive agreement with SGI Canada to acquire 75% of the Insurance Company of Prince Edward Island ("ICPEI"). The transaction closed on June 30, 2014, and is accounted for commencing July 1, 2014.

## QUARTERLY HIGHLIGHTS

- Net operating income of $0.02 per share compared to $0.49 in the second quarter of 2013.
- An underwriting loss of $3.3 million for the quarter, excluding ICPEI integration costs and the foreign exchange impact on claims.
- A combined operating ratio of 105.3% compared to 91.8% in the second quarter of 2013. The combined ratio, excluding UK weather impact, was 102.7%.
- A 30% increase in direct written premiums over the same period in 2013 to $101.4 million, driven by the increase in premiums in the International division.
- Total pre-tax return on invested assets of $6.6 million in the quarter compared to $3.5 million in the second quarter of 2013.
- An increase in book value per share of 0.5% in the quarter to $14.99 per share.

The following financial information compares three and six months ended June 2014 results with the same period in 2013.

| | 3 months ended June 30 | | 6 months ended June 30 | |
|---|---|---|---|---|
| **($ THOUSANDS except per share amounts)** | **2014** | **2013** | **2014** | **2013** |
| Direct written and assumed premiums | 101,428 | 78,121 | 181,196 | 131,361 |
| Net written premiums | 77,029 | 69,199 | 142,194 | 114,405 |
| Net earned premiums | 61,885 | 50,449 | 123,983 | 95,015 |
| Claims incurred | 40,482 | 27,644 | 76,218 | 59,668 |

| ($ THOUSANDS except per share amounts) | 3 months ended June 30 2014 | 3 months ended June 30 2013 | 6 months ended June 30 2014 | 6 months ended June 30 2013 |
|---|---|---|---|---|
| Acquisition costs | 17,741 | 12,987 | 35,840 | 23,836 |
| Operating expenses | 6,973 | 5,738 | 14,704 | 10,946 |
| Underwriting income (loss) [(1)] | (3,311) | 4,080 | (2,779) | 565 |
| ICPEI integration costs | (1,347) | – | (1,347) | – |
| Investment income | 5,496 | 5,328 | 11,630 | 10,416 |
| Impact of foreign exchange on claims | (725) | – | (725) | – |
| Impact of discount rate on claims | (267) | 1,759 | (267) | – |
| Net (loss) income before income taxes | (154) | 11,167 | 6,512 | 10,981 |
| Income taxes expense | (449) | (2,428) | (1,720) | (2,212) |
| Net income (loss) – continued operations | (603) | 8,739 | 4,792 | 8,769 |
| Net income attributable to shareholders | 244 | 8,126 | 5,539 | 7,305 |
| Net operating income attributable to shareholders | 263 | 5,848 | 3,941 | 5,840 |
| Earnings per share on continuing operations | | | | |
| Basic | $0.02 | $0.73 | $0.47 | $0.74 |
| Diluted | $0.02 | $0.73 | $0.46 | $0.74 |
| Return on equity (ROE) [(1)] | 1.7% | 16.0% | 1.7% | 16.0% |
| Return on equity (ROE) continuing operations [(1)] | 5.8% | 17.4% | 5.8% | 17.4% |
| Net operating income per share – diluted | $0.02 | $0.49 | $0.33 | $0.49 |

(1) Before impact of change in discount rate and foreign exchange, increasing unpaid claims by $267 and $725 respectively in the three months ended June 30, 2014, compared to a $1,759, decrease in unpaid claims for the corresponding period in 2013.

## Insurance Operations

*Written and Earned Premiums*

In the second quarter of 2014, direct written premiums increased $23.3 million, or 30%, to $101.4 million compared to $78.1 million in the same period last year. The increase in written and earned premiums was primarily due to growth in the International division.

*Incurred Claims Expense*

For the quarter ended June 30, 2014, net claims expense increased $12.8 million or 46% to $40.5 million compared to $27.6 million in the second quarter of 2013. This resulted in an increased loss ratio of 65.4% for the three months ended June 30, 2014, compared to 54.8% for the same period in 2013 as the increase in net claims expense was higher than the 23% increase in earned premiums.

On a consolidated basis, net favourable development of prior year claims of $1.8 million was recorded in the second quarter of 2014 compared to net favourable development of $2.9 million in the same period in 2013.

*Acquisition Costs*

Net acquisition costs, which consist mainly of commissions and premium taxes, increased $4.7 million or 37% to $17.7 in the quarter ended June 30, 2014, compared to $13.0 in the same period in 2013. The increase is larger than the increase in the net earned premiums of 23% due to the larger acquisition costs in the International division.

*Operating Expenses*

Operating expenses increased $1.2 million or 22% to $7.0 million in the second quarter of 2014 compared to $5.7 million in the comparative quarter due to the 23% increase in earned premiums and amortization of information system initiatives.

*Underwriting Income*

Underwriting loss of $3.3 million was recorded in the second quarter of 2014 compared to an underwriting income of $4.1 million in the same period in 2013. The decrease was attributable to lower underwriting income in Personal Lines and an underwriting loss in the International division, partially offset by improved performances in Specialty Programs.

*ICPEI Integration Expenses*

Integration expenses of $1.3 million primarily relating to the integration of ICPEI systems with EGI are considered to be non-recurring expenses and excluded from underwriting income.

*Net Income before Income Taxes*

For the quarter ended June 30, 2014, loss before income taxes was $0.2 million compared to income of $11.2 million for the second quarter of 2013. This was the result of a decrease in underwriting income of $7.4 million, decrease in impact of discount rate on claims of $2.0 million, integration costs of $1.3 million, and foreign exchange impact of $0.7 million, offset by higher investment income of $0.2 million compared to the same period in 2013.

*Income Taxes*

For the quarter ended June 30, 2014, the provision for income taxes reflects an expense of $0.4 million compared to $2.4 million for the same period last year.

## SEGMENTED FINANCIAL INFORMATION

### Personal Lines

| | 3 months ended June 30 | | | | 6 months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| **($THOUSANDS)** | **2014** | **2013** | **$Variance** | **%Variance** | **2014** | **2013** | **$Variance** | **%Variance** |
| Direct written premiums | 45,931 | 43,518 | 2,413 | 6 | 73,674 | 72,309 | 1,365 | 2 |
| Net earned premiums | 30,546 | 32,058 | (1,512) | (5) | 61,101 | 62,295 | (1,194) | (2) |
| Net claims: | | | | | | | | |
| Current year claims | 23,043 | 20,544 | 2,499 | 12 | 44,301 | 44,612 | (311) | (1) |
| Current year loss ratio | 75.4% | 64.0% | | | 72.5% | 58.3% | | |
| Favourable prior year claim development | 4,721 | 2,677 | 2,044 | 76 | 8,228 | 4,146 | 4,082 | 98 |
| Total net claims | 18,322 | 17,867 | 455 | 3 | 36,073 | 40,466 | (4,393) | (11) |
| Claims ratio[1] | 60.0% | 55.7% | | | 58.7% | 65.0% | | |
| Expense ratio | 31.9% | 30.3% | | | 32.5% | 30.0% | | |
| Combined ratio[1] | 91.9% | 86.0% | | | 91.2% | 95.0% | | |
| Underwriting income (loss) [1] | 2,461 | 4,478 | (2,017) | (45) | 5,373 | 3,146 | 2,227 | 71 |

(1) Before impact of change in discount rate increasing unpaid claims by $216, in the three months ended June 30, 2014, compared to a $1,463, decrease in unpaid claims for the corresponding period in 2013.

***Second Quarter 2014***

Personal Lines recorded an underwriting income in the second quarter of 2014 of $2.5 million, compared to $4.5 million in the second quarter of 2013, a decrease of $2.0 million.

This segment's combined ratio increased to 91.9% in the quarter as a result of the following factors:

1. Ontario non-standard auto continued to perform well, although the combined ratio of 91.9% was weaker than the exceptional comparative ratio of 82.6% in the second quarter of 2013.
2. Increased positive development of prior year claims of $4.7 million compared to $2.7 million in the same period in 2013. However, total IBNR increased in the quarter by $0.4 million compared to a release of $2.6 million in the same period in 2013.
3. The performance of EGI's motorcycle and Personal Lines business outside of Ontario recorded a combined ratio of 89.9% in the second quarter of 2014 compared to a combined ratio of 88.8% in the same period in 2013.

***Year to Date***

Personal Lines recorded an underwriting income in the first six months of $5.4 million, compared to $3.1 million in the same period of 2013, an increase of $2.2 million.

This segment's combined ratio decreased as a result of the following factors:

1. Improved performance of Ontario non-standard auto, which recorded a combined ratio of 93.3% in the six months ended June 2014 compared to 99.8% in the same period of 2013, despite harsh winter driving conditions in early 2014.
2. Increased positive development of prior year claims of $8.2 million year to date 2014, compared to $4.1 million the same period last year. However, total IBNR increased by $4.9 million compared to an increase of $2.6 million in the same period in 2013.
3. EGI's Personal Lines business in the Western Canada recorded a strong combined ratio of 85.7% in the six months ended June 2014 compared to a 108.0% combined ratio in the same period in 2013.

**Specialty Programs**

| | 3 months ended June 30 | | | | 6 months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| **($THOUSANDS)** | **2014** | **2013** | **$Variance** | **%Variance** | **2014** | **2013** | **$Variance** | **%Variance** |
| Direct written premiums | 12,181 | 10,586 | 1,595 | 15 | 21,391 | 20,151 | 1,240 | 6 |
| Net earned premiums | 8,371 | 6,442 | 1,929 | 30 | 16,742 | 13,806 | 2,936 | 21 |
| Net claims: | | | | | | | | |
| Current year claims | 1,811 | 4,637 | (2,826) | (61) | 6,823 | 9,656 | (2,833) | (29) |
| Current year loss ratio | 21.6% | 72.0% | | | 40.6% | 69.9% | | |
| Favourable (unfavourable) prior year claim development | (1,527) | 493 | (2,020) | (410) | (1,775) | 393 | (2,168) | (552) |
| Total net claims | 3,338 | 4,125 | (787) | (19) | 8,598 | 9,263 | (665) | (7) |
| Claims ratio(1) | 39.9% | 64.0% | | | 51.4% | 67.1% | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Expense ratio | 53.4% | 46.3% | | | 55.0% | 45.8% | | |
| Combined ratio[(1)] | 93.3% | 110.3% | | | 106.4% | 112.9% | | |
| Underwriting income (loss) [(1)] | 557 | (667) | 1,224 | 184 | (1,072) | (1,786) | 714 | 40 |

(1) Before impact of change in discount rate increasing unpaid claims by $51, in the three months ended June 30, 2014, compared to a $362, decrease in unpaid claims for the corresponding period in 2013.

***Second Quarter 2014***

Specialty Programs recorded an underwriting income of $0.6 million compared to an underwriting loss of $0.7 million in the second quarter of 2013.

This segment's combined ratio decreased to 93.3% in this quarter as a result of the following factors:

1. The property line of business experienced an underwriting profit of $1.3 million in Q2 2014 compared to an underwriting loss of $0.7 million.
2. The liability line of business experienced underwriting losses of $1.0 million in Q2 2014 compared to an underwriting loss of $0.2 million in Q2 2013.
3. Lower current accident year claims ratio of 21.6% compared to 72.0% in the same period of the prior year.

***Year to Date 2014***

Specialty Programs recorded an underwriting loss of $1.1 million in the first six months of 2014 compared to $1.8 million in the same period in 2013.

This segment's combined ratio decreased to 106.4% compared from 112.9% in 2013 as a result of the following factors:

1. The property line of business experienced a reduced underwriting loss of $0.3 million in Q2 YTD 2014 compared to underwriting loss of $2.1 million in the same period 2013.
2. The liability line of business experienced underwriting losses of $1.0 million in Q2 YTD 2014 compared to an underwriting loss of $0.1 million in the same period 2013.
3. Lower current accident year claims ratio of 40.6% compared to 69.9% in the same period of the prior year.

**International Division**

| | 3 months ended June 30 | | | | 6 months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| **($THOUSANDS)** | **2014** | **2013** | **$Variance** | **%Variance** | **2014** | **2013** | **$Variance** | **%Variance** |
| Direct written premiums | 43,314 | 24,016 | 19,298 | 80 | 86,130 | 38,900 | 47,230 | 121 |
| Net earned premiums | 22,968 | 11,947 | 11,021 | 92 | 46,140 | 18,912 | 27,228 | 144 |
| Net claims: | | | | | | | | |
| Current year claims | 16,963 | 5,407 | 11,556 | 214 | 29,688 | 9,558 | 20,130 | 211 |
| Current year loss ratio | 73.9% | 45.3% | | | 64.3% | 50.5% | | |
| Favourable (unfavourable) prior year claim development | (1,859) | (245) | (1,614) | (659) | (1,859) | (380) | (1,479) | (389) |
| Total net claims | 18,822 | 5,652 | 13,170 | 233 | 31,547 | 9,938 | 21,609 | 217 |
| Claims ratio[(1)] | 81.9% | 47.3% | | | 68.4% | 52.5% | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Expense ratio | 41.7% | 44.2% | | | 42.6% | 43.9% | | |
| Combined ratio[(1)] | 123.6% | 91.5% | | | 111.0% | 96.4% | | |
| Underwriting income (loss) [(1)] | (5,429) | 1,015 | (6,444) | (635) | (5,042) | 682 | (5,724) | (839) |

(1) Before impact of change in foreign exchange rate increasing claims by $725, in the three months ended June 30, 2014, compared to a $nil, increase in unpaid claims for the corresponding period in 2013.

***Second Quarter 2014***

The International division recorded $43.5 million of written premiums in the second quarter of 2014 compared to $24.0 million in the same period in 2013, an increase of $19.5 million. The strong growth in written premiums is due primarily to the growth in existing programs. At the end of the second quarter, the International division wrote approximately 30 programs, mainly in the UK and Denmark.

The International division recorded an underwriting loss of $5.4 million in the second quarter compared to underwriting income of $1.0 million in the comparable period in 2013. This is as a result of:

1. Higher current accident year claims ratio of 73.9% compared to 45.3% in the same period of the prior year, as a result of poor performance of the Auto book in the UK market due to warm and extremely wet winter weather conditions in the UK that increased the frequency of claims on the UK Auto book by approximately 30%. The impact of UK weather in the quarter was $1.6 million.
2. Increase in IBNR reserves of approximately $3.3 million for the quarter compared to $1.2 million in the same period in 2013.
3. Negative prior year claims development of $1.9 million in Q2 2014 compared to $0.2 million in the same period in 2013. The negative prior year claims development primarily relates to latent claims reported on the UK motorcycle program.

***Year to Date 2014***

The International division recorded $86.1 million of written premiums in the year compared to $38.9 million in the same period in 2013, an increase of $47.2 million. The strong growth in written premiums is due primarily to the growth in existing programs.

The International division recorded an underwriting loss of $5.0 million in the year compared to underwriting income of $0.7 million in the comparable period in 2013. This is as a result of:

1. Higher current accident year claims ratio of 64.3% compared to 50.5% in the same period of the prior year, as a result of poor performance of the Auto book in the UK market due to warm and extremely wet winter weather conditions in the UK that increased the frequency of claims on the UK Auto book by approximately 30%. The impact of UK weather in the year was $1.6 million.
2. Negative prior year claims development of $1.9 million in Q2 2014 compared to $0.4 million in the same period in 2013.

## SUMMARY OF QUARTERLY RESULTS

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

| | 2014 | | 2013 | | | | 2012 | |
|---|---|---|---|---|---|---|---|---|
| **($ THOUSANDS EXCEPT PER SHARE DATA)** | **Q2** | **Q1** | **Q4** | **Q3** | **Q2** | **Q1** | **Q4** | **Q3** |
| Direct written and assumed premiums | 101,428 | 79,768 | 74,300 | 62,706 | 78,121 | 53,240 | 49,513 | 53,561 |
| Net earned premiums and other revenue | 61,885 | 62,098 | 59,738 | 50,711 | 50,449 | 44,566 | 43,084 | 42,063 |
| Underwriting (loss) income[1] | (3,311) | 532 | (4,309) | 1,157 | 4,080 | (3,515) | 3,131 | 459 |
| Income (loss) before income taxes | (154) | 6,666 | 1,428 | 2,998 | 11,167 | (186) | 7,672 | 19,239 |
| Net (loss) income | (603) | 5,395 | 1,158 | 2,440 | 8,739 | 30 | 5,672 | 14,012 |
| Net income attributable to shareholders | 244 | 5,295 | 2,270 | (4,894) | 8,126 | (821) | 4,693 | 14,062 |
| Earnings per adjusted share | | | | | | | | |
| (a) Basic | $0.02 | $0.45 | $0.17 | $0.22 | $0.73 | $0.01 | $0.49 | $1.18 |
| (b) Diluted | $0.02 | $0.44 | $0.16 | $0.22 | $0.72 | $0.01 | $0.49 | $1.18 |
| Net operating income per share – diluted | $0.02 | $0.30 | $0.08 | $0.32 | $0.49 | $0.00 | $0.30 | $0.23 |
| Selected financial ratios | | | | | | | | |
| Loss ratio[1] | 65.4% | 57.5% | 69.5% | 61.1% | 54.8% | 71.9% | 52.8% | 60.3% |
| Expense ratio | 39.9% | 41.6% | 37.7% | 36.6% | 37.0% | 36.0% | 39.9% | 38.6% |
| Combined ratio [1] | 105.3% | 99.1% | 107.2% | 97.7% | 91.8% | 107.9% | 92.7% | 98.9% |
| Book value per share | $14.99 | $14.92 | $14.57 | $13.98 | $14.37 | $14.09 | $13.98 | $13.58 |

(1) Before impact of change in discount rate increasing unpaid claims by $267, in the three months ended June 30, 2014, compared to a $1,769 decrease in unpaid claims for the corresponding period in 2013.

The quarterly results reflect the seasonality of our business. While net earned premiums are relatively stable from quarter to quarter, underwriting results vary significantly by quarter as they are affected by changes in weather conditions.

### Net Operating Income

Details of Net Operating Income are as follows:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| **($ THOUSANDS except per share amounts)** | **2014** | **2013** | **2014** | **2013** |
| Net income (loss) | (603) | 8,218 | 4,792 | 7,308 |
| Impact of discount rate | 267 | (1,759) | 267 | – |
| Impact of foreign exchange on claims | 725 | – | 725 | – |
| Realized gains (losses) on investments | (1,512) | (3,739) | (3,175) | (5,044) |
| FVTPL investments | (801) | 1,466 | (1,353) | 1,175 |
| Discontinued Operations | – | 521 | – | 1,461 |
| ICPEI Integration Expense | 1,347 | – | 1,347 | – |
| Tax impact [1] | (7) | 1,233 | 591 | 943 |
| Net operating income (loss) | (584) | 5,940 | 3,194 | 5,843 |

| | | | | |
|---|---|---|---|---|
| Minority interest | 847 | (92) | 747 | (3) |
| Net operating income attributable to shareholders | 263 | 5,848 | 3,941 | 5,840 |
| Net operating income per share – diluted | $0.02 | $0.49 | $0.33 | $0.49 |

(1) Statutory tax rate utilized for calculation purposes.

### Balance Sheet Highlights

Selected balance sheet highlights and book value per share details are as follows:

| ($ THOUSANDS except per share amounts) | As at June 30, 2014 | As at Dec 31, 2013 |
|---|---|---|
| Cash and short-term deposits | 50,216 | 18,156 |
| Investments | 450,828 | 454,317 |
| Total assets | 687,514 | 618,103 |
| Provision for unpaid claims | 313,370 | 296,857 |
| Unearned premiums | 157,668 | 127,247 |
| Total equity attributable to shareholders | 176,515 | 170,535 |
| Book value per share (1) | $14.99 | $14.57 |
| Echelon MCT Ratio | 216% | 219% |

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

## BALANCE SHEET ANALYSIS

*The Balance Sheet analysis that follows should be read in conjunction with the unaudited condensed consolidated interim financial statements for the second quarter of 2014 and notes therein.*

### Investments

EGI has an investment policy that seeks to provide a stable income base to support EGI's liabilities without incurring an undue level of investment risk. In addition to this risk-return analysis, the chosen asset mix also considers the amount of regulatory capital that is required.

EGI's investment portfolio is invested in well-established, active and liquid markets in Canada, the United States and Europe. Fair value for most investments is determined by reference to observable market data.

### Fair Value of Investments

The following table sets forth EGI's invested assets as at June 30, 2014, and December 31, 2013.

| | Carrying and fair values | |
|---|---|---|
| **Available-for-sale** | **As at June 30, 2014** | **As at December 31, 2013** |
| Fixed income | | |
| Canadian | | |
| Federal | 53,397 | 54,374 |
| Provincial | 43,743 | 42,718 |
| Municipal | 4,720 | 5,714 |
| Corporate | 178,603 | 162,316 |
| | 280,463 | 265,122 |
| Fixed income lent through securities lending program | | |

| | Carrying and fair values | |
|---|---|---|
| **Available-for-sale** | **As at June 30, 2014** | **As at December 31, 2013** |
| Federal | 14,351 | 49,165 |
| Provincial | 2,562 | 7,656 |
| Municipal | – | 411 |
| Corporate | 4,494 | 3,980 |
| | 21,407 | 61,212 |
| Foreign fixed income | | |
| Government | 23,271 | 12,799 |
| Corporate | 63,302 | 45,608 |
| | 86,573 | 58,407 |
| Total fixed income | 388,443 | 384,741 |
| Commercial Mortgages pooled fund | 2,110 | 2,052 |
| Common shares | | |
| Canadian | 8,656 | 13,491 |
| Foreign | 14,905 | 24,693 |
| | 23,561 | 38,184 |
| Total available-for-sale | 414,114 | 424,977 |
| | | |
| **Fair value through profit or loss** | | |
| Preferred shares | 36,714 | 29,340 |
| Preferred share lent through securities lending program | – | – |
| Total preferred shares | 36,714 | 29,340 |
| Total investments | 450,828 | 454,317 |

### Impairment Assets and Provisions for Losses

EGI has an established policy to write down or make a provision for any investment with objective evidence that the value of the investment is impaired.

Management has reviewed currently available information and the advice of its investment managers regarding those investments whose estimated fair values are less than carrying values. For those securities whose decline in fair value was considered to be objective evidence that the value of the investment is impaired, the Company recorded the difference between the carrying amount of the investment and its fair value as an impairment which reduces investment income in the year recorded.

There was no impairment loss recognized in the second quarter of 2014 and $0.9 million recognized in the second quarter of 2013.

A gross unrealized loss of $1.2 million (June 30, 2013 – $1.7 million) on investments held as at June 30, 2014, is recorded, net of tax, in the amount of $0.9 million [June 30, 2013 – $1.2 million in Accumulated Other Comprehensive Income/(Loss)]. The Company has concluded, based on its review, these fair value deficiencies do not meet the criteria for impairment and they will be monitored on an ongoing basis.

### Fixed Income Securities

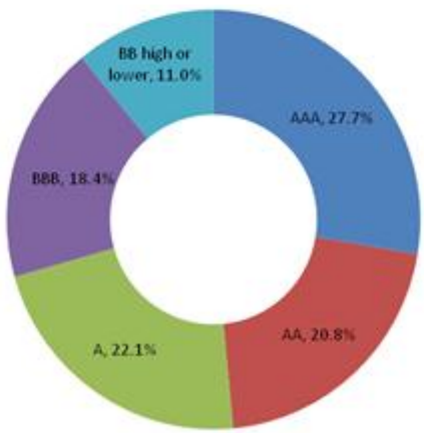
EGI holds fixed income securities to provide a steady, predictable level of income with reasonable liquidity and minimal risk of loss and a fixed sum at maturity. EGI's portfolio is diversified by selecting various types of government and corporate bonds. Constraints on types of issuers take liquidity, diversification and risk into account by limiting the portfolio mix by issuer.

An additional $2 million of preferred shares were purchased in the quarter, primarily fixed rate reset shares.

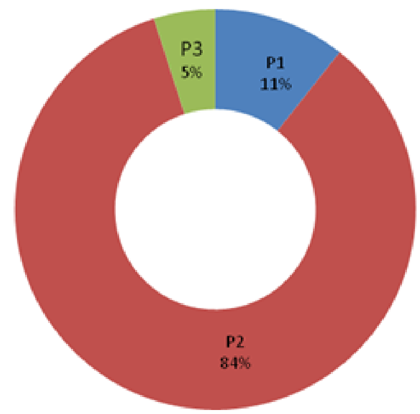
EGI's bond portfolio has a high overall credit quality with an average rating of A. The preferred shares have an average rating of P2. Duration of the bond portfolio is 3 years.

The charts below set forth EGI's fixed income and preferred share portfolios by credit quality determined by DBRS ratings as at June 30, 2014.

**Bond Ratings Q2 2014**




**Preferred Share Ratings Q2 2014**




### Common Shares

Common shares are a key component of EGI's portfolio to enhance the capital appreciation opportunities of EGI's invested assets. Diversification by industry sector also reduces the overall risk level inherent in EGI's common share portfolio.

### Common Share Portfolio

The following table outlines EGI's Canadian common share exposure to industry sectors as at June 30, 2014, and December 31, 2013.

| | As at June 30, 2014 | | As at December 31, 2013 | |
|---|---|---|---|---|
| **($ THOUSANDS)** | **Fair value and carrying amounts** | **% of fair value** | **Fair value and carrying amounts** | **% of fair value** |
| U.S. Pool Funds | 9,719 | 41 | 15,923 | 42 |
| Canadian Pool Funds | 8,218 | 35 | 13,014 | 34 |
| Technology | 2,085 | 9 | 2,352 | 6 |
| Consumer Goods | 1,074 | 5 | 3,168 | 8 |
| Services | 1,133 | 5 | 1,348 | 4 |
| Health Care | 998 | 4 | 960 | 3 |
| Conglomerates | 334 | 1 | 446 | 1 |
| Energy | – | – | 491 | 1 |
| Other | – | – | 482 | 1 |
| Total | 23,561 | 100 | 38,184 | 100 |

As at June 30, 2014, 37% of the common share portfolio was in Canadian equities with 63% in foreign equities.

### Recoverable from Reinsurers

| ($ THOUSANDS) | As at June 30, 2014 | As at Dec. 31, 2013 |
|---|---|---|
| Reinsurers' share of unpaid claims | 38,829 | 32,762 |
| Reinsurers' share of unearned premiums | 33,239 | 19,985 |
| Total | 72,068 | 52,747 |

As at June 30, 2014, the recoverable from reinsurers increased by $19.3 million, or 37%, to $72.1 million from $52.7 million as at December 31, 2013. The increase was due to increased reliance on reinsured premiums in the International division partially offset by reduced reliance on Personal Lines claims reinsurance, as older claims with higher reinsurance run off. All reinsurers, with balances due, have a rating of $A^{-}$ or above as determined by Standard & Poor's and A.M. Best, except for several Specialty Programs distributors who share a portion of the risk with EGI, for whom EGI holds deposits as collateral.

### Accounts Receivable

| ($ THOUSANDS) | As at June 30, 2014 | As at Dec. 31, 2013 |
|---|---|---|
| Premium financing receivables | 22,667 | 15,680 |
| Agents and brokers | 25,577 | 15,627 |
| Other | 4,492 | 4,619 |
| Total | 52,736 | 35,926 |

Premium financing receivables represents 43% of total receivables as at June 30, 2014. Premium financing receivables increased to $22.7 million at June 30, 2014, from $15.7 at December 31, 2013. The increase in agent and broker receivables from $15.6 million in 2013 to $25.6 million in 2014 was mainly as a result of increased balances due to Qudos, in line with the increase of written premiums in this entity.

### Provision for Unpaid Claims

EGI establishes loss reserves to provide for future amounts required to pay claims related to insured events that have occurred and been reported but have not yet been settled, and related to events that have occurred but have not yet been reported to EGI. Provision for unpaid claims consists of the aggregate amount of individual case reserves established and management's estimate of claims incurred but not reported, based on the volume of business currently in force and historical claims experience. In order to help ensure that EGI's provision for unpaid claims (often called "reserves") is adequate, management has retained the services of an independent actuary. Provisions for unpaid claims are discounted to present value. The discount rate used for June 30, 2014, was 1.97%, a decrease from 2.05% at the end of 2013.

### Share Capital

As of August 7, 2014, there were 11,774,682 common shares issued and outstanding.

## LIQUIDITY AND CAPITAL MANAGEMENT

The purpose of liquidity management is to ensure there is sufficient cash to meet all of EGI's financial commitments and obligations as they come due. EGI believes that it has the flexibility to obtain, from internal sources, the funds needed to fulfill its cash requirements, during the following financial year and to satisfy regulatory capital requirements.

Contractual obligations include operating leases, for which $0.8 million is due in less than a year and $5.5 million is due over the next nine years.

EGI is primarily a holding company and, as such, has limited direct operations of its own. EGI's principal assets are the shares of its insurance, reinsurance and insurance management subsidiaries. Accordingly, its future cash flows depend in part upon the availability of dividends and other statutorily permissible distributions from the insurance subsidiaries. The ability to pay such dividends and to make such other distributions is limited by applicable laws and regulations of the jurisdictions in which the insurance subsidiaries are domiciled, which subject the insurance subsidiaries to significant regulatory restrictions. These laws and regulations require, among other things, that the insurance subsidiaries maintain minimum solvency requirements and may also limit the amount of dividends that the insurance subsidiaries can pay to EGI.

### Capital Management

The total capitalization of EGI at June 30, 2014, was $176.7 million compared to $168.4 million at December 31, 2013.

The Minimum Capital Test (MCT) ratio of EGI's Canadian subsidiary, Echelon General Insurance Company, as at June 30, 2014, was 216%, which comfortably exceeds the supervisory regulatory capital level required by the Office of the Superintendent of Financial Institutions (OSFI).

In addition to excess capital at Echelon, the Company has approximately $20 million of excess deployable capital invested in liquid assets in the holding company. All regulated entities remain well-capitalized.

In July 2014, EGI injected $2 million of capital into its European subsidiary to support its strong premium growth and strengthen its regulatory ratios. As a result, EGI's ownership stake will increase to 75% from 51% at the beginning of the year and 71% as at 31st March 2014.

The continued growth in capitalization reflects the strengthening of EGI's balance sheet and provides for better capital adequacy as a P&C insurance underwriter. A common measure of capital adequacy is the net written premium-to-surplus or equity ratio. This ratio was 1.8:1 as at June 30, 2014, compared to 1.2:1 in 2013. EGI's current capitalization provides it with adequate financial resources for planned growth.

**Equity**

| ($ THOUSANDS) | As at June 30, 2014 | As at Dec. 31, 2013 |
|---|---|---|
| Common shares | 67,753<br>(11,772,682 shares) | 67,211<br>(11,703,082 shares) |
| Retained earnings | 94,658 | 94,593 |
| Contributed surplus | 1,926 | 1,561 |
| Accumulated other comprehensive income | 12,178 | 7,170 |
| Non-controlling interest | 227 | (2,156) |
| Total capitalization | 176,742 | 168,379 |

## ACCOUNTING POLICIES

The condensed consolidated interim financial statements have been prepared in accordance with IFRS and in compliance with IAS 34 "Interim Financial Reporting." Please refer to note 3 of the unaudited condensed consolidated interim financial statements for the quarter ended June 30, 2014.

## CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

For a description of EGI's accounting policies, which are on an IFRS basis, refer to note 3 in the condensed consolidated interim financial statements for the quarter ended June 30, 2014. A description of EGI's critical accounting estimates and assumptions is also detailed in note 4 of the interim financial statements.

## CONTROLS AND PROCEDURES

*Disclosure Controls and Procedures*

Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by EGI is recorded, processed, summarized and reported in a timely manner. This includes controls and procedures that are designed to ensure that information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

As of June 30, 2014, an evaluation was carried out, under the supervision of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures as defined under Multilateral Instrument 52-109. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the design of these disclosure controls and procedures was effective.

*Internal Controls over Financial Reporting*

As at the quarter ended June 30, 2014, the Chief Executive Officer and the Chief Financial Officer evaluated the design of the Company's internal control over financial reporting. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the design of internal controls as at June 30, 2014, was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

There have been no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2014, that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.