economical®

2018

ANNUAL REPORT

INSURANCE CAN BE BETTER

Transforming our business by refining what we do to deliver value. Keeping pace with rapidly evolving customer expectations. This is our focus as we work towards becoming a public company.

Insurance is a business of helping people during their time of need. We're being called on more and more to work with our broker partners and support our customers who have not only experienced car accidents or damages to their property, but who are also facing increasing challenges because of severe weather, fraud, or industry-wide rate increases. During these moments of need, we demonstrate compassion and a people-centred focus, developing strong relationships along the way. We're also committed to the communities in which we serve, making a difference where we live and work for the benefit of future generations.

With our strong leadership team, our talented people, and our historic legacy as a proudly Canadian company, we're confident we'll continue to make insurance better, and be there for our customers and brokers when they need us most.

OUR VISION

To be one of Canada's top property and casualty insurers, recognized for our business innovation and how well we take care of our customers.

OUR MISSION

To be the insurance partner Canadians choose to protect what they value most.

OUR VALUES

We focus on customers first

We bring our best

We're stronger together

Financial Strength Rating
A.M. BEST
A- Excellent

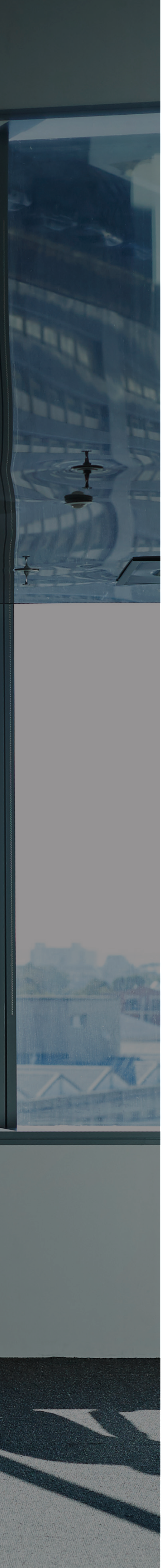
At the end of 2018, the independent rating agency A.M. Best reaffirmed the financial strength of Economical with an A- (Excellent) rating for the sixth consecutive year. This recognition provides additional confidence for our valued broker partners and customers as we drive our strategy forward.

91%

CUSTOMER SATISFACTION

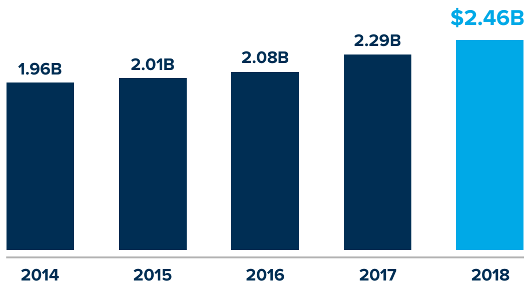
*The claims satisfaction percentage is based on 13,285 claimant survey responses measuring customer satisfaction with claims services from January to December 2018.

2018 PERFORMANCE AT A GLANCE



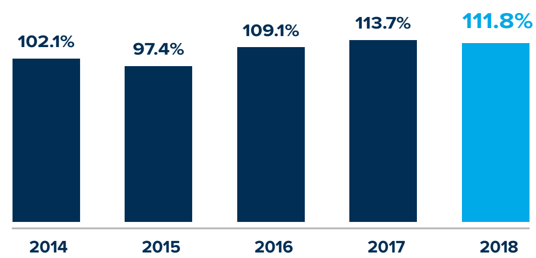
GROSS WRITTEN PREMIUMS (GWP)

Economical continued to increase its GWP levels in 2018, which grew by **$169.4 million** or **7.4%** compared to the prior year, driven by growth in both Sonnet and in our personal lines broker business.



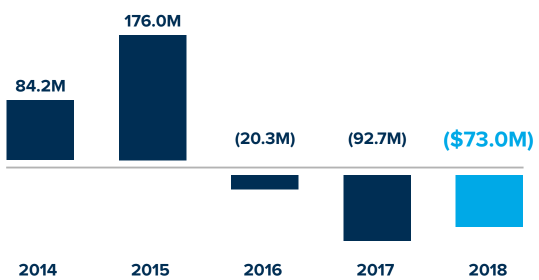
COMBINED RATIO (COR)

While our underwriting results in 2018 remained elevated, our COR improved despite elevated catastrophe losses. We continue to make significant investments in Sonnet and the development and implementation of the Vyne platform. Our COR for 2018 was 111.8%, a decrease of **1.9 percentage** points from the prior year.



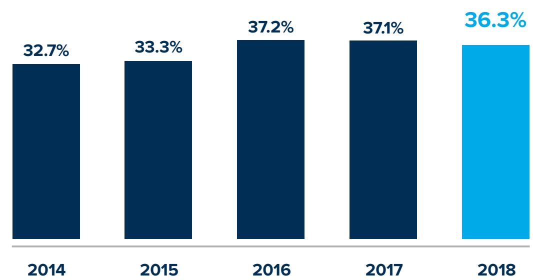
NET INCOME (LOSS)

The continued impact of our strategic initiatives and elevated catastrophe losses resulted in a net loss for the year, although improvements to our underwriting actions and rate increases, as well as an increase in investment income, resulted in a **$19.7M** improvement from the prior year.



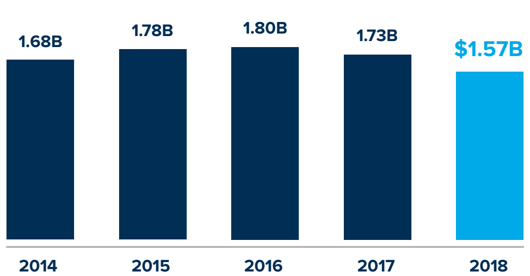
EXPENSE RATIO

Our expense ratio in 2018 decreased slightly from the prior year. We continue to make investments in our strategic initiatives, which we expect to drive profitable growth and improve our operational efficiency in the longer term.



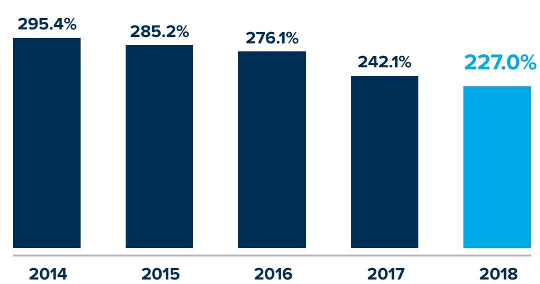
TOTAL EQUITY

Total equity decreased by **$163.1 million** from the prior year, to a total of **$1.57 billion**.



MINIMUM CAPITAL TEST (MCT)

Our MCT ratio of **227.0%** continues to be well in excess of both minimum internal capital and external regulatory requirements as of December 31, 2018.



MESSAGE FROM JOHN BOWEY, BOARD CHAIR

In 2018, Economical made significant progress in advancing our major strategic initiatives, executing our robust profit improvement plans, and passing very important milestones along the path to demutualization. This progress is part of our cohesive plan to ensure we build momentum leading into our initial public offering (IPO) that will position our company for future success. We are now poised to grow profitably with alignment across our business, setting ourselves up as a stronger competitor in our industry now and into the future.

We acknowledge that the financial results for 2018 are not yet where we need them to be, but I am encouraged that our investments and improvement plans are moving the company in the right direction. The implementation of key innovations is already demonstrating a competitive advantage for us that enables our growth. By driving operational efficiencies across the business at the same time as we grow, we are gradually moving the needle to harness that growth profitably. We anticipate that improvement will continue in 2019.

In this letter, I will share more about the progress made in our strategic initiatives throughout 2018 and how it impacts our aspirations for the future.

POISED FOR PROFITABLE GROWTH

Dating back to our roots in 1871, Economical was built on a promise of neighbour helping neighbour during times of hardship. We continue to deliver on that promise as a proudly Canadian company. As we look ahead, we will not lose sight of our heritage, and will draw from our experience for a successful future.

The work that Economical is doing to achieve future success is complex and multi-tiered. It aims to simultaneously manage the day-to-day operations of a large insurance company while also pursuing innovative new technologies and navigating the unique regulatory process that governs our planned demutualization. We are committed to making significant updates to our business so that we operate competitively, with a constant focus on profitability. This is no easy task, but I'm pleased to share the accomplishments that we achieved in the last year.

- Throughout 2018, we unveiled and launched our updated broker offering, Vyne. This innovative solution makes it easier for our broker partners to work with Economical, through refreshed products and pricing and simplified processes, including automated underwriting and streamlined workflows. Having completed this significant undertaking on time and on budget, with a 94% adoption rate from our broker partners, is a great accomplishment for Economical. With Vyne, we are continuing to set the pace in our industry with innovative solutions that simplify the insurance experience.
- Our digital direct channel, Sonnet, demonstrated its ability to drive top-line growth for Economical in 2018. Through sophisticated data and analytical insights, Sonnet has continued to refine its operation, move towards profitability, and ready itself to scale for success going forward.
- Concurrently with our strategic initiatives, Economical has been implementing profit improvement plans across the core of our business to refine operational efficiency and improve underwriting results. These foundational improvements include updated products and pricing, sophisticated underwriting practices, and efficiencies across our claims operations. These improvements will continue into 2019 and ensure that we are focused on managing our operations effectively.

Taken together, these initiatives are redefining Economical as a competitive Canadian insurer. What will take us even further is the access to capital we can achieve through becoming a public company, a process which also advanced significantly in 2018.

WE ARE COMMITTED TO MAKING SIGNIFICANT UPDATES TO OUR BUSINESS SO THAT WE OPERATE COMPETITIVELY, WITH A CONSTANT FOCUS ON PROFITABILITY.

MILESTONES ON THE PATH TO DEMUTUALIZATION

Our strategy to become a leader in our industry supports our decision to demutualize. As a public company we will have greater opportunities to compete. We are the first P&C company in Canada to navigate the current demutualization regulatory framework. It has been a long and complex journey, but in 2018 we achieved a significant milestone: the committees representing mutual and non-mutual policyholders came to an agreement on the allocation of benefits.

These committees worked tireless hours through a difficult process, and took the time needed to get to a result. We are thankful for their efforts, and the efforts made by many financial, legal, and actuarial experts that helped them achieve this milestone. Their contributions allowed the committees to finalize a fair and equitable allocation of benefits. This allocation is included in our conversion plan, which outlines how we will transform from a mutual company to a public share company. In June 2018, we submitted that conversion plan to OSFI, the Office of the Superintendent of Financial Institutions, for their thorough and diligent review, and have since presented it to eligible mutual policyholders as one of the required steps in the demutualization process.

In addition to the benefits allocated to the mutual and non-mutual policyholders, we were pleased to share that a new charitable foundation will be established as part of Economical's planned demutualization. The Economical Insurance Heritage Foundation will receive a $100 million gift from the proceeds of demutualization to honour Economical policyholders and employees, past and present, to have a great impact in our communities. It will be a lasting legacy of our demutualization and something we should all feel very proud about.

Getting to this stage in the process is a major step forward for Economical, and moves us closer to achieving our vision of becoming a top P&C insurer in Canada.

FOCUS ON THE FUTURE

As we look ahead to 2019, we have the momentum and the focus to achieve our goal of becoming an independent, successful public company. Economical has demonstrated that we have the leadership and the talent to execute industry leading innovations like Sonnet and Vyne, revitalize our core business operations for greater efficiency, and pursue a unique path towards demutualization.

The Board is confident that the decisions we are making, and the strategy we are executing, is in the best long-term interests of the company. We are unlocking our full potential to support our employees, our brokers, and our customers, as a dynamic and independent Canadian competitor.

JOHN BOWEY
Board Chair

MESSAGE FROM ROWAN SAUNDERS, PRESIDENT AND CEO

2018 was an important year for Economical to refine our core business and deliver on our strategic initiatives, which together make up the foundation for our future success. I am proud to see how our leaders, employees, and broker partners have executed significant change across our business as we become a modern, competitive insurer. We have built strong momentum on our journey towards becoming a top P&C insurer in Canada, and it wouldn't be possible without the support and encouragement of our Board, our broker partners, and our teams who prove every day that we're stronger together.

Economical is truly transforming its business. While our combined ratio was challenged in 2018, we remain focused on achieving profitability and continuing the pace that we've set to make us a successful, independent Canadian insurer in the long-term.

OUR FINANCIAL PERFORMANCE IN 2018

Our underwriting results remained elevated in 2018. Our combined ratio improved despite experiencing one of our worst weather years, with a combined ratio of 111.8% and a net loss of $73 million. Our strategic investments impacted the combined ratio by 6.1 percentage points. These investments are disproportionate in comparison to our industry, as we build market-leading capabilities that will be instrumental in maintaining profitability in the future. When turning around an insurance operation, there are no quick fixes. The aggressive actions we continue to pursue through operational efficiencies, rate increases, underwriting improvements, and exiting unprofitable lines of business, will take time to be realized.

Where we see significant potential in our operations is through growth in our business, with a 7.4% increase in gross written premiums over the prior year. This increase was driven by our strategic initiatives, such as Sonnet and Vyne, and was achieved while also improving risk selection and rate increases. Our commercial portfolio, which has underperformed for an extended period of time, will continue to be repositioned throughout 2019 to improve our mix of business and long-term underwriting profitability.

In November 2018, the independent rating agency A.M. Best reaffirmed Economical's financial strength rating of A- (Excellent) for the sixth consecutive year. A.M. Best acknowledged our strong capitalization, and commitment to improving and transforming our operations through systems upgrades, brand consolidation, and the development of our digital direct brand, Sonnet.

Our capital position remains well in excess of both minimum internal capital and external regulatory requirements, with total equity of approximately $1.6 billion and a Minimum Capital Test ratio of 227%, as of December 31, 2018.

BUILDING MOMENTUM FOR SUCCESS

Economical has been concurrently pursuing a number of strategic initiatives in recent years that have laid the foundation for our future growth and improved performance. Alongside this, we have made core business improvements to support this growth and drive efficiency and effectiveness. We believe we are now positioned for success.

In 2018, Economical executed the significant task of completely overhauling and updating our policy administration system for brokers. Not only did we update this system, we created a completely new offering for our broker partners that uses advanced analytics, sophisticated underwriting, refreshed products and pricing, and streamlined processes and workflows with Vyne. We believe this ease of use for brokers through Vyne will be a significant growth engine for our business and will enable the continued improvement of our underwriting results. We saw the first signs of this in the strong top-line growth in our fourth quarter following the national rollout of Vyne. Our broker partners have strongly adopted this new offering, and the initial volume of policies through the Vyne platform has outpaced our expectations.

Our digital direct channel, Sonnet, launched in late 2016, remains the only online P&C insurance product that's available nationally in Canada. In 2018, Sonnet demonstrated its ability to drive growth with gross written premiums exceeding $127 million. We will continue to use Sonnet's insights and experience to improve its performance, and we have confidence in the actions already undertaken. Moving forward, we will focus on continuing to scale Sonnet to achieve profitability.

While we've been building and refining these industry-leading products, we haven't lost sight on the core of our business.

WE REMAIN FOCUSED ON ACHIEVING PROFITABILITY AND CONTINUING THE PACE THAT WE'VE SET TO MAKE US A SUCCESSFUL, INDEPENDENT CANADIAN INSURER IN THE LONG-TERM

In 2018, we implemented improved capabilities in product and pricing, underwriting, and claims. Through our claims business alone, these actions have achieved run-rate savings of more than $45 million. We believe this will support the growth we're expecting from Sonnet and Vyne while continuing to improve our business efficiency and overall competitiveness.

In addition, we achieved significant advancements in our demutualization process that are instrumental for our future growth.

EXECUTIVE BENCH STRENGTH

I believe in the strength of Economical's entire leadership team to simultaneously manage the multiple changes going on in our business and industry.

In 2018 we retained experienced leaders on our executive team, while also completing additions to oversee three key operational areas of our business. These leaders round out the team, and have made strategic updates to deliver results:

- Paul MacDonald (EVP, Personal Insurance) joined Economical in January 2018 and has focused on refining business operations in underwriting and pricing, in addition to advising on the integration of Vyne with 22,000 brokers across the country.
- Fabian Richenberger (EVP, Commercial Insurance) has been leading a reset of our commercial capabilities, by exiting unprofitable lines of business and shifting into new areas of targeted growth for the future.
- Roger Dunbar (SVP, Sonnet) has built the industry's leading digital marketing team, now fully in-house for significant cost savings, and continues to build Sonnet's business, focusing on scaling profitably.

This year, I was also pleased to introduce two new leaders to Economical's executive team:

- Brigid Pelino has joined as SVP and Chief Human Resources Officer at Economical, with a priority to further a high-performing culture and improve the effectiveness of our employees and leaders through performance-oriented programs and talent development capabilities.
- Hans Reidl took over the reins of our largest department as SVP, Claims, with a focus on strengthening operational efficiency and enhancing customer experience, all while contributing to loss ratio improvements.

In addition, the executive team we've retained continue to introduce business improvements and lead our teams to execute flawlessly. Officers include:

- Philip Mather (EVP, Chief Financial Officer)
- Alice Keung (SVP, Chief Transformation Officer)
- Innes Dey (SVP, Legal, Risk, and Strategy; Chief Risk Officer)
- Linda Goss (SVP, Chief Actuary)
- Tom Reikman (SVP, Chief Distribution Officer)

Across our executive team, and throughout the organization, we have attracted proven leaders who are committed to our vision and our goal of becoming a top P&C insurer in Canada.

STRONGER TOGETHER

At Economical, our values drive the commitments we've made across our business. At work and in the community, our employees focus on customers first, bring their best, and show that we are stronger together. These values make Economical a great place to work, and they're why we've been named one of Waterloo Area's Top Employers.

Economical has a long-standing commitment to giving back in the places where we live and work. Through the Economical Insurance community giving program, we support our employees by matching donations and supporting volunteer opportunities, as well as partnering with our broker partners for meaningful opportunities in their communities.

We were pleased to see an extension of this commitment come to life in our demutualization conversion plan, which includes an allocation of $100 million for the Economical Insurance Heritage Foundation to support those in need.

EXECUTING FOR SUCCESS

The initiatives Economical has undertaken in recent years strengthen our reputation. We are recognized for our business innovation and how well we take care of our customers. Our ongoing investments and commitments to modernization are creating long-term value for the company. This is why we are dedicated to building our business alongside the path to demutualization, including scaling Sonnet, fully realizing Vyne's capabilities, and continuing the improvements in our business operations.

We are successfully navigating the complexity of being a modern insurance company in Canada. We must compete on multiple levels. With the right leadership team to guide technological innovation, meet evolving customer expectations, and manage increasing claims costs, we are tackling these challenges head-on and setting the stage for a profitable future.

ROWAN SAUNDERS
President & CEO

MANAGEMENT'S DISCUSSION AND ANALYSIS

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INTRODUCTION

April 1, 2019

The following Management's Discussion and Analysis ("MD&A") is the responsibility of management and has been approved by the Board of Directors. This MD&A is intended to enable the reader to assess our financial position and results of operations as at and for the year ended December 31, 2018, compared to our year ended December 31, 2017. This MD&A should be read in conjunction with our audited consolidated financial statements and accompanying notes for the year ended December 31, 2018. Unless otherwise noted in this MD&A, all information was prepared as at April 1, 2019.

As used in this MD&A, references to "Economical", "the Company", "we", "us", and "our" refer to Economical Mutual Insurance Company, and, unless the context otherwise requires or is otherwise expressly stated, its consolidated subsidiaries.

We use both generally accepted accounting principles as defined by International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB"), which have been adopted as 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 therefore may not be comparable to similar measures presented by other companies. These measures are outlined and defined in this MD&A. See Section 12 — "Non-GAAP financial measures".

This MD&A may include product and brand names, trade names, and trademarks of Economical, our subsidiaries and other companies, each of which is the property of their respective owners.

All dollar amounts are in Canadian dollars. Certain totals, subtotals, and percentages may not reconcile due to rounding. A change column has been provided showing the variation between the current year and the prior year for certain financial analyses.

This MD&A may contain forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from these forward-looking statements as a result of various factors, including those discussed later in the document. Please read the "Cautionary note regarding forward-looking statements" included in this MD&A.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain of the statements made in this MD&A, including, but not limited to, statements in Section 5 — "Canadian P&C industry outlook", and statements regarding our current and future plans, expectations and intentions, results, levels of activity, performance, goals or achievements, or any other future events or developments may constitute forward-looking statements. When used in this MD&A, the words "may", "will", "would", "should", "could", "expects", "plans", "intends", "trends", "indications", "anticipates", "believes", "estimates", "predicts", "likely", "looking to", "potential", or negative or other variations of these words, or other similar or comparable words or phrases suggesting future events or outcomes, are typically intended to identify forward-looking statements.

Forward-looking statements are based on estimates and assumptions made by management based on management's knowledge, 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 Economical's actual results, performance or achievements, or future events or developments to differ materially from those expressed or implied by the forward-looking statements, including, without limitation, the following factors: Economical's ability to appropriately price its insurance products to produce an acceptable return; its ability to accurately assess the risks associated with the insurance policies that it writes; its ability to assess and pay claims in accordance with our insurance policies; litigation and regulatory actions; Economical's ability to obtain adequate reinsurance coverage to alleviate risk; management's ability to accurately predict future claims frequency or severity, including the frequency and severity of weather-related events; the occurrence of unpredictable catastrophic events; unfavourable capital market developments, interest rate movements, or other factors which may affect our investments; Economical's ability to successfully manage credit risk from its counterparties; foreign currency fluctuations; Economical's ability to meet payment obligations as they become due; Economical's dependence on key employees; Economical's ability to manage and protect the appropriate collection and storage of information; Economical's reliance on information technology and telecommunications systems; failure of key service providers or vendors to comply with contractual or business terms; changes in government regulations, interpretation or application, supervisory expectations or requirements, including risk-based capital guidelines; deceptive or illegal acts undertaken by an employee or a third party; Economical's ability to respond to events impacting its ability to conduct business as normal; Economical's ability to implement its strategy or operate its business as management currently expects; general economic, financial, and political conditions, particularly those in Canada; the competitive market environment; the introduction of disruptive innovation; distribution channel risk, including Economical's reliance on independent brokers to sell its products; Economical's ability to manage capital effectively; and periodic negative publicity regarding the insurance industry or Economical.

All of the forward-looking statements included in this MD&A are qualified by these cautionary statements and those made in Section 11 — "Risk management and corporate governance". These factors are not intended to represent a complete list of the factors that could impact Economical, and other factors and risks could impact our actual results, performance and achievements; however, these factors should be considered carefully, and readers should not place undue reliance on the forward-looking statements we make. We do not undertake and have no intention to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, except as required by law.

SECTION 1 — CORPORATE OVERVIEW

ABOUT ECONOMICAL

Economical is a leading property and casualty ("P&C") insurer in Canada. We are the eighth largest P&C insurer in Canada, with 4.2% market share[1], and $2.5 billion in gross written premiums ("GWP") in 2018. Our P&C insurance business is supported by our investment management activities with approximately $3.9 billion in invested assets as at December 31, 2018.

We rank among the top ten P&C insurance companies in Canada in both personal and commercial lines[2]. Our personal lines insurance operations, representing 72.4% of our GWP in 2018, include property, auto, liability and pet insurance products. Our commercial lines insurance operations, representing 27.6% of our GWP in 2018, include auto, property, liability, and specialty insurance products sold to businesses of all sizes.

As a multi-channel insurer, we distribute our insurance products both directly and indirectly through brokers and other partners. We have a network of more than 700 independent brokers, who work with individuals and businesses to assess their insurance needs. Our personal insurance products are sold primarily through brokers, but increasingly direct to customers through our digital direct channel. This includes Sonnet, which was launched in 2016, our pet insurance channel Petline, which was acquired in 2017, and portions of our group insurance offering. Our commercial insurance products are only sold through brokers. Broker and direct distribution represented 92.5% and 7.5%, respectively, of our total GWP in 2018.

Economical is currently pursuing demutualization to convert from a mutual to a public company. Through a successful demutualization process and initial public offering ("IPO"), we will have greater access to capital, enhanced financial flexibility, and the ability to pursue larger growth opportunities. As a public company we believe we will be better positioned to compete more effectively with other leaders in our industry.

CORPORATE STRATEGY

Our strategy is how we strive to achieve our vision — to be one of Canada's top P&C insurers, recognized for our business innovation and how well we take care of our customers. At the heart of our strategy is our mission — to be the insurance partner Canadians choose to protect what they value most. Our strategy is powered by two underlying imperatives: growing our business profitability and operating effectively. Across Economical, we are focused on four core strategic thrusts which serve those imperatives:

Combining sound fundamentals and exceptional experiences to exceed customer and broker expectations

Customer expectations for the brands they engage with and the products and services they buy are at an all-time high. Experiences with top-tier brands have become the yardstick by which all other interactions are measured — our industry is no exception. Customers and brokers expect exceptional experiences from insurance companies, but delivering on those expectations at the expense of sound insurance fundamentals is not sustainable.

In 2018, we refined Sonnet's customer targeting and acquisition approach using advanced analytics to reduce fraud and improve profitability. We also completed the deployment of an agile operating model that allows our direct channel team to be more responsive to customer needs and market learnings. We expect to realize the benefits from these actions in 2019 and beyond.

We also launched Vyne™ in 2018, a new policy administration and billing system for our personal lines and individually rated commercial auto broker business that will help us to accelerate how we embed analytics into our business. Vyne is powered by Guidewire and delivers an industry-leading end-to-end experience to our broker partners. Vyne leveraged the learnings from, and Guidewire capabilities of, Sonnet allowing us to improve investment return and have a scalable platform across broker and direct channels. Specifically, Vyne enables a broader range of customer-centric products, an enhanced pricing model, and an improved service and workflow experience. It also increases the speed at which Economical can bring new products and pricing changes to market. This platform is expected to further strengthen our relationships with broker partners and expand our market share in the broker distribution channel.

To improve profitability and reduce risk in the commercial portfolio, we completed a portfolio review exercise in 2018. This review drove actions to better align the commercial business to our target segments. At the same time, to drive future growth, we are focusing on developing speed and simplicity to service small commercial business, deepening our underwriting expertise for mid-market business, and expanding our capabilities for large accounts and specialty lines.

We continue to enhance our foundational underwriting and pricing capabilities, leveraging analytics and new data sources. We are embedding analytical capabilities to target desired customers, price better, reduce fraud, and deliver a personalized customer experience. Our focus on insurance fundamentals will be ongoing with progressive sophistication, seeking to strengthen our competitive advantage, and our ability to deliver predictable and stable returns.

1 As of June 30, 2018, based on direct written premiums ("DWP"), company filings and overall industry data published by MSA Research Inc. All industry ranking and market share comparisons exclude Genworth Financial Mortgage Insurance Company, Insurance Corporation of British Columbia, Lloyd's Underwriters Canada, and Saskatchewan Auto Fund from industry data. GWP is adjusted for assumed reinsurance premiums. Our DWP and GWP are substantially the same.

2 As of June 30, 2018, based on volume of DWP, from overall industry data published by MSA Research Inc.

Creating industry-leading speed and agility through productivity and efficiency

Efficient and flexible processes and systems are essential to respond to rapidly changing industry conditions, and are key to effectively managing expenses. Work processes that are simple, streamlined, and efficient have a broad positive impact across the organization — from financial to culture. Ability to adapt products and pricing quickly to changing market needs is essential to deliver sustainable profitable growth. Scalable systems and processes also impact the ability to effectively integrate future acquisitions.

In 2017, we conducted a comprehensive review of our business to identify opportunities to manage controllable costs. In 2018, we focused on executing the rapid payback cost improvements in sourcing and procurement, technology application rationalization, and claims recovery. We expect to realize the benefits of these improvements in 2019 and beyond.

Our new Vyne platform improves the efficiency and productivity in our broker channel, allowing for rapid adaptation of underwriting rules and pricing to respond to market conditions. The platform integrates with leading quoting vendors to allow for guaranteed quote accuracy at the point-of-sale, and with all major broker management systems to improve efficiencies in customer policy management for brokers. Through automation of administrative processes and the removal of process inefficiencies, we have made it easier for our broker partners to do business with Economical. We also have a number of technology modernization initiatives underway focused on application rationalization, improving agility and resiliency, and reducing costs of our technology infrastructure. These initiatives are expected to provide a more scalable platform to integrate future acquisitions.

To address the constant change in market dynamics, customer expectations, and evolving technology, we are continuing to emphasize enterprise innovation capabilities. In 2018, we created a structured approach to harnessing the innovation capabilities across the organization. We formed new partnerships to accelerate our innovation agenda and we expect innovation to remain a key focus in the coming years.

Empowering a culture that delivers on our brand

Culture is both intangible and pervasive. It's a key ingredient to being a high-performance organization. Building an engaging values-based culture where customer focus, operational excellence, innovation, and collaboration are championed by all, enables an organization to deliver on its brand promise.

We made significant progress in 2018 on advancing a high performance culture that delivers on the essence of our brand. Some of the key accomplishments to advance our culture included: revamped competency frameworks to reflect change in market needs and our business, revitalized broker channel organization structure to support the Vyne platform, and implementation of an agile operating structure for our direct channel.

We know there is a strong relationship between a highly engaged workforce and company performance; engaged employees produce superior quality, deliver better financial results, create better customer experiences, and drive continuous improvement and innovation. We will continue to focus on enhancing our employee value proposition — "Let's Rethink Insurance, Together" — to create an inspiring and engaging environment that enables our people to maximize their individual and collective contribution to long-term value creation.

Growing and diversifying inorganically

Size matters in our industry, driving competitors to grow in scale and reach by aggressively swallowing up smaller carriers and brokers. Executing on acquisitions requires access to capital, and superior acquisition execution and integration capabilities.

Demutualization is expected to culminate with an IPO, opening access to capital markets and allowing us to grow and diversify inorganically, among other investments. At the same time, this journey is maturing various parts of our company to operate as a public company through enhancement of capital modeling, investment management, risk management, reporting and disclosure practices, and development of new compensation programs.

One of the capabilities we are focused on is our ability to integrate acquisitions. In 2018, we built on this capability and started to realize back-office and market synergies from our most recent Petline acquisition. We expect to realize further benefits we had projected for this acquisition. In addition, the significant operational transformations we have completed over the past few years have developed and strengthened many of the core capabilities required to execute large scale initiatives with speed and discipline, and to effectively capture planned financial benefits.

We are pursuing a partnership strategy to enhance our value proposition for our customers and broker partners. In 2018, we formed a number of partnerships — some have been launched, and others are ready to be launched in 2019. We expect these partnerships to help us differentiate in the market, pursue targeted growth, and diversify our business mix.

SECTION 2 — FINANCIAL PERFORMANCE

HIGHLIGHTS FOR THE YEAR:

- Gross written premiums grew 7.4% compared to 2017
- Sonnet gross written premiums grew to over $127 million in 2018
- Combined ratio of 111.8%, reflecting strategic investments which impacted the combined ratio by 6.1 percentage points
- Successfully deployed our Vyne platform for personal lines and individually rated commercial auto
- Advancement of our demutualization process with the announcement of our second special meeting

RESULTS FROM OPERATIONS

Figure 1 shows the results from operations for the years ended December 31.

Figure 1

(in millions of dollars, except as otherwise noted)	**2018**	2017	Change
Policies in force (thousands)	**1,483.8**	1,411.5	72.3
Gross written premiums[1]	**$ 2,456.3**	$ 2,286.9	169.4
Net written premiums[1]	**$ 2,380.7**	$ 2,218.1	162.6
Net earned premiums	**$ 2,244.6**	$ 2,165.8	78.8
Net claims and adjustment expenses, undiscounted	**1,694.7**	1,659.1	35.6
Other underwriting expenses[2]	**815.5**	802.4	13.1
Underwriting loss[1]	**(265.6)**	(295.7)	30.1
Impact of discounting	**4.3**	37.2	(32.9)
Underwriting loss including the impact of discounting	**(261.3)**	(258.5)	(2.8)
Investment income	**166.1**	139.1	27.0
Other expense	**5.0**	19.5	(14.5)
Restructuring expenses	**17.3**	–	17.3
Loss before income taxes	**(117.5)**	(138.9)	21.4
Income tax recovery	**(44.5)**	(46.2)	1.7
Net loss	**$ (73.0)**	$ (92.7)	19.7
Other comprehensive (loss) income	**(90.1)**	20.0	(110.1)
Comprehensive loss	**$ (163.1)**	$ (72.7)	(90.4)
Claims ratio[1]	**75.5%**	76.6%	(1.1) pts
Expense ratio[1,2]	**36.3%**	37.1%	(0.8) pts
Combined ratio[1,2]	**111.8%**	113.7%	(1.9) pts
Return on equity[1]	**(4.5%)**	(5.4%)	0.9 pts

1 Refer to Section 12 — “Non-GAAP financial measures”. These non-GAAP measures are considered key performance indicators, and are measures that we monitor regularly.

2 Other underwriting expenses, the expense ratio, and the combined ratio are presented in the MD&A net of other underwriting revenues.

GROSS WRITTEN PREMIUMS

GWP increased by 7.4%, driven by growth in our personal lines of business. Personal lines GWP grew by 15.7%, driven primarily by rate increases and new business across both our broker and digital direct channels. Commercial lines GWP declined by 9.6%, due to our continued underwriting actions which we expect to improve long-term profitability. These actions were necessary in order to address the profitability challenges and level of volatility of results within our commercial lines book of business.

Further details by line of business are provided in Section 3 — “Results by line of business”.

NET WRITTEN PREMIUMS AND NET EARNED PREMIUMS

Net written premiums grew relatively consistent with GWP growth. GWP outpaced growth in net earned premiums due to the significant GWP growth in the second half of 2018.

NET CLAIMS AND ADJUSTMENT EXPENSES

Figure 2 summarizes the composition of the claims ratio for the years ended December 31, illustrating the impact of accident year claims incurred, catastrophe losses, and prior year claims development.

Figure 2	**2018**		2017		Change	
(in millions of dollars, except as otherwise noted)	**$**	**Ratio**	$	Ratio	$	Ratio
Core accident year claims	**$ 1,620.4**	**72.2%**	$ 1,568.5	72.4%	51.9	(0.2) pts
Catastrophe losses	**93.1**	**4.1%**	58.0	2.7%	35.1	1.4 pts
Prior year (favourable) adverse claims development	**(18.8)**	**(0.8%)**	32.6	1.5%	(51.4)	(2.3) pts
Total	**$ 1,694.7**	**75.5%**	$ 1,659.1	76.6%	35.6	(1.1) pts

The core accident year claims ratio, which excludes catastrophe losses and prior year claims development, decreased slightly in 2018. We were impacted by unseasonably cold and frequent fluctuations in temperatures during the first quarter of 2018, and increased claims severity in personal auto and commercial property & liability, which were more than offset by a decrease in claims frequency in our auto lines and in commercial property & liability compared to 2017.

Poor weather conditions and high catastrophe losses incurred throughout 2018 have resulted in one of the worst weather years we have experienced. In 2018, we were impacted by eleven catastrophe losses, including Ontario and Quebec wind and ice storms, and an Ontario and Quebec tornado. Comparatively, in 2017 we were also impacted by eleven catastrophe losses, but of much smaller severity than those in 2018.

We experienced improved claims development in both personal and commercial auto lines. The return to favourable from adverse claims development, overall, is consistent with our longer-term experience. Refer to Figure 19, which shows the level of prior year claims development over the past ten calendar years.

To address our underwriting performance challenges, a number of actions continue to be implemented across our entire book of business, including targeted rate increases, pricing segmentation, exiting unprofitable books of business, increased underwriting discipline and quality, as well as enhanced broker management. In addition, in 2018 we refined Sonnet's customer targeting and acquisition approach using advanced analytics to reduce fraud and improve profitability. New tools and process improvements are also being implemented in claims surrounding our claims recovery and claims procurement processes. These actions will take time to be reflected in our results.

In 2018, we launched Vyne, our new broker platform for personal lines and individually rated commercial auto in Alberta, New Brunswick, Nova Scotia, Ontario, Prince Edward Island, and Quebec. We are encouraged by early results and expect Vyne will improve operating efficiency, pricing, underwriting, and ease of doing business with our broker partners.

OTHER UNDERWRITING EXPENSES

Figure 3 shows the key components of our reported expense ratio for the years ended December 31.

Figure 3	**2018**		2017		Change	
(in millions of dollars, except as otherwise noted)	**$**	**Ratio**	$	Ratio	$	Ratio
Net commissions	**$ 381.0**	**17.0%**	$ 379.3	17.5%	1.7	(0.5) pts
Operating expenses (net of other underwriting revenues)	**353.8**	**15.7%**	345.4	16.0%	8.4	(0.3) pts
Premium taxes	**80.7**	**3.6%**	77.7	3.6%	3.0	–
Total	**$ 815.5**	**36.3%**	$ 802.4	37.1%	13.1	(0.8) pts

The net commissions ratio decreased due to the impact of Sonnet which pays no commissions, and whose impact on net earned premiums is increasing.

The operating expenses ratio decreased slightly due primarily to Sonnet which had lower operating expenses and higher net earned premiums. These were partially offset by increased expenses related to our continued investment in the Vyne platform.

We continue to make significant investments in Sonnet, and the development and implementation of the Vyne platform. We expect that the costs of these strategic investments will continue to negatively impact our underwriting results during the ongoing implementation and start-up phases, but the impact should continue to decrease in 2019. In the longer term, these investments are expected to improve our ability to deliver products and services to the market in a timely, competitive, and efficient manner. To improve long-term profitability, we are also implementing expense management and organizational changes to support our overall strategy and enable executional efficiency.

In the first quarter of 2018, we announced a restructuring program to improve the effectiveness and efficiency of our operations, the costs of which are included in "Restructuring expenses" on the consolidated statement of comprehensive loss. We are updating our operational structure to optimize efficiency and simplicity for our broker partners and customers. The changes to the operational structure include the consolidation of our brands, headcount reductions of approximately 10% of our workforce, and substantial third-party cost reductions, aimed to improve future operating results.

UNDERWRITING RESULTS

Figure 4 summarizes the composition of the undiscounted and discounted combined ratio for the years ended December 31.

Figure 4	2018		2017		Change	
(in millions of dollars, except as otherwise noted)	$	Ratio	$	Ratio	$	Ratio
Net claims and adjustment expenses	**$ 1,694.7**	**75.5%**	$ 1,659.1	76.6%	35.6	(1.1) pts
Other underwriting expenses	**815.5**	**36.3%**	802.4	37.1%	13.1	(0.8) pts
Combined ratio, undiscounted	**2,510.2**	**111.8%**	2,461.5	113.7%	48.7	(1.9) pts
Impact of discounting	**(4.3)**	**(0.2%)**	(37.2)	(1.7%)	32.9	1.5 pts
Combined ratio, discounted	**$ 2,505.9**	**111.6%**	$ 2,424.3	112.0%	81.6	(0.4) pts

As outlined in Figures 2 and 3, our underwriting results improved despite elevated catastrophe losses. Catastrophe losses impacted the combined ratio by 4.1 percentage points in 2018 as compared to 2.7 percentage points in 2017. Excluding the impact of catastrophe losses, there was an underlying improvement of 3.3 percentage points in the combined ratio. Our results in 2018 benefited from our underwriting actions and rate increases, as well as a return to favourable claims development. Our continued investments in Sonnet and the development of the Vyne platform impacted our combined ratio by 6.1 percentage points, compared to 7.4 percentage points in 2017. We expect the impact of our strategic investments to continue to decrease in 2019. Refer to Section 3 — “Results by line of business” for additional details.

The discounting recovery decreased over the prior year as the increase in yields of investments supporting the claim liabilities in 2018 was lower than in 2017. This impact was partially offset by a decrease in recognized losses associated with the Fair Value Through Profit or Loss (“FVTPL”) investment portfolio. Refer to Figure 5, which shows the composition of investment income.

INVESTMENT INCOME

Figure 5 shows the composition of investment income recorded in the consolidated statement of comprehensive loss for the years ended December 31.

Figure 5			
(in millions of dollars, except as otherwise noted)	**2018**	2017	Change
Interest income	**$ 71.8**	$ 59.4	12.4
Dividend income	**35.4**	38.5	(3.1)
Total interest and dividend income	**107.2**	97.9	9.3
Realized gains on Available for Sale (“AFS”) portfolio	**74.6**	79.6	(5.0)
Realized losses on FVTPL bonds	**(22.4)**	(8.1)	(14.3)
Unrealized gains (losses) on FVTPL bonds	**22.4**	(18.9)	41.3
Net impairment losses on AFS portfolio	**(15.7)**	(11.4)	(4.3)
Total recognized gains on investments	**58.9**	41.2	17.7
Total investment income	**$ 166.1**	$ 139.1	27.0

Total interest income increased due to the book yield of our bond portfolio benefiting from the rising interest rate environment. Dividend income declined due to lower holdings of dividend-paying common stocks.

A subset of the bond portfolio is designated as FVTPL. Changes in the fair value of FVTPL instruments are included in recognized gains on investments in the consolidated statement of comprehensive loss. The designation of the FVTPL bond portfolio aims to reduce the accounting mismatch in net loss that would otherwise be generated by the fluctuations in fair values of underlying claim liabilities due to changes in interest rates. We manage the FVTPL portfolio’s quantum and duration so that the impact of changes in interest rates on claim liabilities and the FVTPL portfolio reasonably offset each other. As at December 31, 2018, the quantum of investments in the FVTPL portfolio represented 71.2% (2017: 70.5%) of the underlying claim liabilities that these investments support, and the average duration of our FVTPL portfolio was 4.11 years (2017: 4.41 years). The balance of the bond portfolio, along with the short-term investments and equity portfolios, is designated as AFS. Changes in the fair value of AFS instruments are included in other comprehensive (loss) income (“OCI”) unless the instrument is disposed of or considered to be impaired, in which case they are included in net loss.

Realized gains on the AFS portfolio decreased due to lower gains on domestic common stocks, and an increase in yields in 2018 which resulted in losses on AFS bonds. These were partially offset by higher gains on foreign stocks. The net realized and unrealized losses on the FVTPL bond portfolio decreased as 2017 saw a significant increase in yields, which resulted in unrealized losses in the prior year. The investment impairment losses in 2018 increased slightly from 2017, mostly driven by the fourth quarter declines in the capital markets. The impairment losses pertained primarily to our common equity holdings in materials and energy.

Refer to Section 6 — “Financial position” for additional details of our investment portfolio mix.

OTHER EXPENSE

Other expense in 2018 includes investment expenses, costs incurred to prepare for our potential demutualization, and the results from our investments in associates. Other expenses decreased $14.5 million over the prior year attributable primarily to the gain on sale of a brokerage in January, and decreased demutualization costs. Demutualization costs in 2018 totalled $9.7 million as compared to $13.4 million in 2017.

RESTRUCTURING EXPENSES

Included in restructuring expenses, which totalled $17.3 million, are employee severance and outplacement services, and legacy system-related restructuring costs that reflect decisions and plans communicated as of December 31, 2018. Headcount reductions have taken place in 2018 with further reductions expected in 2019, which have been reflected in restructuring expenses. Legacy system-related restructuring costs include the write-down of our legacy policy administration system for personal lines and the costs associated with decommissioning this system. We believe that the amounts provided for the restructuring expenses are reasonable, however actual results could differ from these estimates. We do not anticipate any significant additional restructuring related expenses will be incurred in 2019.

INCOME TAX RECOVERY

The effective tax rate for 2018 was a recovery of 37.9% compared to a recovery of 33.3% in 2017. The effective tax rate is more favourable than the statutory rate of 26.9% (2017: 26.7%) due primarily to the beneficial impact of non-taxable Canadian dividend income.

NET LOSS

Net loss decreased by $19.7 million, due primarily to lower underwriting losses and higher investment income, partially offset by restructuring charges.

OTHER COMPREHENSIVE (LOSS) INCOME

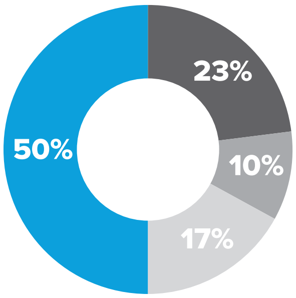
Other comprehensive (loss) income shifted from income in 2017 to a loss in 2018. Significant volatility in capital markets, particularly in the month of December, resulted in unrealized losses in our AFS portfolio. Refer to Figure 17, which outlines the unrealized (losses) gains on AFS securities by type of security. This was partially offset by a gain arising from a decrease in our post-employment benefit obligation. The reduction in the obligation is driven by the results of an actuarial valuation as of January 1, 2018, which reduced assumptions for per capita claims costs and aging. There was a further reduction in the obligation due to an increase in the year-end discount rate.

SECTION 3 — RESULTS BY LINE OF BUSINESS

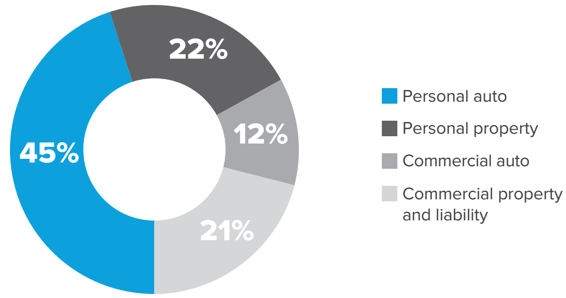
We provide a wide range of P&C insurance products throughout Canada in two broad lines of business: personal insurance and commercial insurance. Each line is further subdivided between auto and property, or in the case of commercial, property and liability lines of business. Included in personal property are pet insurance products.

The following charts illustrate our GWP mix on this basis for the fiscal years 2018 and 2017:

2018 GWP BY LINE OF BUSINESS

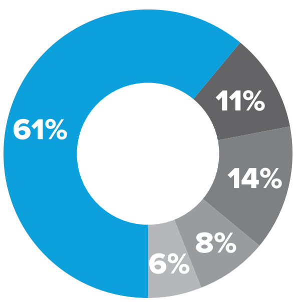


2017 GWP BY LINE OF BUSINESS

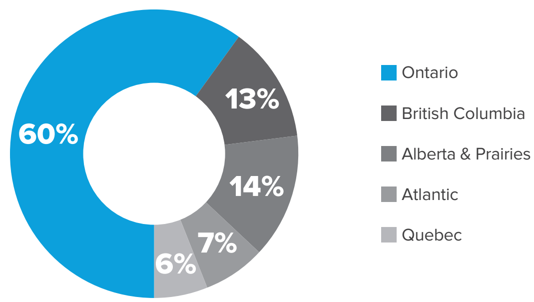


Our business mix shifted from commercial lines to personal lines due to the combined impact of strong growth in personal lines and our corrective actions in commercial.

2018 GWP BY REGION



2017 GWP BY REGION



There was a slight shift in the regional mix away from the British Columbia region, which was impacted by corrective actions particularly in personal auto and commercial property and liability.

UNDERWRITING — PERSONAL LINES

Figure 6 presents selected results of operations of the personal lines of business for the years ended December 31.

Figure 6 (in millions of dollars, except as otherwise noted)	**2018**	2017	Change
Policies in force (thousands)			
Auto	**751.8**	693.8	58.0
Property	**582.2**	547.6	34.6
Total	**1,334.0**	1,241.4	92.6
Gross written premiums			
Auto	**$ 1,224.4**	$ 1,041.2	183.2
Property	**554.1**	495.7	58.4
Total	**$ 1,778.5**	$ 1,536.9	241.6
Net earned premiums			
Auto	**$ 1,099.2**	$ 980.6	118.6
Property	**494.6**	449.6	45.0
Total	**$ 1,593.8**	$ 1,430.2	163.6
Underwriting (loss) income (undiscounted)			
Auto	**$ (155.2)**	$ (211.6)	56.4
Property	**(18.1)**	2.7	(20.8)
Total	**$ (173.3)**	$ (208.9)	35.6

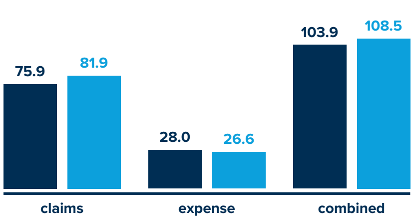
The underwriting activity of Sonnet and the expenses pertaining to our investment in the development and implementation of the Vyne platform are included in the personal insurance line of business performance. The collective impact of these strategic investments on our combined ratios are noted in Figure 7 below to show the combined ratios with and without these investments.

Figure 7	**2018 Combined ratio**	**2018 Impact of strategic investments**	**2018 Adjusted combined ratio[1]**	2017 Combined ratio	2017 Impact of strategic investments	2017 Adjusted combined ratio[1]
Auto	**114.1%**	**10.2 pts**	**103.9%**	121.5%	13.0 pts	108.5%
Property	**103.7%**	**5.1 pts**	**98.6%**	99.4%	6.7 pts	92.7%
Total	**110.9%**	**8.7 pts**	**102.2%**	114.6%	11.1 pts	103.5%

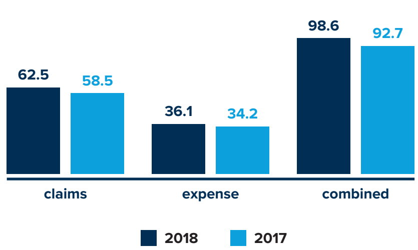
[1] This item is a non-GAAP measure which is defined below.

The impact of strategic investments on our personal lines combined ratio has decreased in 2018 as compared to 2017 due to Sonnet's significant growth in premiums, as it continues to scale. This was partially offset by increased Vyne development and implementation costs due to the deployment of the platform in 2018.

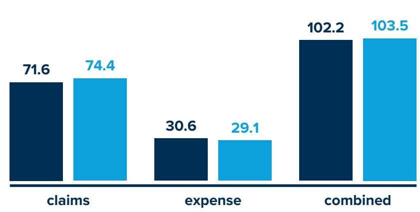
PERSONAL AUTO RATIOS[1]



PERSONAL PROPERTY RATIOS[1]



TOTAL PERSONAL LINES RATIOS[1]



[1] These adjusted ratios exclude the impact of our strategic investments

Figure 8 summarizes the composition of the adjusted claims ratio for the years ended December 31 for our personal lines of business.

Figure 8	Auto			Property		
	2018[1]	2017[1]	Change	**2018[1]**	2017[1]	Change
Core accident year claims	**78.6%**	81.6%	(3.0) pts	**52.9%**	53.3%	(0.4) pts
Catastrophe losses	**1.2%**	0.2%	1.0 pts	**10.9%**	6.9%	4.0 pts
Prior year (favourable) adverse claims development	**(3.9%)**	0.1%	(4.0) pts	**(1.3%)**	(1.7%)	0.4 pts
Total	**75.9%**	81.9%	(6.0) pts	**62.5%**	58.5%	4.0 pts

[1] These adjusted ratios exclude the impact of our strategic investments

Personal auto GWP grew significantly in 2018, due primarily to new business growth from Sonnet, increased auto policy volumes in most regions within our broker channel, and rate increases in personal auto across the country in both channels. These were partially offset by a decline in GWP in British Columbia, due to reduced volumes arising from our underwriting actions in this region focused on restoring profitability. The adjusted personal auto combined ratio improved due primarily to rate increases, underwriting actions, decreases in claims frequency, and a return to favourable claims development in 2018. Although progress has been made, and our actions in 2018 are still earning through, our loss ratios in personal auto remain elevated. Further rate increases and underwriting actions are planned for 2019.

Personal property GWP also grew in 2018, due primarily to rate increases and increased personal property policy volumes across most regions in Canada within our broker channel, and the digital direct contribution from Sonnet. The adjusted personal property combined ratio in 2018 was heavily impacted by elevated catastrophe losses, which contributed 10.9 percentage points to the combined ratio in 2018 compared to 6.9 percentage points in 2017. Excluding for this impact, the underlying core accident year claims ratio improved slightly.

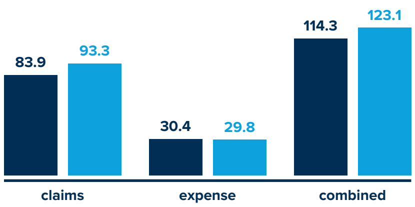
During the second quarter of 2018, we began the deployment of our Vyne platform for personal lines in New Brunswick and Prince Edward Island. In the third quarter of 2018, we launched Vyne in Ontario and Nova Scotia, and subsequently launched Vyne in Alberta and Quebec in October. This is a significant milestone achievement for our personal lines business, which we expect will improve operating efficiency, pricing, underwriting, and ease of doing business with our broker partners. Near-term results are encouraging, with significant growth generated since the platform implementation.

UNDERWRITING — COMMERCIAL LINES

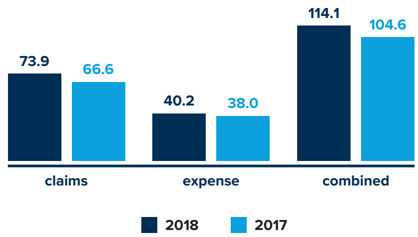
Figure 9 presents selected results of operations of the commercial lines of business for the years ended December 31.

Figure 9 (in millions of dollars, except as otherwise noted)	**2018**	2017	Change
Policies in force (thousands)			
Auto	**50.1**	52.0	(1.9)
Property and liability	**99.7**	118.1	(18.4)
Total	**149.8**	170.1	(20.3)
Gross written premiums			
Auto	**$ 251.9**	$ 281.2	(29.3)
Property and liability	**425.9**	468.8	(42.9)
Total	**$ 677.8**	$ 750.0	(72.2)
Net earned premiums			
Auto	**$ 254.2**	$ 287.0	(32.8)
Property and liability	**396.6**	448.6	(52.0)
Total	**$ 650.8**	$ 735.6	(84.8)
Underwriting loss (undiscounted)			
Auto	**$ (36.4)**	$ (66.5)	30.1
Property and liability	**(55.9)**	(20.3)	(35.6)
Total	**$ (92.3)**	$ (86.8)	(5.5)

COMMERCIAL AUTO RATIOS



COMMERCIAL PROPERTY AND LIABILITY RATIOS



TOTAL COMMERCIAL LINES RATIOS

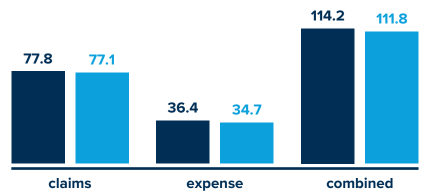


Figure 10 summarizes the composition of the claims ratio for the years ended December 31 for our commercial lines of business.

Figure 10	**Auto**			**Property and liability**		
	2018	2017	Change	**2018**	2017	Change
Core accident year claims	**77.6%**	82.6%	(5.0) pts	**63.0%**	59.4%	3.6 pts
Catastrophe losses	**0.1%**	0.1%	–	**6.4%**	5.4%	1.0 pts
Prior year adverse claims development	**6.2%**	10.6%	(4.4) pts	**4.5%**	1.8%	2.7 pts
Total	**83.9%**	93.3%	(9.4) pts	**73.9%**	66.6%	7.3 pts

Commercial auto GWP decreased compared to 2017, driven primarily by targeted underwriting actions in our fleet and managing general agent business. The commercial auto combined ratio improved due to a decrease in claims frequency, and a reduction in adverse claims development, mostly in Ontario, for fleet exposure.

Commercial property and liability GWP decreased in 2018, driven primarily by targeted underwriting actions in this line of business, which are necessary in order to remediate the performance of this book of business. The commercial property and liability combined ratio was impacted mainly by increased claims severity, adverse claims development, and catastrophe losses. Catastrophe losses contributed 6.4 percentage points to the combined ratio in 2018 compared to 5.4 percentage points in 2017. The increase in claims severity was due in part to an increase in property losses driven by the poor winter weather conditions experienced in the first quarter of 2018.

To address the profitability challenges in the commercial lines of business, a number of actions have already been implemented and continue to work through our book of business, with additional actions planned in 2019. These actions include targeted rate increases, exiting unprofitable books of business, increased underwriting discipline and quality, as well as enhanced broker management. We will continue to implement targeted pricing and underwriting actions to improve our profitability, especially in underperforming commercial property and liability segments. We are focused on strengthening underwriting rigour, risk assessment and selection, market segmentation, pricing, and expense management to deliver improved operating performance in commercial insurance. We expect these actions to negatively impact volume in the near-term, but substantially improve our mix of business and long-term underwriting profitability.

SECTION 4 — BUSINESS DEVELOPMENTS AND OPERATING ENVIRONMENT

DEMUTUALIZATION

Demutualization is the process whereby a mutual company converts into a share company. On November 3, 2015, our Board of Directors announced its decision to proceed with demutualization within the federal demutualization regulatory framework. At the first special meeting on demutualization held on December 14, 2015, our eligible mutual policyholders passed a special resolution to authorize the start of negotiations of the allocation of demutualization benefits with eligible non-mutual policyholders. Following the completion of those negotiations, a second special meeting was held on March 20, 2019 where eligible mutual policyholders passed a special resolution that amended company by-laws in a targeted manner to permit eligible non-mutual policyholders to participate in a third, and final, special meeting on demutualization.

Assuming a successful outcome at that third special meeting, we will be in a position to apply to the federal Minister of Finance for approval to demutualize. Economical will continually evaluate market conditions, company performance, and other relevant factors that may impact the timing and success of an IPO and, by extension, the demutualization process.

PERSONAL AUTO ENVIRONMENT

Ontario

Despite legislative changes implemented in June 2016, we continue to see cost escalation in the Ontario personal auto market. Recent proposals have suggested eliminating perceived inappropriate discriminatory territory rating. These proposals do not address any underlying issues driving the cost of automobile insurance. In January and February of 2019, the government conducted a public consultation on auto insurance, which is a positive development in the process towards implementing product reforms. In the meantime, insurers continue to implement rate increases to partially mitigate escalating fraud and claim costs in the system.

The Ontario personal auto market is very dynamic from many perspectives — political, regulatory, and consumer. We continue to actively participate in industry and government consultation on potential reforms and to implement rate increases and other corrective actions to the extent permitted by the provincial regulator.

Alberta

Insurers operating in Alberta continue to experience increases in claim costs relating to automobile bodily injury claims. Persons injured in motor vehicle accidents in Alberta by a third party can only sue for damages for injuries that are considered non-minor. Recent court decisions have limited the scope of the Minor Injury definition, thereby increasing the number of claims reported under the bodily injury liability coverage and thereby increasing the claim costs for this coverage, and the occurrence of pain and suffering awards. In addition, as claims take longer to settle in the courts, there are higher awards for prejudgment interest. Product reform is needed to bring long-term stability to both consumers and the insurance industry. To date, the government has announced no measures to address increasing claim costs and has extended the cap on rate increases, putting increased pressure on profitability and availability concerns in this line of business. We have taken rate increases to the maximum permissible level and a number of other underwriting and broker-related actions, and we are monitoring market conditions closely to address profitability issues.

British Columbia

For the past several years, we have seen deterioration in the British Columbia personal automobile environment. Insurers operating in this province face strong competition from the Insurance Corporation of British Columbia ("ICBC"), which is a government-controlled entity. Private insurers are only permitted to offer optional automobile coverages, most notable of which is third-party liability coverage, which provides coverage in excess of the basic $200,000 coverage provided by ICBC.

British Columbia is a full tort legal environment and claim costs in the province have been escalating due to a larger frequency of liability claims and increasing court awards. The trends in loss costs are significant for ICBC, who cover all liability claims from the first dollar, but for insurers who cover losses in excess of the $200,000 minimum, the loss trends are even greater as they pay the full increase of costs over the minimum limit on the policies that they write.

The British Columbia government passed legislation to implement a $5,500 cap on damage awards for minor injuries that result from auto accidents effective April 1, 2019. While these reforms are expected to curtail increasing costs for basic insurance coverage in the future, they do not benefit or reduce the impact on optional, excess liability coverages.

We continue to implement rate and other corrective actions to address the deterioration on this product while monitoring and assessing the political pressures on this issue in the province.

CHANGING CUSTOMER NEEDS AND BEHAVIOURS

Demographic shifts are significantly impacting our industry, from the need for better pricing sophistication, to expanding the range of customer service options, to potentially disruptive business models. The large population of aging and retiring baby boomers in North America means a higher concentration of wealth. This generation accounts for a higher percentage of auto and home purchases and significantly spend on insurance which influences expectations on services and protection of those assets. Technology-savvy millennials, on the other hand, are influenced in their purchasing decisions by a unique array of factors and have their own perspectives on asset ownership, privacy, and loyalty.

Short-term home/property sharing is giving rise to the need for on-demand and time-bound insurance products. 2018 saw an acceleration in the launch of new products to meet this demand. We are closely monitoring the activity in this space and taking into account the developments into our product development roadmaps.

Distracted driving — due primarily to smartphone usage by drivers — is contributing significantly to auto accidents, and in turn, insurance claims. Canada legalized recreational cannabis use in October 2018, which not only opened up new opportunities for insurance products, but also amplified the impact of impaired driving on road safety, our health care system, and the insurance industry. The post-legalization period in 2018 was too short to fully assess the resulting scale and impact of cannabis-related impaired driving. We have been educating our customers on the risks of distracted and impaired driving and will continue to do so.

In addition to distracted driving, fraud continues to impact the industry, becoming more complex and sophisticated. We are applying analytics to help prevent fraud before it occurs and to detect fraudulent claims. As an example, Sonnet is applying advanced analytics coupled with third-party data sources to look at a broad range of symptoms of fraud. We are starting to see the benefits of these efforts across our business and expect to realize further benefits in 2019.

The always-connected consumer is changing how our industry serves customers. Customers are increasingly demanding simplicity, personalization, transparency, and speed in their transactions with businesses. They want to research, shop, and transact seamlessly. They engage across multiple devices and channels — picking up and dropping off — expecting a consistent experience from their smartphone to a website to a contact centre. Another aspect of the always-connected consumer is the increasing influence of social media. We are using social media not only for our business but also helping our broker partners to effectively use this channel to reach consumers.

Despite being always-connected, the desire to have personal interactions and live conversations remains strong. We have strengthened our assets to support these customer preferences by making investments in our customer support teams and improving customer self-service capabilities.

We continue to invest in robust data and analytics capabilities to analyze risk and detect customer trends earlier, enabling us to quickly address changing consumer behaviours.

TECHNOLOGICAL INNOVATION AND INDUSTRY DIGITIZATION

New technologies introduce new ways to deliver services and products that can compete with, or complement, an existing service or product. In some instances they give rise to fundamentally different operating models that are being supported by significant venture capital investments. Insurtech companies have become more prevalent in Canada and in the United States with primarily niche products. Most of these companies are focused on customer-facing aspects and require partnerships with existing players to complete their products and services. In 2018, we invested in a strategic venture capital fund focused exclusively on global insurtech opportunities which works actively with its investors to align the fund's early and growth stage investments with the investors' innovation priorities and long-term strategies. This investment relationship represents a strategic opportunity to broaden Economical's exposure to rapidly changing global insurtech trends.

Digital solutions also expanded in 2018, moving into more complex areas such as claims. Many new solutions are aiming to digitize the claims experience and match it to the seamless customer acquisition experience. Over time, we expect this to deepen further into the foundational elements of insurance such as underwriting.

Insurers continue to invest heavily in modernization of legacy technologies. The launch of cloud-based platforms for digital products has provided an alternative to insurers to launch new products much more cheaply and faster than ever before. Mobile applications are maturing and are able to support a multitude of customer-facing functions in conjunction with traditional channels. Our digital direct channel provides us the platform to integrate new approaches and deliver a transparent, simple and understandable insurance experience. By using a broad range of real-time third-party data sources, personalized, detailed quotes can be provided to customers after answering only a few questions. Sonnet is currently the only solution in Canada that allows customers coast-to-coast to fully complete home and auto insurance purchases directly online in just five minutes.

Carriers also increased their focus and investments into corporate innovation. Innovation investments are taking one of many forms — functional staffing, partnerships, or corporate venture funds. These investments are also extending insurer capabilities into related industries such as home protection and finance. Our approach to innovation seeks to integrate customer-centric insights, predictive analytics, and leading technologies to shape the experiences we offer, reduce cost, and drive operational efficiency. We enhanced our focus on enterprise innovation capabilities in 2018 and plan to progressively build on it.

In addition to the digitization of the insurance industry, there are numerous sources of potential disruptions from outside our industry that could significantly change the size, dynamics, and profitability of addressable markets, forcing insurers and intermediaries to make changes to their business models. For example, technological innovation in the automotive industry is introducing a broadening array of automated safety features that is expected to ultimately increase safety of vehicles and roads (decrease in claims frequency and severity), increase repair and replacement costs for vehicles, and the apportionment of liability away from drivers and toward equipment manufacturers and software providers. Another example is the application of Blockchain technologies that have the long-term potential to reduce fraud and increase transaction speed, while reducing operational costs. We have a framework to develop and periodically re-evaluate perspectives on the impact of significant disruptive trends. Through our digital direct business, we've built an industry-leading personal insurance customer experience, a key battleground for industry disruption. Elsewhere in our business, we are preparing for more significant shifts by building new capabilities and diversifying our business to complement our historical strength in personal auto.

CLIMATE CHANGE

The impact of climate change is increasing the size and frequency of weather events across the country, creating a challenging environment for the entire P&C insurance industry. This was highlighted in 2016, when the P&C industry endured the largest insured loss in Canadian history, as a result of the Fort McMurray wildfire in Alberta. In 2018, we were impacted by eleven catastrophe losses, including a significant Ontario wind storm in May, an Ontario ice storm in April, and an Ontario and Quebec tornado in September. Although we were not significantly impacted by catastrophe losses in the first quarter of 2018, the extreme temperature swings in Ontario resulted in increased losses, which heavily impacted our core accident year claims ratio. Weather events are expected to continue to create increased volatility in results, particularly in our property lines of business. We address our catastrophe loss exposure by managing the geographic concentration of policy exposures, purchasing reinsurance, the use of our policy deductibles and product design, pricing in expected long-term costs, and monitoring the impact on our capital position and overall risk tolerances.

INVESTMENT ENVIRONMENT

The expansion enjoyed by the global economy came to an end in 2018. Investor concerns over trade tensions, slowing global growth, uncertainty surrounding Brexit, and further Federal Reserve policy normalization were broadly reflected in increased risk aversion and volatility throughout the year but particularly in December. Global equities posted sharp declines in the fourth quarter of 2018, entirely erasing the gains posted earlier in the year. Global commodity prices also fell in the fourth quarter, capping off a weak year for the Canadian Dollar which underperformed the major currencies.

We continue to manage the risk and volatility inherent in capital markets by focusing on long-term value creation through investing in high quality fixed income and equity securities, while maintaining an optimal asset allocation aimed at maximizing returns within acceptable risk parameters. Given the volatile and challenging investment environment, we prudently reduced our common stock holdings throughout the year.

SECTION 5 — CANADIAN P&C INDUSTRY OUTLOOK

Below is an overview of our expectations for the P&C industry over the next twelve months, together with our current strategies intended to improve our performance and industry standing. These expectations are subject to risks and uncertainties, and our actual results could differ materially as a result of various factors, including those discussed earlier in the document. Please read the "Cautionary note regarding forward-looking statements" included in this MD&A.

	Canadian P&C insurance industry	Our response
Personal lines – underwriting profitability	• Over the past few years, the industry has been impacted by deterioration in personal auto performance across a number of provinces, particularly Ontario, Alberta, and New Brunswick which we expect will continue to pressurize performance in the near term due to the political environment and affordability concerns. Automobile physical damage coverages continue to deteriorate across the country due to rising costs of repair and increased frequency of claims attributable to distracted driving. • Despite reforms to Ontario automobile insurance implemented in 2016 designed to reduce insurance premiums, many insurers have filed or implemented rate increases subsequent to these reforms to address industry-wide rate deficiencies in this line of business. Further reforms are needed to reduce fraud and claims costs in the system. The Ontario government has committed to review rate regulation, including potential territorial rating changes. It also recently announced a public consultation seeking feedback from consumers and businesses on how to improve auto insurance affordability for drivers. • Automobile rate increases in Alberta are currently capped at 5% to address affordability concerns for consumers. As claim costs continue to escalate, product reform is needed to bring long-term stability to both consumers and the insurance industry. If no reforms are forthcoming, the market will continue to be increasingly unstable as insurers attempt to address profitability issues in this line of business. • We believe that severe weather caused by climate change will continue to affect the industry and result in higher and more volatile claim costs in both personal and commercial property lines. This will necessitate changes to property products to provide appropriate insurance coverage to consumers.	• We continue to monitor the personal auto markets and proactively adjust rates to address deficiencies to the extent permitted by the regulators. We will be an active participant as other reforms are considered by the industry and governments in Ontario and Alberta. • We continue to invest in the Vyne platform to improve operating efficiency, pricing, underwriting, and ease of doing business with our broker partners. • We continue to focus on improving our predictive analytics, pricing sophistication, and processes. We expect that these investments will drive profitable growth through enhancements to risk selection and pricing. In particular, we will continue to focus on profitability improvements in certain underperforming auto lines. This will likely constrain our policy volumes in the near term. • We continue to proactively monitor product developments and our suite of personal lines products to respond to the changing market. We have implemented product changes and continue to employ geographic segmentation to manage our overall aggregation of exposure to weather-related events. • We continue to review the adequacy of our reinsurance programs to determine whether sufficient reinsurance protection is in place at an appropriate cost. • New tools and process improvements are being implemented in claims surrounding our claims recovery and claims procurement processes.

	Canadian P&C insurance industry	Our response
Commercial lines – underwriting profitability	• The industry has been impacted by deterioration in performance in the auto sector, particularly in the Ontario and Quebec transportation industry, which we expect will continue to challenge performance in the near term. In select segments of commercial auto, rates have started to increase throughout 2018 and we expect this market firming to continue into 2019. • The market firming present on the auto line is also impacting the property & liability line of business, particularly in Realty and Hospitality industry segments, where pricing is expected to increase in the near term. • As noted in the personal lines discussion above, weather events are expected to continue to create increased volatility in results, particularly in our property lines of business. 2018 has seen an increase in the frequency of catastrophe events across the country significantly impacting industry results across both personal lines and commercial lines. Moving into 2019, we also expect rate increases in personal auto across the marketplace, which we believe will have a corresponding impact on commercial auto pricing.	• We continue to focus on improving profitability in our commercial lines book of business through a range of underwriting actions and mix of business improvements. • The commercial lines leadership team is focused on improved underwriting, risk assessment and selection, market segmentation, pricing, and expense management. In 2018, we augmented the commercial lines leadership team by adding individuals with specialized skill sets to better align this line of business to our target segments. • We expect downward pressure on the commercial lines premiums to continue in 2019 as our performance improvement actions continue to be implemented. • Additional focus has been implemented on ensuring new business follows the same governance around improved underwriting, risk assessment, and segmentation as our renewal strategy. New business is primarily focused on target and core segments to improve our overall mix of business.
Multi-channel distribution	• Consumer demographics are shifting and their behaviours continue to evolve with the rise of the always-connected consumer. Consumer connectivity is creating increased demand for digital and direct offerings of insurance products. We expect growth in this part of the market to continue to increase.	• We expanded our distribution strategy in 2016 with the launch of Sonnet. Combined with Petline and certain group business, direct distribution now contributes 7.5% of our premium base, compared to 5.7% in 2017. Our broker business continues to be a core part of our business model. Our multi-channel distribution strategy is expected to drive profitable future growth in the medium term by optimizing our competitive position to address changing customer and market dynamics, although it will continue to be a drag on our combined ratio in the near term.
Economic conditions	• We expect heightened political and policy risks will result in continued volatility in global bond and equity markets. • We anticipate interest income will ultimately be supported by the rise in bond yields, although any further changes in yields will take time to be reflected in interest income.	• We plan to maintain an investment strategy that focuses on long-term value creation while effectively managing our financial risks. Our target asset class allocations are aimed at maximizing returns within acceptable risk parameters. • Our cash and investment portfolio continues to be largely composed of high quality, actively traded securities including Canadian fixed income investments issued or guaranteed by domestic governments, investment-grade bonds, and Canadian and foreign equities.
Industry consolidation	• Premium levels are becoming increasingly concentrated within the industry's largest companies. • Scale and diversification are becoming increasingly important for P&C insurers to achieve sustainable profitability through use of big data, enhanced price segmentation, and operational efficiencies. • Consolidation of the broker network is accelerating as brokers execute succession plans but also expand access to capital and formalize partnerships that improve future acquisition capacity.	• Preparation for a potential demutualization and IPO continues, which is intended to enhance access to capital. • Ongoing investments in our business are expected to improve our operational efficiency and scalability. This should better position us for future large scale or bolt-on acquisitions. • Our broker investment strategy supports the growth objectives of our broker partners.

	Canadian P&C insurance industry	Our response
Overall	• We expect overall results to continue to be impacted by the scale and frequency of weather-related events, as well as challenges in regulated auto results. In a period of continued low and volatile investment returns and challenging insurance results, we expect that the industry will continue to focus on underwriting and pricing actions and active consolidation.	• We are focused on the effectiveness of our operations across the organization and implementing further meaningful actions in 2019 across our book of business, which we expect will improve underwriting performance over time as they earn through. In the first quarter of 2018, we announced a restructuring program that, once fully implemented, we expect will improve the effectiveness and efficiency of our operations. • We continue to focus on our investments in our analytic capabilities and our operating platform in order to advance our competitive position. We are also focused on expanding our distribution strategy by growing Sonnet, and continue to invest in corporate development capabilities to effectively position us for meaningful participation in industry consolidation. These strategic investments will continue to elevate our combined ratio in the near-term, although we expect the impact will lessen in 2019 as the Vyne implementation is completed and Sonnet continues to scale and mature its business model.

SECTION 6 — FINANCIAL POSITION

FINANCIAL HIGHLIGHTS FOR THE YEAR:

- Total assets increased by $88.5 million (1.6%) to $5.7 billion
- Gross claim liabilities increased by $142.9 million (5.7%) to $2.7 billion
- Total equity decreased by $163.1 million (9.4%) to approximately $1.6 billion

Figure 11 shows the significant consolidated balance sheet line items as at December 31.

Figure 11

(in millions of dollars, except as otherwise noted)	**2018**	2017	Change
Cash and cash equivalents	**$ 135.3**	$ 166.4	(31.1)
Investments	**3,940.7**	3,996.0	(55.3)
Premiums receivable	**837.0**	699.6	137.4
Reinsurance receivable and recoverable	**64.7**	59.1	5.6
Deferred policy acquisition expenses	**230.1**	221.2	8.9
Deferred income tax assets	**105.0**	33.4	71.6
Goodwill and intangible assets	**225.6**	229.2	(3.6)
Other assets	**172.0**	217.0	(45.0)
Total assets	**$ 5,710.4**	$ 5,621.9	88.5
Unearned premiums	**$ 1,268.5**	$ 1,131.4	137.1
Claim liabilities	**2,670.6**	2,527.7	142.9
Accounts payable and other liabilities	**204.0**	232.4	(28.4)
Total liabilities	**4,143.1**	3,891.5	251.6
Retained earnings	**1,588.3**	1,644.8	(56.5)
Accumulated other comprehensive (loss) income	**(21.0)**	85.6	(106.6)
Total equity	**1,567.3**	1,730.4	(163.1)
Total liabilities and equity	**$ 5,710.4**	$ 5,621.9	88.5

CASH AND INVESTMENTS

Figure 12 shows the composition of our cash and cash equivalents, and investments recorded on the consolidated balance sheet as at December 31.

Figure 12

	2018		2017	
(in millions of dollars, except as otherwise noted)	**Carrying value**	**Percent of carrying value**	Carrying value	Percent of carrying value
Cash and cash equivalents	**$ 135.3**	**3.3%**	$ 166.4	4.0%
Short-term investments	**329.7**	**8.1%**	19.6	0.5%
Bonds	**2,792.4**	**68.5%**	2,687.1	64.6%
Preferred stocks	**334.0**	**8.2%**	384.1	9.2%
Common stocks	**329.9**	**8.1%**	701.2	16.8%
Pooled funds	**53.2**	**1.3%**	107.8	2.6%
	3,974.5	**97.5%**	4,066.2	97.7%
Commercial loans	**101.5**	**2.5%**	96.2	2.3%
Total cash and investments	**$ 4,076.0**	**100%**	$ 4,162.4	100.0%

Our investment strategy seeks to generate appropriate levels of income while preserving capital. The strategy focuses on maximizing our long-term capital strength, while seeking to optimize risk-adjusted returns. We have an established investment policy and strategy that is based on our risk appetite, the prudent person approach, regulatory guidelines, and reflects the expected settlement pattern of claim liabilities.

Our proportionate share of investments in fixed income securities, including cash and cash equivalents, increased to 79.9% of the total portfolio as at December 31, 2018 compared with 69.1% as at December 31, 2017. Given the volatile and challenging investment environment, we prudently reduced our common stock holdings throughout the year.

Investments decreased due primarily to a decrease in the market value of our investments, partially offset by investment purchases in 2018. Refer to Note 2 — "Summary of significant accounting policies" of our audited consolidated financial statements which provides further details pertaining to the classification and measurement of our financial instruments.

INVESTMENTS

Investment sector mix

Figure 13 summarizes our investments by sector as at December 31.

Figure 13	2018					2017
(in millions of dollars, except as otherwise noted)	Short-term investments and bonds	Preferred stocks	Common stocks	Pooled funds	Total	Total
Government	56%	–	–	–	45%	40%
Financials	32%	71%	30%	15%	34%	29%
Energy	4%	16%	20%	8%	6%	9%
Telecommunications	1%	2%	6%	12%	2%	3%
Industrials	1%	–	11%	6%	2%	3%
Utilities	2%	9%	1%	16%	3%	4%
Consumer discretionary	–	–	7%	4%	1%	2%
Materials	–	–	11%	3%	1%	2%
Consumer staples	3%	–	3%	13%	3%	4%
Information technology	1%	–	6%	7%	1%	2%
Health care	–	–	5%	11%	1%	1%
Real estate	–	2%	–	5%	1%	1%
Total	100%	100%	100%	100%	100%	100%
Total	$ 3,122.1	$ 334.0	$ 329.9	$ 53.2	$ 3,839.2	$ 3,899.8

This figure demonstrates the secure and highly liquid nature of our overall investment portfolio with a significant concentration in the government and financials sectors.

Investment credit quality

Figure 14 and Figure 15 illustrate the strong credit quality of our fixed income securities and preferred stocks, respectively, as at December 31.

Credit rating[1] — bonds

Figure 14	2018		2017	
(in millions of dollars, except as otherwise noted)	Carrying value	Percent of carrying value	Carrying value	Percent of carrying value
AAA	$ 1,642.5	58.9%	$ 1,532.1	57.0%
AA	358.7	12.8%	175.4	6.5%
A	589.3	21.1%	724.7	27.0%
BBB	201.9	7.2%	254.9	9.5%
Total bonds	$ 2,792.4	100.0%	$ 2,687.1	100.0%

[1] Using the lowest of Standard & Poor's and Dominion Bond Rating Service ratings.

Credit rating[1] — preferred stocks

Figure 15	2018		2017	
(in millions of dollars, except as otherwise noted)	Carrying value	Percent of carrying value	Carrying value	Percent of carrying value
P1	$ 3.2	1.0%	$ 3.3	0.9%
P2	278.3	83.3%	302.1	78.6%
P3 or not rated	52.5	15.7%	78.7	20.5%
Total preferred stocks	$ 334.0	100.0%	$ 384.1	100.0%

[1] Using the lowest of Standard & Poor's and Dominion Bond Rating Service ratings.

We continuously monitor the credit ratings of investments within the portfolio and take the necessary actions to ensure that a high level of quality is maintained. As at December 31, 2018, this resulted in 92.8% (2017: 90.5%) of our bonds being rated “A-” or better and 84.3% (2017: 79.5%) of the preferred stocks being rated “P2” or better. “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.

Investment portfolio region of issuer

Figure 16 summarizes the region of issuer of our investment portfolio as at December 31.

Figure 16	2018		2017	
(in millions of dollars, except as otherwise noted)	**Carrying value**	**Percent of carrying value**	Carrying value	Percent of carrying value
Canada	**$ 3,636.5**	**94.7%**	$ 3,538.3	90.7%
United States	**142.2**	**3.7%**	226.4	5.8%
Europe	**35.1**	**0.9%**	85.5	2.2%
Other	**25.4**	**0.7%**	49.6	1.3%
Total	**$ 3,839.2**	**100.0%**	$ 3,899.8	100.0%

Our investment portfolio is concentrated mainly in Canada. Our estimated exposure to foreign exchange is outlined in Section 11 — “Risk management and corporate governance”.

Unrealized (losses) gains on AFS securities

Figure 17 outlines the unrealized (losses) gains on AFS securities by type of security as at December 31.

Figure 17 (in millions of dollars, except as otherwise noted)	**2018**	2017
Short-term investments	**$ 0.8**	$ –
Bonds	**(5.6)**	(6.5)
Preferred stocks	**(56.1)**	(8.1)
Common stocks	**27.0**	122.4
Pooled funds	**(2.6)**	5.0
Unrealized (losses) gains	**$ (36.5)**	$ 112.8

The significant volatility in capital markets, particularly in the month of December, and the reduction in common stock holdings in 2018 resulted in lower unrealized gains in our common stocks. Our preferred stock portfolio was impacted by interest rate volatility and a widening of credit spreads which resulted in an increase in unrealized losses in 2018.

PREMIUMS RECEIVABLE AND UNEARNED PREMIUMS

Premiums receivable and the unearned premiums balance increased, driven primarily by the overall growth in GWP, which includes organic growth in the broker channel, as well as continued strong growth in Sonnet. This growth was particularly evident in the second half of the year, resulting in the increase in these premium related balances outpacing annual GWP growth rates.

REINSURANCE RECEIVABLE AND RECOVERABLE

Consistent with industry practice, our reinsurance receivables and amounts recoverable from licensed Canadian reinsurers ($56.3 million as at December 31, 2018, $43.0 million as at December 31, 2017) are usually unsecured. Canadian regulatory requirements, as set out by the Office of the Superintendent of Financial Institutions Canada (“OSFI”), require these reinsurers to maintain adequate assets to meet their Canadian obligations. Claim liabilities take precedence over the reinsurers’ subordinated creditors. Amounts receivable and recoverable from unregistered reinsurers are secured by cash deposits and marketable securities.

DEFERRED INCOME TAX ASSETS

Deferred income tax assets have increased as a result of income tax loss carryforwards. In 2017, we utilized the majority of our income tax loss carrybacks, and as a result, income tax recoveries are now generally recorded in deferred income taxes rather than current income taxes. We expect to generate sufficient taxable income from ordinary operations to fully utilize the deferred income tax assets in the future.

OTHER ASSETS

Other assets decreased from December 31, 2017 due mainly to a decrease in income taxes receivable and the sale of our shareholding in a brokerage during the first quarter of 2018.

CLAIM LIABILITIES AND ADJUSTMENT EXPENSES

Figure 18 shows the change in our net unpaid claim liabilities as at December 31.

Figure 18

(in millions of dollars, except as otherwise noted)	**2018**	2017
Net unpaid claim liabilities, beginning of year	**$ 2,473.2**	$ 2,301.0
Acquisition of Petline	**–**	3.3
Current year claims incurred	**1,713.5**	1,626.5
Prior year (favourable) adverse claims development	**(18.8)**	32.6
Claims and adjustment expenses	**1,694.7**	1,659.1
Impact of discounting (including PfAD)	**(4.3)**	(37.2)
Claims paid during the year	**(1,548.4)**	(1,453.0)
Net unpaid claim liabilities, end of year	**$ 2,615.2**	$ 2,473.2

The consolidated net discounted claim liabilities as at December 31, 2018 increased by 5.7% or $142.0 million from December 31, 2017 due primarily to an increase in business volumes and case reserve strengthening in auto and property lines. The main components of the discounted claim liabilities are case reserves, undiscounted incurred but not reported ("IBNR"), undiscounted internal claims expense, and the discounting impact thereon.

Figure 19 shows the level of prior year claims development as a percentage of opening net unpaid claim liabilities and the impact on the claims ratio by fiscal year.

Figure 19

(in millions of dollars, except as otherwise noted)	**2018**	2017	2016	2015	2014	2013	2012	2011	2010	2009
Net unpaid claim liabilities, beginning of the year, undiscounted	**$ 2,410.4**	$ 2,199.7	$ 2,122.8	$ 2,163.3	$ 2,108.6	$ 2,052.1	$ 2,122.6	$ 2,220.0	$ 2,200.1	$ 2,155.0
(Favourable) adverse development on prior year claims, undiscounted	**$ (18.8)**	$ 32.6	$ (40.1)	$ (73.1)	$ (2.9)	$ (63.0)	$ (57.4)	$ (128.9)	$ (71.8)	$ (55.7)
(Favourable) adverse development on prior year closing claims, undiscounted	**(0.8%)**	1.5%	(1.9%)	(3.4%)	(0.1%)	(3.1%)	(2.7%)	(5.8%)	(3.3%)	(2.6%)
Impact on claims ratio	**(0.8%)**	1.5%	(2.1%)	(3.8%)	(0.2%)	(3.6%)	(3.4%)	(8.0%)	(4.3%)	(3.1%)

2010 – 2018 under IFRS, 2009 under Canadian GAAP.

In 2018, we have returned to more normal levels of claims development overall. In 2017, prior year claims development was negatively impacted by the challenges in the performance of our auto lines. This, combined with reserve strengthening, resulted in overall adverse prior year claims development in 2017.

ACCOUNTS PAYABLE AND OTHER LIABILITIES

Accounts payable and other liabilities decreased, due primarily to a decrease in other post-employment benefit obligations, as a result of a revaluation and an increase in the discount rate used to measure the liability, as well as lower accrued costs associated with Vyne. The balance of the change is due primarily to the timing of billing and payment of invoices.

TOTAL EQUITY

Figure 20 illustrates the change in our total equity over the prior year.

Figure 20

(in millions of dollars, except as otherwise noted)	**2018**	2017
Retained earnings	**$ 1,588.3**	$ 1,644.8
Accumulated other comprehensive (loss) income	**(21.0)**	85.6
Total equity	**$ 1,567.3**	$ 1,730.4
Change in total equity	**$ (163.1)**	

Retained earnings decreased $56.5 million since December 31, 2017, due primarily to underwriting losses, ongoing spend on our strategic initiatives, and restructuring charges recorded in 2018. These were partially offset by investment income and a gain arising from a decrease in our post-employment benefit obligation. The significant volatility in capital markets, particularly in the month of December, resulted in unrealized losses in our AFS portfolio and, combined with realized gains in our common stock portfolio, shifted our accumulated other comprehensive income into a loss position. Overall, total equity decreased 9.4% in the year.

SECTION 7 — LIQUIDITY AND CAPITAL RESOURCES

CAPITAL MANAGEMENT

As a mutual company with limited access to external sources of capital, we have adopted a capital management policy intended to maintain sufficient capital to protect us and our policyholders from adverse events. As a federally-regulated P&C insurance company, our capital position, along with those of our insurance subsidiaries, is monitored by OSFI. OSFI evaluates our financial strength primarily through the Minimum Capital Test (“MCT”), which measures available capital against required risk-weighted capital.

Available capital comprises total equity subject to adjustments prescribed by OSFI. Capital required is calculated by applying risk factors to certain assets and liabilities. As at December 31, 2018, our regulatory capital exceeded the supervisory minimum MCT requirement of 150% required by OSFI, as well as a higher and more stringent internal target established in our capital management policy.

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

Figure 21 shows our regulatory capital position as at December 31. Capital available and capital required included in the figure below are determined in accordance with rules prescribed by OSFI.

Figure 21

(in millions of dollars, except as otherwise noted)	**2018**	2017
Capital available	**$ 1,146.4**	$ 1,406.5
Capital required	**$ 504.9**	$ 581.1
MCT%	**227.0%**	242.1%
Excess capital at 175%	**$ 262.8**	$ 389.7
Excess capital at 200%	**$ 136.5**	$ 244.4

The MCT ratio continues to be well in excess of both minimum internal capital and external regulatory requirements. The MCT ratio declined from December 31, 2017 due mainly to a decrease in capital available, which was partially offset by a decrease in capital required. Capital available decreased due to underwriting losses, the ongoing deployment of capital for our strategic investments, the impact of investment portfolio losses particularly in December, and the impact of the inadmissibility of a portion of our deferred tax assets. Capital required decreased due primarily to our proactive de-risking of our investment portfolio, which was somewhat offset by increased required capital due to growth in premiums and claim liabilities.

We continue to be adequately capitalized from a solvency standpoint. We regularly monitor our MCT ratio, our Own Risk Solvency Assessment ratio, the results of our annual dynamic capital adequacy stress testing, and periodic stress testing, to seek to ensure that an adequate regulatory capital position is maintained and take corrective actions as deemed necessary. Reinsurance is also used to protect our capital from large losses, including those of a catastrophic nature, which could have a detrimental impact on capital. We have formal policies that specify tolerance for financial risk retention. Once the retention limits are reached, reinsurance is utilized to cover the excess risk.

We also have intercompany reinsurance agreements (the “Agreements”) in place, which results in each insurance company subsidiary, excluding Petline Insurance Company, reporting the same combined ratio. The Agreements are supported by documented agreements between each of the companies, and the cash flows resulting from the arrangement are settled on a monthly basis. The Agreements allow the impact of any insurance losses to be spread across each insurance company subsidiary, enabling each subsidiary to maintain its capital position without the need to move capital via dividends or capital injections. Further supporting the Agreements, the insurance companies, excluding Petline, have pooled all of their invested assets into a partnership, The Economical Insurance Group Investment Partnership. The vast majority of invested assets of the companies are held in the partnership with each company owning an interest in the partnership generally approximating to its participation in the Agreements.

Own Risk and Solvency Assessment (“ORSA”)

The ORSA is a framework for federally-regulated insurers to internally assess their risks and determine the level of capital required to support future solvency. The ORSA documents how risk assessment and capital management are integrated into our decision-making process and are monitored to maintain financial viability.

We integrate the ORSA with our enterprise risk management framework, management reporting, and decision-making processes. Our Board of Directors, Risk Review Committee, and Management Risk Committee provide oversight and review of the ORSA, critically assessing assumptions and results to confirm we consider them to be reasonable in the circumstances.

We develop the ORSA by reviewing our key risks and identifying key risk indicators, then performing a range of quantitative risk sensitivity, stress testing, and other analyses, to relate our key risks to capital requirements. This process includes thoroughly assessing the methodology for relating risks to capital reflected in OSFI's MCT guidelines, and determining the appropriateness to our risk profile. As that regulatory methodology has been developed with consideration to the entire industry, some capital factors are more suitable than others in addressing our risks. Depending on the risk, the regulatory approach may need to be modified to our circumstances, or we may determine that a different methodology is appropriate. We may also determine that the regulatory method is adequate and adopt it without modification. The output of this effort is the relation of risks to ORSA capital requirements using both quantitative and qualitative methods in a deterministic capital model. Stress testing is then utilized to assess the resiliency of our capital under a range of adverse conditions, including extreme scenarios. The ORSA is integrated into the budgeting and planning process to determine our ability to meet internal and regulatory capital targets in the future, and to identify contingency plans and procedures should capital levels threaten to fall below pre-determined warning levels, as specified in our capital management policy. Our current ORSA capital level is higher than our minimum internal requirement established in our capital management policy.

FINANCIAL STRENGTH RATING

On November 14, 2018, A.M. Best reaffirmed our A- (Excellent) financial strength rating and "a-" issuer credit rating. The ratings of A- (Excellent) and "a-" respectively provide further reinforcement of our financial strength assessment. The outlook for these ratings is stable.

LIQUIDITY

The liquidity requirements of our business are met primarily by funds generated by insurance operations and investment returns. Cash provided from these sources normally exceeds cash requirements to meet claim payments and operating expenses. We have no outstanding debt.

As at December 31, 2018, we have $135.3 million (2017: $166.4 million) of cash and cash equivalents and short-term investments of $329.7 million (2017: $19.6 million). We also have a highly liquid investment portfolio comprising of actively traded securities including: Canadian fixed income investments issued or guaranteed by domestic governments, investment-grade corporate bonds, publicly-traded Canadian and foreign equities, and a foreign equity pooled fund. We believe our internal resources will provide sufficient funds to fulfil cash requirements during the next twelve months. Adherence to the liquidity policy seeks to ensure that we have sufficient cash and liquid resources to meet our financial obligations, to support our future growth initiatives, and that excess cash is appropriately invested.

Figure 22 provides a summary of cash flows for the years ended December 31.

Figure 22

(in millions of dollars, except as otherwise noted)	**2018**	2017	Change
Operating activities			
Cash provided by operating activities	**$ 44.6**	$ 71.4	(26.8)
Investing activities			
Investments purchased, net of investments sold	**(38.9)**	14.0	(52.9)
Commercial loans advanced, net of commercial loans repaid	**(5.3)**	(11.1)	5.8
Other assets purchased	**(49.5)**	(47.7)	(1.8)
Business dispositions (acquisitions)	**18.0**	(93.3)	111.3
Cash used in investing activities	**(75.7)**	(138.1)	62.4
Net decrease in cash and cash equivalents	**$ (31.1)**	$ (66.7)	35.6

We generated positive cash flows from operations in 2018 as premium growth outpaced an increase in claims paid and operating expenses. Cash flows from operations decreased from 2017 due primarily to an increase in claims paid and increased expenses to support our strategic initiatives, which were partially offset by an increase in premiums written and lower income taxes paid. Cash used in investing activities decreased as the prior year cash flow was impacted by our acquisition of Petline and the purchase of an ownership interest in a brokerage in January 2017. The disposition in 2018 pertained primarily to the sale of our shareholding in a brokerage in the first quarter of 2018. These were partially offset by an increase in investments purchased, net of investments sold.

SECTION 8 — COMMITMENTS AND CONTINGENCIES

COMMITMENTS

Our commitments include operating lease commitments and certain non-cancellable contractual commitments. Our non-owned buildings, motor vehicles, computers, and office equipment are supplied through operating leases. The future contractual aggregate minimum lease payments under non-cancellable operating leases and other commitments are outlined in Figure 23 below.

Figure 23

(in millions of dollars, except as otherwise noted)	**2018**	2017
Within 1 year	**$ 33.8**	$ 38.4
Later than 1 year but not later than 5 years	**$ 50.9**	$ 54.1
Later than 5 years	**$ 22.1**	$ 15.3

The total amount of commitments has decreased slightly from 2017, as existing commitments declined with the passage of time, offsetting new building lease contracts entered into during the year.

OFF-BALANCE SHEET LIABILITIES AND CONTINGENCIES

In addition to litigation relating to claims made in respect of insurance policies written by us, we are subject to other litigation arising in the normal course of conducting our business. We are of the opinion that this non-claims litigation will not have a significant effect on our financial position, results of operations, or cash flows. Refer to Section 11 — “Risk management and corporate governance”, Claims reserving risk, which describes our process for ensuring appropriate provisions are recorded for reported and unreported claims.

We participate in a securities lending program managed by a major Canadian and US financial institution, whereby we lend securities we own to other financial institutions to allow them to meet delivery commitments. The lending agents assume the risk of borrower default associated with the lending activity. As at December 31, 2018, securities with an estimated fair value of $591.6 million (2017: $569.4 million) have been loaned and securities with an estimated fair value of $608.5 million (2017: $585.8 million) have been received as collateral from the financial institutions. Lending collateral as at December 31, 2018 was 100.0% (2017: 100.0%) held in cash and government-backed securities. The securities loaned under this program have not been removed from “Investments” on the consolidated balance sheet because we retain the risks and rewards of ownership.

The financial compensation we receive in exchange for securities lending is reflected in the consolidated statement of comprehensive loss in “Interest”.

SECTION 9 — RELATED PARTY TRANSACTIONS

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

At the reporting date, commercial loans of $23.6 million (2017: $27.3 million) are due from companies subject to significant influence. The loans are included in “Investments” in the consolidated balance sheet and are initially measured at the exchange amount. The loans are subsequently measured in accordance with the accounting policy for loans and receivables as noted in Note 2 — “Summary of significant accounting policies”, included in our audited consolidated financial statements.

POST-EMPLOYMENT BENEFIT PLANS

We provide certain pension and other post-employment benefits through defined benefit, defined contribution, and other post-employment benefit plans to eligible participants upon retirement. Information regarding transactions with the plans is included in Note 16 — “Post-employment benefits” of our audited consolidated financial statements.

SECTION 10 — ACCOUNTING AND INTERNAL CONTROLS

INTERNAL CONTROLS AND PROCEDURES

We have designed and validated key internal controls and procedures to reasonably ensure that accurate financial information is available internally to the Board of Directors and senior management, and externally to regulators, rating agencies, 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 fraud or errors are detected. We continue to monitor, assess, and improve our system of internal controls and procedures.

CRITICAL ACCOUNTING JUDGMENTS, ESTIMATES, AND ASSUMPTIONS

The preparation of our audited consolidated financial statements in conformity with IFRS requires management to make judgments, estimates, and assumptions that affect the reported amounts of assets, liabilities, and the disclosure of contingent assets and liabilities as at the reporting date and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. Although some variability is inherent in these estimates, management believes that the amounts provided are reasonable.

The most complex and significant judgments, estimates, and assumptions used in preparing our audited consolidated financial statements are discussed below:

Judgments

In the process of applying our accounting policies, management has made the following judgments, which have the most significant effect on the amounts recognized in the audited consolidated financial statements.

We have applied judgment in our assessment of control or significant influence over investees, of the identification of objective evidence of impairment for financial instruments, the recoverability and recognition of tax losses, the determination of cash-generating units, the evaluation of current obligations requiring provisions, and the identification of the indicators of impairment for property and equipment, goodwill, and intangible assets.

Estimates and assumptions

The key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed in Note 4 — "Significant accounting judgments, estimates and assumptions" of our audited consolidated financial statements. The key estimates are as follows:

- Valuation of claim liabilities
- Impairment of goodwill and intangible assets
- Impairment of financial assets
- Control or significant influence over investees
- Valuation of post-employment benefits obligation
- Measurement of income taxes

Our significant accounting policies are discussed in Note 2 — "Summary of significant accounting policies" of our audited consolidated financial statements.

FUTURE ACCOUNTING AND REPORTING CHANGES

IFRS standards issued but not yet effective are discussed in Note 3 — "Standards issued but not yet effective" of our audited consolidated financial statements.

SECTION 11 — RISK MANAGEMENT AND CORPORATE GOVERNANCE

OVERVIEW

A strong risk management culture contributes to making sound business decisions, both strategically and operationally. Our corporate governance and enterprise risk management frameworks are designed to provide reasonable assurance that:

(i) our business is understood from a risk perspective and our actions are consistent with our governing objectives, risk management capabilities, risk-taking capacity, and risk appetite; and

(ii) we maintain an appropriate risk and reward balance to protect us from events that have the potential to materially impair our financial strength or our achievement of business objectives

Our enterprise risk management framework is rooted in the understanding that we are in the business of taking risk for an appropriate return. Balancing risk and reward is achieved through dynamic alignment between business strategy and risk appetite, diversifying risk, seeking appropriate compensation for risk, mitigating risk through preventive and detective controls, and transferring risk to third parties. Economical has an integrated approach to the identification, assessment, monitoring, reporting and mitigation of risks across the organization, including emerging risks. All identified top and emerging risks are assessed relative to their potential impact on our corporate strategy, competitive position, operational results, reputation, and financial condition.

The Board of Directors, directly or through its Risk Review Committee, oversees senior management, confirming whether senior management has put appropriate risk management policies in place and whether risk management processes are effective. Regular reports on significant risks, risk appetite exposures, and significant exceptions to risk management policies and controls are provided to senior management, the Board of Directors, and its committees.

ALIGNMENT

We seek to align our risk appetite with our overall vision, mission, and business objectives by considering whether risks are core, non-core, or collateral in nature.

Core risks are risks that we are willing to accept in order to achieve our return expectations and business objectives, and primarily consist of insurance risks and financial risks. Non-core risks are those associated with activities outside of our risk appetite and approved business strategies, and are therefore generally avoided, regardless of expected returns. Collateral risks are those we incur as a by-product of pursuing the risk and return optimization of core risks. Operational risks often fall into this category. We endeavour to mitigate collateral risks to the extent that the benefit of risk reduction aligns with or exceeds the cost of mitigation.

We also seek to align our risk appetite with our risk management capabilities. We actively seek profitable risk-taking opportunities in those areas where we have established risk management capabilities, and seek to avoid risks that are beyond those capabilities.

CORPORATE GOVERNANCE AND ACCOUNTABILITY

Our enterprise risk management framework addresses responsibility and authority for risk-taking, risk governance, and risk control.

Governance Structure

Risk management occurs at all levels of the organization and is the responsibility of every employee. Our Board of Directors is ultimately responsible for the enterprise risk management framework. Our Board of Directors approves and oversees, among other things, our risk appetite framework, our internal control framework, significant policies, plans and strategic initiatives related to the management of, or that materially impact, capital and liquidity, and our Code of Business Conduct. It also provides challenge, advice, and guidance to senior management on the ORSA, on our business performance, and the effectiveness and outcomes of risk management practices, as well as significant operational, business, risk, and crisis management policies. To assist in fulfilling these responsibilities for confirming that the key risks facing us are appropriately identified, critically assessed, and managed, the Board of Directors has delegated certain risk management functions to the following committees:

BOARD OF DIRECTORS COMMITTEES	
Risk Review Committee	The Risk Review Committee, which is composed entirely of independent directors, is responsible for the oversight of the enterprise-wide risk management framework and the regulatory compliance management program. The Risk Review Committee reviews the ORSA and the results of our regulatory compliance management program. It approves significant enterprise risk management policies and articulation of risk appetite. It also monitors our key and emerging risks.
Audit Committee	The Audit Committee, which is composed entirely of independent directors, is responsible for overseeing the integrity of our financial statements and related public disclosures; the qualifications, independence, appointment, and performance of our internal and external auditors; and the design, implementation, and evaluation of our internal controls over financial reporting and our disclosure controls.
Corporate Governance Committee	The Corporate Governance Committee, which is composed entirely of independent directors, is responsible for developing effective corporate governance guidelines and processes, reviewing policies and processes to sustain ethical behavior, assessing the effectiveness of the Board of Directors and its committees as well as the contributions of individual directors, and identifying and recommending for election as directors those individuals with appropriate competencies, skills, and experience.
Human Resources and Compensation Committee	The Human Resources and Compensation Committee, which is composed entirely of independent directors, is responsible for overseeing our human resources practices and policies. This includes reviewing our overall compensation philosophy, approving compensation to our senior executives, and reviewing retention, development, and succession plans.
Investment Committee	The Investment Committee, which is composed of a majority of independent directors, is responsible for the oversight of investment policies, practices, procedures, and controls related to the management of the investment portfolio, the performance of the investment portfolio, and monitoring the investment performance of our pension plans.

From time to time, the Board of Directors may also strike ad hoc committees to provide dedicated oversight to key strategic initiatives. We currently have two such committees: the Strategic Initiatives Committee and the Special Committee on Demutualization.

Three Line of Defence Risk Governance Model

We have implemented a three line of defence risk governance model, consisting of: front line risk-taking through business operations (first line), enterprise risk management and compliance functions (second line), and internal audit (third line). Primary accountability for enterprise risk management resides with our President and Chief Executive Officer, who further delegates responsibilities throughout the Company under a framework of management authorities and responsibilities. Key components of that framework include the following:

First line of defence

Business management provides day-to-day risk management and control:

- Employees within each functional and business area identify, take, and manage risk on a daily basis, adhering to risk appetite statements, and supporting policies and practices.
- Executives within each functional and business area establish and perform ongoing monitoring and oversight of functions and controls to review employee compliance with our risk management policies and practices. These individuals are supported by legal, compliance, actuarial, and enterprise risk management resources.

Second line of defence

Our enterprise risk management and compliance functions provide risk policies, tools, methodologies, and oversight:

- The enterprise risk management function, headed by the Chief Risk Officer, establishes a risk management framework to identify, measure, assess, report, monitor, and respond to risks inherent in our activities. The enterprise risk management framework is comprised of risk policies, processes, methodologies, models, tools, and guidance.
- The enterprise risk management function performs independent monitoring and analysis of risk-taking and risk management activities undertaken by the first line of defence.
- Through the ORSA, the enterprise risk management function internally assesses our risks and determines the level of capital believed to be required to adequately support future solvency.
- The compliance function performs independent review of the first line of defence compliance with internal and external compliance requirements through our regulatory compliance management program.
- The enterprise risk management and compliance functions' own quality assurance and validation practices are applied to ensure that policies, methodologies, practices, models, and other capabilities developed by them comply with applicable requirements and quality standards, and are suitable for use within the Company. The Chief Risk Officer's responsibilities include providing independent functional oversight of our enterprise risk management programs.
- Our Management Risk Committee is a cross-functional management committee composed of members of senior management, including our President and Chief Executive Officer. It is led by the Chief Risk Officer, and oversees the management of major enterprise risk and control activities with a view to understanding existing and emerging risks, their impact on our risk profile, and related capital requirements, as well as monitoring whether the magnitude of those risks remains within our risk appetite.

Third line of defence

Internal audit provides periodic independent assurance:

- Internal audit provides independent assurance including a risk-based evaluation of the system of internal control. Internal audit focuses on the adequacy and effectiveness of first line internal controls, as well as enterprise risk management policies, the enterprise risk management framework, and related processes and practices. Internal audit also reviews compliance with policies, standards, and required practices, taking into account the relative risk in each area of coverage. Internal audit creates an annual risk-based internal audit plan which takes into consideration the key inherent risks of our operations. The annual internal audit plan is approved by the Audit Committee.
- Internal audit has its own quality assurance and validation practices, and applies them to ensure that internal audits are carried out in compliance with established audit policies, standards, and methodologies, and that audit findings and observations are objective and appropriately supported.

MANAGEMENT OF KEY RISKS

The key risks we manage include insurance, financial, operational, and strategic risks, which are explained in greater detail below. Although we have described those risks that we believe to be material, other risks and uncertainties exist. If any of these risks or any other risks or uncertainties actually occur, it is possible that our business could be materially affected in an adverse manner. Our enterprise risk management framework cannot and is not designed to anticipate every risk in all environments, nor the timing or effect of every such risk.

Enterprise Risk Management Framework

Insurance risk

Underwriting risk

Underwriting and pricing

Underwriting risk is the risk of adverse financial exposures arising from various activities integral to the underwriting of insurance products, including product design, pricing, risk acceptance, and claims settlement. Our exposure to concentrations of insured risks is mitigated by the use of segmentation, policy issuance and risk acceptance rules, individual limits, and reinsurance.

In particular, a financial loss occurs when the liabilities assumed exceed the expectation reflected in the pricing of an insurance product. We price our products by taking into account numerous factors including product design and features, claim frequency and severity trends, product line expense ratios, special risk factors, capital requirements, regulatory requirements, and expected investment returns. These factors are reviewed and adjusted on an ongoing basis to ensure they are reflective of current trends and market conditions. We endeavour to maintain pricing levels that produce an acceptable return by appropriately measuring and incorporating these factors into our pricing decisions. Pricing segmentation and risk selection are used together with a view to attracting and retaining risks at acceptable return rates. The process of calculating pricing involves the use of models, which exposes us to model risk in the event that actual results differ from those modelled, due to model limitations, data issues, human error, or other factors.

New products and product changes are subject to a detailed review by management, including our actuarial specialists, prior to their launch in order to mitigate the risk that they are priced at an inadequate level. The performance and pricing of all of our products are regularly monitored, and corrective action is taken as considered necessary, including re-pricing of the products, modification of product terms, conditions, and eligibility requirements, the level of capacity provided, and the use of reinsurance.

To minimize the risk arising from underwriting, we have policies that set out our underwriting risk appetite and criteria, as well as specifying tolerances for maximum financial risk retention and management processes to monitor compliance with these limits. We utilize reinsurance in order to manage our exposure to insured risks. Once the retention limits are reached, reinsurance is utilized with the aim of covering the excess risk. We review the adequacy of our reinsurance programs, at least annually, with the objective of ensuring sufficient reinsurance protection is in place at an appropriate cost.

Claims settlement

To control our exposure to unpredictable future developments that could negatively impact claims settlement, we promptly respond to new claims and actively manage existing claims, thereby shortening the claims cycle. In addition, our regular detailed review of claims handling procedures, active litigation management, and proactive identification and investigation of possible fraudulent claims seeks to ensure our claims risk exposure does not exceed the claim cost expectations inherent in the pricing of our products.

Legal and regulatory implications

In the normal course of our business, we are from time to time subject to a variety of legal and regulatory actions relating to our business operations. In addition, plaintiffs continue to bring new types of legal claims against insurance and related companies. Current and future court decisions and legislative and regulatory activity may increase our exposure to these types of claims. This risk of potential liability may make reasonable resolution of claims more difficult to obtain.

Quality review procedures

Quality review procedures seek to ensure that our underwriting and claim activities fall within established guidelines and pricing structures. Head Office and field level reviews are conducted on a test basis. The results of these quality reviews are shared with the appropriate field management staff to ensure any issues identified can be promptly addressed.

Reinsurance

We use reinsurance to manage our exposure to insurance risks. Reinsurance coverage risk arises because reinsurance terms, conditions, availability, and/or pricing may change on renewal, particularly during times of high levels of catastrophe events, either in Canada or globally, or as a result of higher than expected claims activity on non-catastrophe reinsurance treaties. In addition, reinsurers may seek to impose terms that are inconsistent with corresponding terms in the policies written by us. Ceding risk to reinsurers does not relieve us of the obligation to our policyholders for claims, thereby requiring us to manage the level of credit risk associated with our reinsurers and our recoverable balances. Senior management reviews our reinsurance program with the intention of ensuring its cost effectiveness and that adequate coverage is obtained, which reflects our risk tolerances, underwriting practices, and financial strength, while at the same time complying with our reinsurance and capital risk management policies.

Claims reserving risk

Claims reserving risk represents the risk that our estimates of claim liabilities are insufficient to cover future insurance claim payments. Our underwriting profitability depends upon our ability to accurately assess the risk associated with the insurance contracts underwritten by us. We establish claim liabilities to cover the estimated liability for payment of all claims and claims adjustment expenses incurred with respect to insurance contracts underwritten by us. Claim liabilities do not represent an exact calculation of the liability. Rather, they are our best estimate of the expected ultimate future cost of resolution and administration of claims. The process of calculating claim liabilities involves the use of models, which exposes us to model risk in the event that actual results differ from those modelled, due to model limitations, data issues, human error, or other factors. To address inflation risk, expected inflation is taken into account when estimating claim liabilities.

Claim liabilities include an estimate for reported claims, as established by our claims adjusters based on the details of reported claims, plus a provision for IBNR, as established by our corporate actuaries.

Individual claims estimates are determined by claims adjusters on a case-by-case basis in accordance with documented policies and procedures. These specialists apply their experience, knowledge, and expertise, after taking into account available information regarding the circumstances of the claim to set individual case reserve estimates. Uncertainty exists on reported claims in that all information may not be available at the valuation date. Uncertainty also exists regarding the number and size of claims not yet reported, as well as the timing of when the claims will be reported. Accordingly, the IBNR provision is intended to cover future additional costs emerging on both reported claims and claims that have occurred but have not yet been reported.

The valuation of claim liabilities is based on estimates derived by geographical region and line of business using generally accepted actuarial techniques. Numerous individual assumptions that impact average claim costs or frequency of late reported claims are made for each line of business. The main assumption in the majority of actuarial techniques employed is that future claims development will follow a pattern similar to recent historical experience. However, there are times where historical experience is deemed inappropriate for evaluating future development because there isn't enough credible data, or because recent judicial decisions, changes to legislation, or major shifts in a book of business indicate a departure from historical trends. Such instances can require significant actuarial judgment, often supported by industry benchmarks, in establishing an adequate provision for claim liabilities.

Establishing an adequate level of claim liabilities is an inherently uncertain process and is closely monitored by our corporate actuarial department. Claim liabilities, including the provision for IBNR as established by our corporate actuaries, is subject to an internal and external peer review process to assess the adequacy of the provision for claim liabilities.

As the outstanding claim liabilities are intended to represent payments that will be made in the future, they are discounted to reflect the time value of money, effectively recognizing that the bonds held to support insurance liabilities will earn a return during that period. The discount rate used to discount the actuarial value of claim liabilities is based on the fair value yield of our bonds that support the claim liabilities. In assessing the risks associated with investment income and therefore the discount rate, we consider the nature of the bond portfolio and the timing of claim payments, and the extent to which they match, to expected investment cash flows. Future changes in the bond portfolio could change the value of claim liabilities by impacting the fair value yield.

The following table presents the interest rate sensitivity analysis for a 1 percentage point change in interest rates on the net claim liabilities:

(in millions of dollars)	**2018**		2017	
Impact on:	**+1**	**-1**	+1	-1
Net claim liabilities	**$ (71.8)**	**$ 72.7**	$ (69.7)	$ 74.7

Catastrophe risk

Catastrophe risk may arise if we experience a considerable number of losses due to human-made or natural catastrophes that result in significant impacts on claims costs. Catastrophes can cause losses in a variety of different lines of business and may have continuing effects which, by their nature, could impede efforts to accurately assess the full extent of the damage they cause on a timely basis. Although we evaluate catastrophe events and assess the probability of occurrence and magnitude of impact through various commonly used, industry accepted modelling techniques, and through the aggregation of limits exposed in each geographical territory in which we operate, such events are inherently unpredictable and difficult to quantify. In addition, the incidence and severity of catastrophe events may become increasingly unpredictable as climate patterns change, and severe weather caused by climate change will likely continue to affect the P&C industry and result in higher claims costs.

We manage our catastrophe events exposure through the deductibles charged to policyholders, by limitations on policies, by purchasing reinsurance, and monitoring the impact on capital position and overall risk tolerances.

Financial risk

Our investment holdings are exposed to interest rate risk (including the impact of credit spreads), equity market price risk and preferred stock price risk, credit risk, foreign exchange risk, and liquidity risk.

We have established a detailed investment policy for the investment portfolio, which is subject to regular review and approval by our Investment Committee. The policy sets out our philosophy of investment management, which is to generate sufficient income while preserving capital. The philosophy focuses on maximizing our long-term capital strength and risk-adjusted returns. The policy includes specific guidelines for 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 relevant requirements of the *Insurance Companies Act* (Canada), is routinely monitored by management and reported to the Investment Committee.

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. Changes in interest rates can occur from both changes in the Government of Canada yield curve and changes in relevant market credit spreads. Typically, interest income will be reduced during sustained periods of declining 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.

As interest rate risk is a significant risk to us due to the nature of our investments and claim liabilities, a portion of our bond portfolio has been voluntarily designated as FVTPL financial assets which, together with a portion of AFS bonds, is managed to offset the effect that interest rate changes have on our claim liabilities.

The impact of an immediate hypothetical 1 percentage point change in interest rates (assuming a parallel shift across the yield curve), on the FVTPL and AFS bond portfolios, with all other variables held constant is as follows:

(in millions of dollars)	**2018**		2017	
Impact on:	**+1**	**-1**	+1	-1
Fair value of FVTPL bonds and income before income taxes	**$ (68.8)**	**$ 77.4**	$ (69.3)	$ 78.0
Fair value of AFS bonds and OCI before income taxes	**$ (44.3)**	**$ 50.6**	$ (48.6)	$ 58.6

As discussed under “Claims reserving risk”, an immediate hypothetical 1 percentage point increase in the discount rate would reduce net claim liabilities, and decrease loss before income taxes, by $71.8 million (2017: $69.7 million). This offsets the corresponding increase in loss before income taxes on the FVTPL bond portfolio discussed above of $68.8 million (2017: $69.3 million).

Common equity market price risk and preferred stock price risk

As part of our investment portfolio, a portion of the investments are held in Canadian and foreign equities. Economic trends, the political environment, and other factors can positively or adversely impact the equity markets and, consequently, the value of equity investments we hold. Our AFS portfolio includes Canadian common stocks with fair value movements that are benchmarked against movements in the Toronto Stock Exchange 60 Index, and foreign stocks and pooled funds with fair values that are benchmarked against movements in the MSCI World Index. Also included in the AFS portfolio are our holdings of preferred stocks. Economic trends, interest rates, credit conditions, regulatory changes, and other factors can positively or adversely impact the value of preferred stocks that we hold. The fair value sensitivity of our preferred stocks is assessed against movements in the BMO 50 Resets Sub-Index.

The estimated impact of a 10% movement in the aforementioned indices to the value of our equity portfolio, with all other variables held constant, to the extent we do not dispose of any of these equities during the year, is as follows:

(in millions of dollars)	**2018**		2017	
Impact on:	**10%**	**-10%**	10%	-10%
Fair value of Canadian stocks and OCI before income taxes	**$ 28.3**	**$ (28.3)**	$ 59.6	$ (59.6)
Fair value of foreign stocks, pooled funds and OCI before income taxes	**$ 11.9**	**$ (11.9)**	$ 25.5	$ (25.5)
Fair value of preferred stocks and OCI before income taxes	**$ 28.5**	**$ (28.5)**	$ 34.3	$ (34.3)

Credit risk

Credit risk is the risk of financial loss caused by our counterparties not being able to meet payment obligations as they become due. Our credit risk is concentrated in the bond, preferred stock and commercial loan portfolios, the securities lending program, premiums receivable, amounts owing from reinsurers, and structured settlements. Unless otherwise stated, our credit exposure is limited to the carrying amount of these assets. Our principal approach to mitigate credit risk is to maintain high credit quality standards and to diversify credit exposures by limiting single name concentrations. Concentration risk also exists where multiple counterparties may be financially affected by changing economic conditions in a similar manner. We have a concentration of investments in Canada and within the financial and energy sectors. These risk concentrations are regularly monitored and adjusted as deemed necessary.

Bonds and preferred stocks

Our investment policy requires that we invest in bonds and preferred stocks of high credit quality, and limit exposure with respect to any one issuer. On a regular basis, we also monitor publicly available information referencing the investments held in the investment portfolio to determine whether there are investments which require closer monitoring of the credit risk. Refer to Section 6 — "Financial position" for further details pertaining to our investment portfolio credit ratings and investment mix.

Securities lending

We participate in a securities lending program managed by a major financial institution, whereby we lend securities we own to other financial institutions to allow them to meet delivery commitments. We manage credit risk associated with this program by only dealing with counterparties who are rated "A" or higher by independent rating agencies and by obtaining collateral with a fair value in excess of the value of the securities loaned under the program. Refer to Section 8 — "Commitments and contingencies" for further discussion.

Premiums receivable

Our credit exposure to any one individual policyholder or broker included in premiums receivable is not significant. We regularly monitor amounts due from policyholders and follow up on all overdue accounts. As permitted by regulation, when premiums are overdue for an extended period of time, we cancel the insurance coverage under the applicable policy. Before a broker is granted a contract, we conduct appropriate reviews. Delinquent accounts are regularly monitored and we take action against non-payment.

Commercial loans

We periodically issue commercial loans to brokers. Collateral, principally in the form of security over a borrowing brokerage's operating assets, is held to protect us against loss in the event of a default of any of these loans. Annually, and where required more frequent, financial reviews are undertaken to determine if the broker is expected to be able to make the payments required by the loan as and when due. Our gross credit exposure on these commercial loans is limited to their carrying value, which amounted to $101.5 million as at December 31, 2018 (2017: $96.2 million). Management does not consider any of these current commercial loans to be impaired as at December 31, 2018.

Reinsurance receivable and recoverable

Credit exposures on our reinsurance receivable and recoverable balances exist to the extent that any reinsurer may not be willing or able to reimburse us under the terms of the relevant reinsurance arrangements. We have policies which limit the exposure to individual reinsurers and we have a regular review process to assess the creditworthiness of reinsurers from whom we purchase coverage. Our reinsurance risk management policy generally precludes the use of reinsurers with credit ratings less than "A-". Currently, all reinsurers have a credit rating of "A-" or better as determined by independent rating agencies. Where appropriate, we obtain collateral for outstanding balances in the form of cash, letters of credit, offsetting balances payable, guarantees, or assets held under reinsurance security agreements.

Structured settlements

We have purchased annuities from life insurers to provide for fixed and recurring payments to claimants. As a result of these arrangements, we are exposed to credit risk to the extent to which any of the life insurers fail to fulfil their obligations. This risk is managed by acquiring annuities from multiple life insurers with proven financial stability, all of which are rated "A-" or better by independent rating agencies. As at December 31, 2018, no information has come to our attention that would suggest any weakness or failure in life insurers from which we have purchased annuities. Consequently, no provision for credit risk was recorded (2017: nil). The original purchase price of the outstanding annuities is $305.8 million (2017: $298.6 million).

Foreign exchange risk

Foreign exchange risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates relative to the Canadian dollar. Our foreign exchange risk relates primarily to our foreign common stock and pooled fund holdings in the AFS portfolio, which are denominated in various foreign currencies.

Our largest foreign currency exposure is to the US dollar. The impact on the fair value of US dollar foreign stocks, pooled funds, and OCI before income taxes from a 10% change in the US dollar relative to the Canadian dollar is $6.8 million (2017: $13.2 million). Under this same scenario, the impact on the fair value of non-US dollar foreign stocks, pooled funds, and OCI before income taxes is $1.9 million (2017: $4.3 million), assuming historical correlations between currency pairs remain intact.

Liquidity risk

Liquidity risk is the risk of having insufficient cash resources to meet current financial obligations, particularly those related to claim payments. The liquidity requirements of our business are met primarily by funds generated from operations, asset maturities, and investment returns. Liquidity risk arises in relation to each of those funding sources. To mitigate this risk, an appropriate portion of invested assets is maintained in short-term (less than one year) highly-liquid money market securities, which are used to satisfy our 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. We have no outstanding debt aside from bank overdraft operating lines and trade payables. Refer to Note 6 — "Nature and extent of risks arising from financial instruments" included in our audited consolidated financial statements, for a summary of the Company's financial assets and financial liabilities maturity profile.

Operational risk

Operational risk is the risk of financial loss from inadequate or failed processes, people, systems, or due to external events. This may relate to any of our activities and includes, for example, faulty process, prohibited employee actions, deceptive actions by third parties, human error, and technology failures. We manage operational risk through our three lines of defence risk governance model (refer to "Corporate Governance and Accountability" above for more detail), and are continually enhancing our enterprise risk management framework to include current risk assessments for our strategic initiatives and significant business and functional areas. There is also ongoing monitoring and follow-up on risks, incidents, and associated controls through regular reporting to senior management, the Management Risk Committee, the Risk Review Committee, and other relevant Board of Directors' committees.

People risk

Successful implementation of our strategy depends, among other matters, on our ability to attract, develop, motivate, and retain employees with the necessary skills, capabilities, and knowledge. The inability to attract, motivate, or retain an appropriate staffing level and/or key employees with specialized skills, capabilities, or knowledge could adversely impact our ability to execute on strategic initiatives, our financial performance, our compliance with applicable legal requirements, or result in an increased risk of operational errors. To mitigate this risk, we focus on the delivery of critical talent management and performance enhancement programs to ensure we identify, attract, develop, motivate, and retain an adequate number of employees with the appropriate skill set. In addition, we continue to strengthen our executive leadership team and Board of Directors so that the necessary competencies are represented at the leadership level and that we have adequate succession plans in place.

Information security risk

Information security risk is the risk of loss or harm resulting from the failure to appropriately manage information during its lifecycle. We routinely collect, process, use, retain, and dispose of various types of information from numerous sources, including personal information, policyholder information, and business or internal proprietary information. An inadvertent disclosure, unauthorized access, or other misuse of such information could have a negative impact on the privacy of our policyholders or other individuals, on the confidentiality of our strategic plans, competitive initiatives, business information, or financial performance. Although we proactively manage information security risk through our three lines of defence risk governance model, including first line internal controls and enterprise risk management policies, the occurrence of such an event could result in reputational damage, financial loss, and/or legal or regulatory consequences.

Information technology risk

Our business depends on the successful and uninterrupted functioning of our computer and data processing systems and user or system interfaces. We rely on third-party service providers for delivering key components of these systems, including data, telephony, information technology infrastructure, and data centre services. The failure of these systems, including failure of our third-party service providers to deliver these services on a timely basis, could interrupt our operations or materially impact our ability to rapidly evaluate and commit to new business opportunities or otherwise conduct business. If sustained or repeated, a system failure could result in the loss of existing or potential business relationships, compromise our ability to process transactions in a timely manner, or otherwise impair our ability to develop, modify, or execute our strategies, and ultimately, could negatively affect our financial results and our reputation. To manage this risk, we have implemented internal control and system monitoring processes. We also require our key third-party service providers to enter into service level agreements to contractually secure their commitment to our minimum expected levels of service. To identify, triage, and respond to critical technology incidents in a timely manner, we have an incident response process. Our data centre is managed by a reputable third-party who provides disaster recovery services, including annual testing of, and redundant systems and facilities for, our critical services. Management regularly monitors the service levels provided by key third-party service providers, the stability of key systems, and the quantity and root cause of critical technology incidents.

To facilitate the achievement of operational and strategic objectives, we need to maintain and upgrade our computer and data processing systems. Such projects require the investment and coordination of resources, and often necessitate trade-offs to balance risk management with execution speed and an appropriate return on investment. The implementation of significant new or revised systems and the adaption of processes have the potential to introduce additional complexity and operational risk until full transition is completed. To address increased operational risk during a transition period change, management considerations are integrated into the implementation process, and additional manual and monitoring controls and reporting are implemented. Significant technology projects are managed and governed as corporate initiatives (refer to "Strategic execution risk" below for more detail).

Cyber security risk is the risk of unauthorized information access, or the loss of system integrity or availability, as a result of an attack delivered electronically via the Internet or by direct access to our systems. There is an increasing prevalence of cyber-attacks affecting a variety of businesses with ever-increasing financial, operational, and reputational impact. We provide employees with cyber security awareness training and reminders to reduce the risk of employee action inadvertently resulting in an exposure. We regularly enhance systems, networks, processes, and data protection measures to detect and reduce the risk of unauthorized access, increase system resilience, and minimize the impact of a cyber-attack if it were to occur. In addition, we also carry cyber incident insurance to mitigate exposure to significant losses arising from a cyber incident, subject to applicable policy limits.

Regulatory and legal risks

Regulatory risk

Regulatory risk refers to the risk that modifications to regulations, or how they are applied by regulators, including increasing volume, complexity and/or stringency, will threaten our ability and capacity to conduct profitable business in the future.

As a participant in the P&C insurance industry, we are subject to significant regulation by federal and provincial governments and administrative bodies, which are in addition to regulations of general applicability such as privacy, health and safety, and employment standards. Insurance legislation delegates regulatory, supervisory, and administrative powers to federal, provincial, or other jurisdictional insurance commissioners and agencies. Such regulation is generally designed to protect policyholders and is related to matters including: rate setting; restrictions on types of investments; the maintenance of adequate capital to support unearned premiums and unpaid claims; the examination of insurance companies by regulatory authorities, including periodic market conduct examinations; and the licensing of insurers and their agents and brokers. In particular, the personal automobile insurance product is subject to significant regulation in each province and it is possible that future regulatory changes may prevent us from taking actions, such as raising rates, to affect operating results.

Changes to capital and solvency standards, restrictions on certain types of investments, and periodic market conduct and financial examinations by regulators could also impact our ability to successfully implement our strategy. We are required by federal regulators to maintain sufficient capital in order to ensure our continued solvency and protect us and our policyholders from adverse events. The primary solvency test we must comply with is the MCT, whereby we are required to hold at least 150% available capital against required risk-weighted capital. In addition, under the ORSA framework (refer to "Own Risk and Solvency Assessment" above for more detail), we internally assess our risks and determine the level of capital required to adequately support future solvency. The internal capital targets established in our capital management policy are higher and more stringent than the regulatory minimum, and our current capital level is higher than our internal targets. Our capital management policy also documents corrective actions that could be taken if capital levels fall, or are projected to fall, below our warning levels.

The application of existing laws or regulatory policy may require a degree of interpretation, particularly with respect to new or emerging issues, or new operations. In addition, changes to laws and regulations, including changes in their implementation, interpretation, or application, or the introduction of new laws and regulations, could affect us by limiting the products or services we can provide, restricting the prices we are able to charge, impacting the manner in which we offer our products to the market, requiring specified claims payments, limiting the effectiveness of our policy wordings, and/or increasing the ability of new or existing competitors to compete with our products and services. The brokers on whom we rely to distribute our insurance products are also subject to laws and regulations governing the conduct of their businesses, and the disclosure they provide to policyholders. We are unable to control the extent to which those brokers comply with applicable laws and regulations, and any failure by them to do so could result in the imposition of significant restrictions on their ability to do business with us, which could adversely affect our results of operations or financial position.

Legal and regulatory action risk

Legal and regulatory action risk refers to the impact of court awards, settlements, penalties, fines, and restrictions on the ability to carry on business as a result of lawsuits or non-compliance with applicable laws or regulatory requirements.

In the normal course of our business, we may, from time to time, be subject to a variety of legal and regulatory actions relating to our operations. In addition, plaintiffs continue to bring new types of legal claims against insurance and related companies. Current and future court decisions and legislative activity may increase our exposure to these types of claims. This risk of potential liability may make reasonable resolution of claims more difficult to obtain.

To manage legal and regulatory action risk, we have established procedures and controls through three lines of defence supported by our Code of Business Conduct. Our regulatory compliance management program provides reasonable assurance that we are currently in material compliance with applicable laws, rules, and regulations. There is also ongoing monitoring and follow-up on risks, incidents, and associated controls through regular reporting to the Management Risk Committee, the Risk Review Committee, and other relevant Board of Directors' committees. We also actively participate in discussions with regulators and governments, and in industry groups to ensure that significant concerns are communicated to these bodies. In addition, our Legal Risk Management Policy requires consultation with the legal department when transactions or activities, either due to size or nature, may pose significant legal or regulatory risk, or in the event of actual or threatened litigation, regulatory or law enforcement activity.

Business interruption risk

Business interruption risk is associated with events that impact, or have the potential to impact, our ability to conduct business as normal. Interruptions to business can be triggered by events affecting our facilities, technology, people, or third-party suppliers; including events such as floods, earthquakes, technology failures, pandemics, etc. Such events can result in losses of financial assets, property and equipment, key employees, and/or the inability to write business and process transactions.

To mitigate business interruption risk, we have established a specialized Enterprise Business Continuity Management ("EBCM") function headed by the Chief Risk Officer. The EBCM function proactively assesses potential risks to the Company and ensures resilient planning and continuity arrangements are in place. Resiliency plans are developed and tested to ensure critical functions can continue despite a disruptive event. For example, resiliency plans exist to support emergency response, incident management, crisis management, crisis communication, disaster recovery, facilities recovery, regional incident response, business continuity, and a pandemic. We have deployed a response structure that provides rapid response to events, and have created teams at all levels to ensure quick and effective decisions can be made at the appropriate level and are executed efficiently. In addition, we also carry business interruption insurance to mitigate exposure to significant losses arising from business interruption events, subject to applicable policy limits.

Strategic risk

Strategic risk is the potential for loss or under-performance arising from the ineffective implementation of appropriate business strategies and/or the inability to adapt strategies to changes in the business environment. Our strategy, and our ability to develop and implement the strategy, is influenced by, among other things, industry competition, changes in the regulatory environment or requirements, legal matters, general economic conditions, capital levels, and access to necessary expertise. Each year the executive leadership team reassesses our strategy in light of industry, general economic, regulatory, technological, and other conditions, and develops a detailed business plan which is reflective of this strategy. The business plan is presented to and approved annually, or more frequently if required, by the Board of Directors.

Strategic execution risk

Strategic execution risk is the risk that we are ineffective in implementing our business strategies. We closely monitor the environment in which we operate, and risks that may impact the execution of our strategy are regularly assessed, managed, and addressed by the executive leadership team, with oversight from the Board of Directors.

From time to time we may undertake corporate initiatives to implement our business strategies. Such initiatives require the investment and coordination of resources, and often necessitate trade-offs to balance risk management with execution speed and an appropriate return on investment. Changes to a strategic initiative's scope, costs, or timing may impact the magnitude or timing of benefits to be achieved from the initiative or the investment required to implement the initiative, and may negatively impact other initiatives and financial performance. To address strategic execution risk, we dedicate resources to execute and manage these strategic initiatives. Where a strategic initiative requires specialized skills or additional personnel not available among our Company employees, we may engage third-party service providers to support strategic initiatives. We exercise careful oversight of third-party service providers to ensure deliverables comply with expected timeliness, quality, and cost criteria, and to approve changes to scope, costs, or timing. We manage the risks associated with strategic initiatives through specified management committees to prioritize and oversee specific strategic initiatives. The Board of Directors also provides oversight to strategic initiatives both directly and through its committees.

Demutualization is one such strategic initiative. Demutualization is a complex process, prescribed by the regulations established by the federal government, designed to allow federally-incorporated mutual P&C insurance companies to demutualize. A number of external or internal events could cause our demutualization process to terminate prior to its completion, including any one of the necessary special resolutions not being passed by at least two-thirds of the policyholders voting at a special meeting, regulatory and government approval not being obtained, or our Board of Directors passing a resolution terminating the demutualization. To address and monitor these risks, we employ subject matter experts, engage third party advisors, and continue to actively engage with stakeholders. The execution of the demutualization process is managed by a specified management committee, overseen by the Board of Directors' Special Committee on Demutualization, and the Board of Directors more broadly.

Business, economic, and political environment risk

Our business and results can be affected significantly by changes in the business, economic, and political environment. Depressed economic conditions may cause changes in the level of demand for insurance or reductions in policy coverages and have been correlated with increases in claims fraud.

Increased political and governmental involvement in the insurance industry may otherwise change the business and economic environment in which we operate. Such changes could cause us to make unplanned modifications to our products or services, or result in other industry participants altering their strategies in a manner that increases competition in our target markets.

Competition risk

The financial performance of the P&C industry has historically tended to fluctuate in cyclical patterns of “soft” markets characterized generally by increased competition resulting in lower premium rates, followed by “hard” markets characterized by reduced competition and increasing premium rates. The risk exists that these fluctuations in industry conditions could produce an underwriting environment that negatively impacts our underwriting results, premium levels, and financial position.

When there is intense competition in the P&C industry for any product line, our 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 or retain market share. If we are unable to realize superior risk selection or sufficient expense efficiencies, our ability to establish or maintain competitive pricing could be adversely affected. Given our disciplined approach to underwriting, there may be market conditions or competitive actions which restrict our ability to grow or maintain our written premium levels.

The entrance of new market participants or a shift in the methods to price insurance by competitors could also undermine our ability to establish or maintain competitive pricing. The introduction of disruptive innovations and changing technologies could affect the way that our customers purchase insurance, how we price insurance, the demand for our products, and our underwriting and other decision-making processes. Our ability to effectively compete may be impaired if we do not respond adequately to new market participants or existing competitors who deploy such technologies.

Distribution risk

In order to meet our overall strategy, we must manage our distribution risk. Distribution risk includes the inherent risk of dealing with independent brokers and new market entrants, as well as the risk that the broker distribution channel would not be viable in a specific market.

We write products through a network of select brokers across Canada. The ability of our broker network to be competitive against other distributors and distribution channels, our ability to maintain a strong relationship with the brokers, and our ability to maintain acceptable service levels are critical for staying competitive in the market. The competitive environment is further complicated by the consolidation of brokers, and the acquisition of brokers by other P&C insurance companies, which may have a direct impact on our market share and ability to grow profitably. We maintain close relationships with brokers through the business development staff, who provide training and guidance to enhance the brokers’ understanding and marketing of our products. Strong competition exists among insurers for brokers with a proven ability to develop and deliver a profitable book of business. Premium volume and profitability could be negatively affected if there is a material decrease in the number of brokers that choose to sell our insurance products. We periodically issue commercial loans to, or participate in equity investments in, certain profitable brokers to maintain broker loyalty. By doing so, we could be exposed to financial risk and potential relationship issues. To mitigate these risks, commercial loans and equity investments in brokers are subject to annual, or more frequent, financial reviews, and are supported by standard agreement terms for oversight and security assignment. The Board of Directors provides supervision by reviewing the loan portfolio and equity holdings semi-annually.

In recognition of ongoing industry growth in the direct distribution channel, we have implemented a multi-channel distribution strategy. While our broker business will continue to be a core part of our business model, we have launched a separately-branded, digital direct channel offering to allow us to serve this distinct market segment. Given the relatively new nature of this distribution channel for us, there is risk that the implementation of the direct distribution channel may not yield the benefits expected, or that it could result in negative reputational impact. We closely monitor the performance of both the direct distribution channel and the broker network.

Capital management risk

Capital management risk refers to the risk of not being able to fully execute on our business strategy as a result of insufficient, or ineffective use of, capital. We are required by federal regulators and our capital management policy to maintain sufficient capital in order to ensure our continued solvency and protect us and our policyholders from adverse events (refer to “Regulatory risk” above). A reduction in capital levels below our internal or regulatory targets could trigger corrective actions as specified in the capital management policy and subject us to regulatory intervention.

If a rating agency downgraded our financial strength rating below minimum acceptable levels, it could result in a loss of business, particularly in our commercial lines business, where certain customers may require that we maintain minimum ratings to enter into or renew business with us.

To ensure sufficient capital levels are maintained, we actively monitor the MCT ratio and the ORSA (refer to “Own Risk and Solvency Assessment” above), and the effect that external and internal forces and actions have on the capital base through our capital management program. Senior management determines the potential impact on capital when establishing the annual business plan, setting strategy, and before entering into any acquisitions or significant investments, to seek to ensure that acceptable levels of capital are maintained.

Reputational risk

Reputational risk is the risk that negative publicity regarding the P&C insurance industry generally, actions by external parties, or our employees' or directors' conduct or business practices, whether true or not, will adversely affect our performance, operations, broker relationships, or customer base, or require costly litigation or other defensive measures.

Reputational risk assessments involve a broad array of factors, including the extent and outcome of relevant legal and regulatory due diligence, the economic intent of particular transactions, the impact of events on the Company, the need for customer or public disclosure, conflicts of interest, fairness issues, and public perception. We consider the potential reputational implications when implementing our business strategies and develop response plans to address anticipated responses where possible. We monitor public, broker, and customer sentiment through formal feedback, complaint handling and ombuds mechanisms, and monitoring of both social and traditional media. Based on monitoring results, we implement response plans as necessary.

Conduct risk

We manage conduct risk by implementing our Code of Business Conduct, governance practices, enterprise risk management programs, and employee and broker training. All of our directors, officers, and employees have a responsibility to conduct their activities in accordance with our Code of Business Conduct.

Under our ethics reporting program, employees are able to contact an independent service provider on a confidential and anonymous basis to communicate any concerns regarding compliance with our Code of Business Conduct, including questionable accounting or auditing matters, internal controls over financial reporting, and our disclosure controls and procedures. All concerns raised are forwarded to designated independent Company individuals for investigation and follow-up. Finally, we also have incident management and communication plans in place to address incidents that may have reputational impact.

SECTION 12 — NON-GAAP FINANCIAL MEASURES

We measure and evaluate performance of our operations using a number of financial measures, which include assessing performance against non-GAAP measures. These non-GAAP financial measures are derived from elements of our audited consolidated financial statements and do not have any standardized meaning prescribed by GAAP. They may not be comparable to similar measures presented by other companies. Accordingly, these measures should not be considered in isolation or as a substitute for analysis of our financial information reported under GAAP.

These non-GAAP financial measures are consistent with financial measures generally used in the P&C insurance industry, and facilitate management's comparisons to our historical operating results and to competitors' operating results. They also provide readers with greater transparency of supplemental information used by management in assessing results and for operational decision-making. These non-GAAP measures are outlined and defined below:

Gross written premiums (GWP)	The total premiums from the sale of insurance during a specified period.
Net written premiums (NWP)	GWP less the cost of reinsurance coverage.
Claims ratio	Claims and adjustment expenses (excluding the impact of discounting) during a defined period expressed as a percentage of net earned premiums for the same period.
Core accident year claims ratio	Claims ratio excluding catastrophe losses and claims development.
Expense ratio	Underwriting expenses, including commissions, operating expenses (net of other underwriting revenues), and premium taxes during a defined period, expressed as a percentage of net earned premiums for the same period.
Combined ratio	Claims and adjustment expenses (excluding the impact of discounting), commissions, operating expenses (net of other underwriting revenues), and premium taxes during a defined period expressed as a percentage of net earned premiums for the same period.
Adjusted combined ratio	Combined ratio excluding the financial impact of our investment in the development and implementation of the Vyne platform and the results of the underwriting activity of Sonnet.
Minimum capital test (MCT)	A regulatory formula defined by the Office of the Superintendent of Financial Institutions Canada, that is a risk-based test of capital available relative to capital required.
Underwriting loss	Net earned premiums for a defined period less the sum of claims and adjustment expenses (excluding the impact of discounting), net commissions, operating expenses (net of other underwriting revenues), and premium taxes during the same period.
Return on equity (ROE)	Net loss after tax for the 12 months ended at a specified date divided by the average retained earnings over the same 12-month period.

SECTION 13 — DEFINITIONS

Refer to Section 12 — "Non-GAAP financial measures" for definitions of non-GAAP measures we use to measure and evaluate performance of our operations.

Catastrophe loss	An event causing gross losses in excess of $2 million, and generally greater than 100 claims.
Claims development	The difference between prior year-end estimates of ultimate undiscounted claim costs and the current estimates for the same block of claims. A favourable development represents a reduction in the estimated ultimate claim costs during the period for that block of claims.
Discounting	To reflect the time value of money, the expected future payments of claim liabilities are discounted back to present value using the market yield rate of the investments used to support those liabilities. Provisions for adverse deviation are also included when determining the discounted value.
Frequency	A measure of how often a claim is reported as a function of PIF.
Incurred but not reported (IBNR)	The amount that is added to case reserves to establish the total claim liabilities. It is intended to cover future development on reported claims, as well as claims that have occurred but not yet been reported to the Company.
Large loss	A single claim with a gross loss in excess of $1 million.
Net earned premiums	The portion of NWP equal to the expired period of time an insurance policy is in effect.
Policies in force (PIF)	The number of insurance policies for which we are at risk at a specified date.
Provision for adverse deviation (PfAD)	An amount that is added to the discounted claims and adjustment expenses to reduce the uncertainty of potential adverse effects that are inherent in the assumptions and data used to estimate such liabilities.
Severity	A measure of the average dollar amount paid per claim.
Total equity	Retained earnings plus accumulated other comprehensive (loss) income.

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REPORT OF MANAGEMENT'S ACCOUNTABILITY

The accompanying consolidated financial statements have been prepared by management in accordance with International Financial Reporting Standards and have been approved by the Board of Directors.

Management is responsible for ensuring that these consolidated financial statements, which include amounts based on estimates and judgments, are consistent with other information and operating data contained in the Annual Report, and fairly reflect the business transactions and financial position of Economical Mutual Insurance Company (the "Company"), in all material respects.

The integrity and reliability of the 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. PricewaterhouseCoopers 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. The Company'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 the Company's 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 appointed actuary is appointed by the Board of Directors pursuant to the Insurance Companies Act (Canada). The appointed 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 appointed actuary is also required to provide an opinion regarding the appropriateness of the policy liabilities at the consolidated 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 appointed 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.

ROWAN SAUNDERS
President and Chief Executive Officer

PHILIP MATHER
Executive Vice-President and Chief Financial Officer

Waterloo, Canada
February 21, 2019

APPOINTED ACTUARY'S REPORT

To the Members of Economical Mutual Insurance Company:

I have valued the policy liabilities and reinsurance recoverables of Economical Mutual Insurance Company for its consolidated balance sheet at December 31, 2018 and their changes in the consolidated statement of comprehensive loss 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 net of reinsurance recoverables makes appropriate provision for all policy obligations and the consolidated financial statements fairly present the results of the valuation.

LINDA M. GOSS
Fellow, Canadian Institute of Actuaries

Waterloo, Canada
February 21, 2019

INDEPENDENT AUDITOR'S REPORT

To the Members of

Economical Mutual Insurance Company

Opinion

We have audited the consolidated financial statements of **Economical Mutual Insurance Company** and its subsidiaries [the "Company"], which comprise the consolidated balance sheet as at December 31, 2018, and the consolidated statement of comprehensive loss, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects the consolidated financial position of the Company as at December 31, 2018, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards ["IFRS"].

Basis for opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards ["Canadian GAAS"]. Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the consolidated financial statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of management and those charged with governance for the consolidated financial statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRS, 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.

In preparing the consolidated financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's responsibilities for the audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian GAAS will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with Canadian GAAS, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure, and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Ernst & Young LLP

Chartered Professional Accountants
Licensed Public Accountants

Waterloo, Canada
February 21, 2019

Consolidated Financial Statements

CONSOLIDATED BALANCE SHEET

AS AT DECEMBER 31

(in thousands of dollars)	Notes	**2018**	2017
ASSETS			
Cash and cash equivalents		**$ 135,288**	$ 166,389
Investments	5	**3,940,715**	3,996,000
Accrued investment income		**15,502**	15,294
Premiums receivable		**837,042**	699,610
Income taxes receivable		**12,991**	45,716
Reinsurance receivable and recoverable	7,9	**64,721**	59,057
Deferred policy acquisition expenses	7	**230,092**	221,172
Property and equipment	10	**38,934**	41,190
Deferred income tax assets	11	**104,973**	33,410
Goodwill and intangible assets	12	**225,618**	229,166
Other assets	13	**104,484**	114,913
		$ 5,710,360	$ 5,621,917
LIABILITIES AND EQUITY			
Unearned premiums	7	**$ 1,268,512**	$ 1,131,366
Claim liabilities	7,8	**2,670,578**	2,527,673
Accounts payable and other liabilities	15	**203,960**	232,500
		4,143,050	3,891,539
EQUITY			
Retained earnings		**1,588,337**	1,644,781
Accumulated other comprehensive (loss) income		**(21,027)**	85,597
Total equity	17	**1,567,310**	1,730,378
		$ 5,710,360	$ 5,621,917
Commitments and contingencies	22		

See accompanying notes.

On behalf of the Board:

J.H. Bowey, Director

R.B. Saunders, Director

CONSOLIDATED STATEMENT OF COMPREHENSIVE LOSS

FOR THE YEAR ENDED DECEMBER 31

(in thousands of dollars)	Notes	**2018**	2017
Gross written premiums	18	**$ 2,456,314**	$ 2,286,855
Net written premiums	9,18	**$ 2,380,738**	$ 2,218,087
Net earned premiums	18	**$ 2,244,630**	$ 2,165,821
Other underwriting revenues		**15,382**	16,558
Total underwriting revenues		**2,260,012**	2,182,379
Underwriting expenses:			
Net claims and adjustment expenses, undiscounted	7,9	**1,694,667**	1,659,080
Net commissions	9	**380,973**	379,339
Operating expenses		**369,268**	361,984
Premium taxes		**80,717**	77,695
		2,525,625	2,478,098
Underwriting loss before the impact of discounting		**(265,613)**	(295,719)
Impact of discounting	7	**4,298**	37,218
Underwriting loss		**(261,315)**	(258,501)
Investment income:			
Interest	5	**71,775**	59,453
Dividends	5	**35,419**	38,480
Recognized gains on investments	5	**58,931**	41,176
		166,125	139,109
Other expense	23	**5,064**	19,529
Restructuring expenses	24	**17,288**	–
Loss before income taxes		**(117,542)**	(138,921)
Income tax recovery	11	**(44,548)**	(46,243)
Net loss		**$ (72,994)**	$ (92,678)
Items that may be reclassified subsequently to net loss:			
Net unrealized (losses) gains on AFS investments	5	**(90,324)**	108,006
Reclassification to net loss of net recognized gains on AFS investments	5	**(58,964)**	(68,133)
Foreign exchange gain (loss) on investments in associates		**2,437**	(1,686)
Income tax (recovery) expense	11	**(40,227)**	11,133
		(106,624)	27,054
Items that will not be reclassified subsequently to net loss:			
Post-employment benefit obligation gain (loss)	16	**22,634**	(9,662)
Income tax expense (recovery)	11	**6,084**	(2,582)
		16,550	(7,080)
Other comprehensive (loss) income		**(90,074)**	19,974
Comprehensive loss		**$ (163,068)**	$ (72,704)

See accompanying notes.

Consolidated Financial Statements

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED DECEMBER 31

(in thousands of dollars)	**2018**			2017		
	Retained earnings	**Accumulated other comprehensive loss**	**Total equity**	Retained earnings	Accumulated other comprehensive income	Total equity
Balance, beginning of the year	**$ 1,644,781**	**$ 85,597**	**$ 1,730,378**	$ 1,744,539	$ 58,543	$ 1,803,082
Net loss	**(72,994)**	**–**	**(72,994)**	(92,678)	–	(92,678)
Other comprehensive (loss) income	**16,550[1]**	**(106,624)**	**(90,074)**	(7,080)[1]	27,054	19,974
Total comprehensive loss	**(56,444)**	**(106,624)**	**(163,068)**	(99,758)	27,054	(72,704)
Balance, end of the year	**$ 1,588,337**	**$ (21,027)[2]**	**$ 1,567,310**	$ 1,644,781	$ 85,597[2]	$ 1,730,378

[1] Actuarial gains (losses) for the post-employment benefit obligation recognized in retained earnings (net of income tax expense of $6,084 (2017: $2,582 income tax recovery)).

[2] Included in accumulated other comprehensive (loss) income is $5,819 (2017: $3,382) related to the cumulative foreign exchange gain on investments in associates.

See accompanying notes.

CONSOLIDATED STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31

(in thousands of dollars)	Notes	2018	2017
Operating activities:			
Receipts:			
Premiums collected (net of reinsurance ceded)		**$ 2,242,564**	$ 2,167,562
Interest received		**79,357**	73,903
Dividends received		**38,349**	38,053
Income taxes recovered		**43,953**	39,643
		2,404,223	2,319,161
Payments:			
Claims paid	7	**1,548,368**	1,453,043
Commissions and expenses paid		**723,616**	706,859
Premium taxes paid		**80,395**	76,668
Income taxes paid		**4,327**	11,201
Restructuring expenses paid	24	**2,887**	–
		2,359,593	2,247,771
Net cash provided by operating activities		**44,630**	71,390
Investing activities:			
Investments purchased		**(5,973,997)**	(4,877,250)
Investments sold, redeemed or matured		**5,935,133**	4,891,209
Commercial loans advanced		**(12,678)**	(24,856)
Commercial loans repaid		**7,384**	13,734
Other assets purchased		**(49,522)**	(47,583)
Business acquisitions	20,21	**–**	(93,308)
Business dispositions		**17,949**	–
Net cash used in investing activities		**(75,731)**	(138,054)
Cash and cash equivalents:			
Net decrease during the year		**(31,101)**	(66,664)
Balance, beginning of the year		**166,389**	233,053
Balance, end of the year		**$ 135,288**	$ 166,389
Cash		**$ 96,633**	$ 166,159
Cash equivalents		**38,655**	230
Total cash and cash equivalents		**$ 135,288**	$ 166,389

See accompanying notes.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS

Economical Mutual Insurance Company (the "Company") is a mutual insurance company which, along with its wholly owned subsidiaries, offers property and casualty ("P&C") insurance in Canada. The Company is incorporated and is domiciled in Canada. Its registered office and principal place of business is 111 Westmount Road South, Waterloo, Ontario, Canada.

These consolidated financial statements were approved by the Company's Board of Directors on February 21, 2019.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of preparation

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") and Canadian accepted actuarial practice and reflect the requirements of the Office of the Superintendent of Financial Institutions Canada ("OSFI").

These consolidated financial statements have been prepared on a historical cost basis, except for those financial instruments that have been measured at fair value and claim liabilities which are valued on a discounted basis in accordance with accepted actuarial practice.

The financial statements of the subsidiaries and material associates are prepared for the same reporting period as the Company. Where necessary, adjustments are made to bring the accounting policies of subsidiaries and associates in line with the Company. The consolidated financial statements include the accounts of Economical Mutual Insurance Company and its wholly owned subsidiaries, Waterloo Insurance Company, Perth Insurance Company, The Missisquoi Insurance Company, Sonnet Insurance Company, Petline Insurance Company ("Petline"), Westmount Financial Inc., Family Insurance Solutions Inc. and the TEIG Investment Partnership (which manages the investment portfolio for all insurance companies in the group, except for Petline). Each of the subsidiaries operate and are incorporated or established in Canada.

The Company's non-controlling interest investments in companies subject to significant influence are accounted for using the equity method and are included in "Other assets". Under the equity method, the original cost of the investments is increased by the comprehensive income of the non-controlling interest since acquisition and reduced by any dividends received. All inter-company transactions and balances have been eliminated on consolidation to the extent of the interest in the associate.

All amounts in the notes are shown in thousands of Canadian dollars, unless otherwise stated.

(b) Insurance contracts

Insurance contracts are those contracts which transfer significant insurance risk at inception. The Company (the insurer) has accepted significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified event (the insured event) with uncertain timing or amount adversely affects the policyholder. Similarly, by purchasing reinsurance, the Company transfers significant insurance risk to the reinsurers. As a general guideline, the Company determines whether significant insurance risk has been transferred for insurance and reinsurance contracts by comparing whether significantly more would be paid or received if the insured event occurs, versus if the insured event did not occur.

Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during this period, unless all rights and obligations are extinguished or expire.

Premiums and unearned premiums

Premiums are recognized in net earned premiums in the consolidated statement of comprehensive income (loss) on a pro-rata basis over the contract period. Premiums on policies written are accounted for in full in gross written premiums in the year written. Premiums receivable include the premiums due for the remaining months of the contracts. Written premiums on multi-year policies are recognized in gross written premiums in the year written and are recognized in net earned premiums on a pro-rata basis over the contract period. Unearned premiums ("UPR") represent the portion of premiums written relating to periods of insurance coverage subsequent to the reporting date and are presented as a liability gross of amounts ceded to reinsurers. UPR ceded to reinsurers is included in "Reinsurance receivable and recoverable".

Claim liabilities

Claim liabilities are calculated based on Canadian accepted actuarial practice. The claim liabilities consist of reserves for reported claims as determined on a case-by-case basis by claims adjusters and an actuarially determined provision for incurred but not reported claims ("IBNR"). The estimates include related investigation, settlement, and internal and external adjustment expenses. Measurement uncertainty in these estimates exists due to internal and external factors that can substantially impact the ultimate settlement costs. Consequently, the Company reviews and re-evaluates claims and reserves on a regular basis and any resulting adjustments are included in "Net claims and adjustment expenses" in the consolidated statement of comprehensive income (loss) in the period the adjustment is made. Claims and adjustment expenses are reported net of reinsurance. The claim liabilities are valued on a discounted basis using a rate that is derived from the fair

(b) Insurance contracts (continued)

Claim liabilities (continued)

value yield of the bonds that have been identified as supporting the claim liabilities and adding in a provision for adverse deviation (“PfAD”). The effect of discounting plus PfAD is included in “Impact of discounting” in the consolidated statement of comprehensive income (loss). The claim liabilities are extinguished when the obligation to pay a claim expires, is discharged or is cancelled.

Deferred policy acquisition expenses

The amount of deferred policy acquisition expenses (“DPAE”) represents the brokers’ commission, premium taxes, and certain direct expenses in respect of the Company’s digital direct business, all of which are associated with the unearned portion of the premiums written during the year to the extent they are considered recoverable. The costs are expensed in the year 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 in the consolidated statement of comprehensive income (loss). The maximum deferrable amount is calculated through the liability adequacy test.

Liability adequacy test

Quarterly, an assessment is made of whether the policy liabilities are adequate, which includes both claim liabilities and premium liabilities. Claim liabilities are assessed using current estimates of future cash flows of unpaid claims and adjustment expenses, discounted to reflect the time value of money. If that assessment shows that the carrying amount of the claim liabilities is insufficient in light of the current expected future cash flows, the deficiency is recognized in the consolidated statement of comprehensive income (loss). Premium liabilities are assessed using current estimates of the discounted future claims and expenses associated with the unexpired portion of written insurance policies. A premium deficiency would be recognized immediately as a reduction of DPAE to the extent that the unearned premiums are not considered adequate to cover DPAE and premium liabilities. If the premium deficiency is greater than DPAE, a liability is accrued for the excess deficiency.

Industry pools

When certain automobile owners are unable to obtain insurance via the voluntary insurance market, they are insured by the Facility Association (“FA”). In addition, entities can choose to cede certain risks to industry administered risk sharing pools (“RSP”) or in Quebec, the Plan de Repartition des Risques (“PRR”) (collectively “the pools”). The related risks associated with FA insurance policies and policies ceded by companies to the pools are aggregated and shared by the entities in the P&C insurance industry, generally in proportion to market share and volume of business ceded to the pools. In accordance with the OSFI guidelines, the Company applies the same accounting policies to FA and pool insurance it assumes and cedes as it does to insurance policies issued by the Company directly to policyholders. The Company’s share of the pool assets backing policy liabilities is included in “Reinsurance receivable and recoverable”.

Reinsurance

Reinsurance receivable and recoverable includes reinsurers’ share of UPR and claim liabilities. The Company presents third party reinsurance balances in the consolidated balance sheet on a gross basis to indicate the extent of credit risk related to third party reinsurance and its obligations to policyholders. The estimates for the reinsurers’ share of claim liabilities are determined on a basis consistent with the related claim liabilities. Reinsurance assets are reviewed at least quarterly for impairment.

Structured settlements

In the normal course of claims settlement, the Company enters into annuity agreements with various Canadian life insurance companies, that are required to have credit ratings of at least “A-” or higher, to provide for fixed and recurring payments to claimants in full satisfaction of the claim liability. Under such arrangements, the Company removes the liability from its consolidated balance sheet when the liability to its claimants is substantially discharged and legal release has also been obtained from the claimant, although the Company remains exposed to the credit risk that life insurers will fail to fulfil their obligations. See note 6 for further discussion of credit risk.

(c) 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. The amount of cash not readily available for use by the Company is not significant.

(d) 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”)
- financial assets and liabilities at fair value through profit or loss (“FVTPL”)

(d) Financial instruments including investments (continued)

- 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 FVTPL to support 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 FVTPL 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. 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 where available 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.

Financial instruments are no longer recognized when the rights to receive cash flows from the investments have expired or have been transferred and the Company has transferred substantially all the risks and rewards of ownership.

Available for sale

All short-term investments, equities (including preferred stocks, common stocks and pooled funds) and bonds, except those voluntarily designated as FVTPL, are designated as AFS. 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 (loss) income” (“OCI”) in the consolidated statement of comprehensive income (loss) until the disposal of the financial instrument, or when an impairment loss is recognized. When the financial instrument is disposed of, the gain or loss is reclassified from “Accumulated other comprehensive (loss) income” (“AOCI”) to “Recognized gains on investments” in the consolidated statement of comprehensive income (loss). Gains and losses on the sale of AFS financial instruments are calculated on an average cost basis.

The Company assesses its AFS financial instruments for objective evidence of impairment quarterly. Objective evidence of impairment exists for individual equities (including common stocks and pooled funds) when there has been a significant or prolonged decline in fair value or net asset value below cost. Objective evidence of impairment exists for individual bonds when a loss event that has a reliably estimable impact on the future cash flows of the financial instrument has occurred. Factors that are considered include, but are not limited to, a decline in current financial position, defaults on debt obligations, failure to meet debt covenants, significant downgrades in credit status, and severity and/or duration of the decline in value. For individual preferred stocks, the key features of the preferred stock are assessed to determine if the instrument is more characteristic of an equity instrument or a debt instrument and objective evidence of impairment is evaluated accordingly. Preferred stock that are redeemable at the Company’s option, and perpetual preferred stock purchased to produce dividend income for the long-term, are assessed using the same methodology as the bond impairment analysis.

When objective evidence of impairment exists for a financial instrument, the impairment loss is measured as the difference between carrying value and fair value. Impairment losses on AFS financial instruments are reclassified from AOCI to “Recognized gains on investments” in the consolidated statement of comprehensive income (loss) in the period such criteria are met. Subsequent fair value increases on previously impaired individual equities and pooled funds are recognized directly in OCI and not reversed through net income (loss), while subsequent fair value decreases are recognized directly in net income (loss). For individual bonds or preferred stocks, subsequent fair value increases that can be attributed to an observable positive development are recognized directly in net income (loss), but otherwise, are recognized directly in OCI. Any subsequent reversal of an impairment loss on a bond or preferred stock is recognized in net income (loss), to the extent that the carrying value of the asset does not exceed its amortized cost at the reversal date.

Fair value through profit or loss

The Company has voluntarily designated a portion of its bonds as FVTPL. The Company has no other FVTPL financial assets. Changes in fair values as well as gains and losses on disposal of FVTPL financial instruments are recorded in “Recognized gains on investments” in the consolidated statement of comprehensive income (loss) with the related tax impact included in “Income tax (recovery) expense”. Gains and losses on the sale of FVTPL financial instruments are calculated on an average cost basis. As changes in the fair value of FVTPL financial instruments are reflected directly within net income (loss) in the consolidated statement of comprehensive income (loss), it is not necessary to record an impairment loss when there has been a significant or prolonged decline in the fair value of FVTPL financial instruments.

The designation of the FVTPL bond portfolio aims to reduce the accounting mismatch in net income (loss) that would otherwise be generated by the fluctuations in fair values of underlying claim liabilities due to changes in interest rates. In compliance with OSFI guidelines, the Company manages the FVTPL portfolio’s quantum and duration so that the impact of changes in interest rates on claim liabilities and on the FVTPL portfolio reasonably offset each other.

(d) Financial instruments including investments (continued)

Loans and receivables/Other financial liabilities

Financial instruments classified as loans and receivables, including commercial loans, and other financial liabilities are initially recognized at fair value and subsequently measured 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 "Recognized gains on investments" in the consolidated statement of comprehensive income (loss).

Evidence of impairment exists for individual commercial loans when there is a deterioration in the counterparties financial performance 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. The treatment of recognized gains and losses on disposal of AFS and FVTPL investments is discussed in "Available for sale" and "Fair value through profit or loss" above.

Dividend income is recognized on the ex-dividend date.

(e) Property and equipment

Property and equipment are recorded at historical cost less accumulated depreciation and accumulated impairment losses, if any.

Cost includes amounts directly attributable to the acquisition of the items of property and equipment. Subsequent costs are added to the cost of the asset only when it is probable that economic benefits will flow to the Company in the future and the cost can be reliably measured.

Depreciation is recorded on a straight-line basis to write down the cost of such assets to their residual value over their expected useful lives. Each component of property and equipment with a cost that is significant in relation to the total cost of the asset is depreciated separately. Residual values, depreciation rates and useful lives are reviewed at least annually and adjusted, if appropriate, at the reporting date. Land is not subject to depreciation and is carried at cost.

Property and equipment are depreciated as follows:

	Basis	Rates
Buildings — structure	Straight-line	50 years
Buildings — infrastructure	Straight-line	25 years
Buildings — fixtures	Straight-line	15 years
Computer equipment	Straight-line	4 years
Furniture and equipment	Straight-line	5 years

Property and equipment are derecognized upon disposal or when no further future economic benefits are expected from their use or disposal. Gains and losses on disposal are calculated as the difference between proceeds and net carrying value and are recognized in "Operating expenses" in the consolidated statement of comprehensive income (loss). Fully depreciated property and equipment are retained in cost and accumulated depreciation accounts until such assets are removed from service.

(f) Leases

Leases of property and equipment where the Company is not exposed to substantially all of the risks and rewards of ownership are classified as operating leases. Incentives received from the lessor on such leases are deferred and amortized on a straight-line basis over the term of the lease in the consolidated statement of comprehensive income (loss). Where substantially all of the risks and rewards have been transferred to the Company, the lease is classified as a finance lease. In these cases, an obligation and an asset are recognized based on the present value of the future minimum lease payments and balances are amortized over the shorter of the lease term or useful life of the asset, as applicable.

(g) Basis of consolidation

Business combinations are accounted for using the acquisition method. The acquisition method requires that the acquirer recognizes, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree, at the acquisition date. Acquisition costs directly attributable to the acquisition are expensed in the year incurred. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured at fair value at the date of acquisition, irrespective of the extent of any non-controlling interest. Any contingent consideration is also measured at fair value at the acquisition date.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

(g) Basis of consolidation (continued)

The Company measures goodwill as the fair value of the consideration transferred, including the recognized amount of any non-controlling interest in the acquiree, less the net recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed, all measured as of the acquisition date. After initial recognition, goodwill is measured at cost less any accumulated impairment losses.

When the Company is exposed, or has rights, to variable returns from its involvement with an investee and has the ability to affect those returns through its power over the investee, the investee is considered a subsidiary. Subsidiaries are fully consolidated from the date that control is obtained by the Company. Subsidiaries are deconsolidated from the date that control ceases.

When the Company has significant influence over an investee, that is the power to participate in the financial and operating decisions of the investee but does not have control or joint control over those decisions, the investee is considered to be an associate. Associates are accounted for under the equity method.

(h) Intangible assets

Intangible assets include capitalized software costs, where the software is not integral to the hardware on which it operates. Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is their fair value as at the date of acquisition, and include assets such as brand, distribution network, and customer relationships. Costs that are directly attributable to the development and testing of identifiable and unique software products controlled by the Company are recognized in other intangible assets when the criteria specified in International Accounting Standard ("IAS") 38 – *Intangible Assets* ("IAS 38") 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 IAS 38 are recognized as an expense as incurred. Following the initial recognition, intangible assets are carried at cost less accumulated amortization and accumulated impairment losses, if any.

Intangible assets with finite useful lives are amortized over their estimated useful economic life. Amortization is recorded in "Operating expenses" in the consolidated statement of comprehensive income (loss). The amortization period and the amortization method for an intangible asset with a finite useful life are reviewed at least annually. Intangible assets with indefinite lives and intangible assets which are under development are not amortized, but are tested at least annually for impairment.

Intangible assets are amortized as follows:

	Basis	Rates
Brand	Indefinite life	Not amortized
Distribution network	Straight-line	11 years
Customer relationships	Straight-line	8 years
Software	Straight-line	1 – 5 years
Other intangible assets	Straight-line	4 – 10 years

(i) Impairment of assets

The Company assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Company compares the asset's recoverable amount to the asset's carrying value. An asset's recoverable amount is calculated based on its value-in-use ("VIU") using a discounted cash flow model. The recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets and, therefore, must be assessed as part of a cash-generating unit ("CGU").

For assets, excluding goodwill and certain financial instruments, an assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such an indication exists, the Company compares the recoverable amount to the carrying value of the asset. If the recoverable amount exceeds the carrying value of the asset, the carrying value is increased to the lesser of the recoverable amount and the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the consolidated statement of comprehensive income (loss).

The following criteria are also applied in assessing impairment of specific assets:

Goodwill

Goodwill is tested for impairment in accordance with IAS 36 – *Impairment of Assets*, which requires goodwill impairment to be assessed at a CGU level. For the purposes of impairment testing, goodwill acquired in a business combination is allocated to each of the Company's CGUs, or groups of CGUs, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the Company are assigned to those units or groups of units.

(i) Impairment of assets (continued)

Goodwill (continued)

Goodwill relating to an associate is included in the carrying amount of the investment and is not tested separately for impairment.

The Company performs a goodwill impairment review at least annually and whenever there is an indication that goodwill may be impaired. The fair value of each CGU has been determined based on the VIU using a discounted cash flow model. Impairment occurs when the carrying amount of the CGU exceeds the recoverable amount, in which case goodwill impairment is recognized prior to impairing other assets. Any impairment of goodwill or other assets is recorded in “Other expense” in the consolidated statement of comprehensive income (loss) in the year that such an impairment becomes evident. Previously recorded impairment losses for goodwill are not reversed in future years if the recoverable amount increases.

Investments in associates

After application of the equity method, the Company determines whether it is necessary to recognize an impairment loss of the Company’s investments in associates. The Company determines at each consolidated balance sheet date whether there is any objective evidence that the investments in associates are impaired. If this is the case, the Company calculates the amount of impairment as being the difference between the fair value of the associate and the carrying value, and recognizes this amount in the consolidated statement of comprehensive income (loss) in “Other expense”.

(j) Income taxes

Income tax (recovery) expense is comprised of current and deferred income tax. Income tax is recognized in net income (loss) except to the extent that it relates to items recognized in OCI or directly to retained earnings.

Current income tax is based on the results of operations in the current year, adjusted for items that are not taxable or not deductible. Current income tax is calculated based on income tax laws and rates enacted or substantively enacted as at the reporting date. Interest income or expenses arising on tax assessments, if any, are included in “Other expense” in the consolidated statement of comprehensive income (loss).

Deferred income tax is provided using the liability method on temporary differences between the tax bases of assets and liabilities and their respective carrying amounts for financial reporting purposes at the reporting date. Deferred income tax is calculated using income tax laws and rates enacted or substantively enacted as at the reporting date, which are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

The carrying amount of deferred income tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable income will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each reporting date and are recognized to the extent that it has become probable that future taxable income will allow the deferred income tax asset to be recovered.

(k) Pensions, other post-employment benefits and other employee benefits

The Company provides certain pension and other post-employment benefits to eligible participants upon retirement.

Pension benefits

The Company operates a defined benefit pension plan for certain employees hired prior to January 1, 2002, which requires contributions to be made to a separately administered fund. The benefit 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 valuation 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 factors as salary escalation and retirement ages of employees. Costs recognized in the consolidated statement of comprehensive income (loss) include the cost of pension benefits provided in exchange for employees’ services rendered during the year, and the net interest cost calculated by applying a discount rate to the net defined benefit obligation. Actuarial gains and losses are recognized in full in OCI in the year in which they occur and then immediately in retained earnings. They are not reclassified to net income (loss) in subsequent years. Past service costs, which are a result of a plan amendment or curtailment, are recognized in “Other expense” in the consolidated statement of comprehensive income (loss) when the amendment or curtailment has occurred.

The defined benefit asset or liability comprises the fair value of plan assets less the defined benefit obligation out of which the obligations are to be settled directly. This is recorded in the consolidated balance sheet in “Other assets” if the balance is in an asset position, and is recorded in “Accounts payable and other liabilities” if in a liability position. Plan assets are held by a long-term employee benefit fund and are not available to creditors of the Company, nor can they be paid directly to the Company. Fair value is based on market price information and in the case of quoted securities it is the published closing price. The value of any defined benefit asset is restricted to the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

(k) Pensions, other post-employment benefits and other employee benefits (continued)

Pension benefits (continued)

The Company also has a defined contribution pension plan for certain employees, for which Company contributions are expensed in the year. The Company has no further payment obligations once the Company contributions and applicable administration fees have been paid.

Non-pension benefits

The Company provides other post-employment benefits for eligible employees hired prior to July 3, 2012. The Company accounts for the cost of all non-pension post-employment benefits, including medical benefits, dental care and life insurance for eligible retirees, their spouses and qualified dependants, on an accrual basis. These costs are recognized in "Operating expenses" in the consolidated statement of comprehensive income (loss) in the year during which services are rendered and are actuarially determined using the projected unit credit valuation 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 factors as salary escalation, retirement ages of employees and expected health care costs. The impact of a plan curtailment is recognized in "Other expense" in the consolidated statement of comprehensive income (loss) when an event giving rise to a curtailment has occurred.

Actuarial gains and losses, except for long-term disability benefits, are recognized in full in OCI in the year in which they occur and then immediately in retained earnings. They are not reclassified to net income (loss) in subsequent years. Actuarial gains and losses for long-term disability benefits are recognized in "Operating expenses" in the consolidated statement of comprehensive income (loss).

The accumulated value for non-pension post-employment benefits is recorded in the consolidated balance sheet in "Accounts payable and other liabilities".

Termination benefits

Termination benefits are payable when employment is terminated, without cause, by the Company before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Company recognizes termination benefits at the earlier of the following dates: (a) when the Company can no longer withdraw the offer of those benefits; and (b) when the Company recognizes costs for a restructuring that is within the scope of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* and involves the payment of termination benefits. In the case of an offer made to encourage voluntary redundancy, the termination benefits are measured based on the number of employees expected to accept the offer. Benefits falling due more than 12 months after the end of the reporting period are discounted to their present value.

Short-term incentive plan

The Company recognizes a liability and an expense for bonuses based on a formula that takes into consideration various financial metrics and qualitative performance criteria. The Company recognizes a provision when contractually obliged or where there is a past practice that has created a reasonable expectation of a constructive obligation.

Medium-term incentive plan

Under the Medium Term Incentive Plan ("MTIP" or "Plan"), notional units (hereinafter referred to as Restricted Units or Performance Units) are granted annually to certain members of management, with a unit value based on the book value of the Company. The value of the Restricted Units ("RUs") will fluctuate based solely on the book value of the Company, while the value of the Performance Units ("PUs") will fluctuate based on the book value of the Company and the Company's performance measured against certain performance criteria. The RUs and PUs vest over one to three years after the grant date, depending on the specific grant, and are then settled in cash. There are floor and ceiling mechanisms in place to ensure that the PUs do not pay when performance is below a minimum threshold and that the total Plan payout does not exceed the ceiling even in periods of significant outperformance.

The cost of the awards is recognized as an expense over the vesting period based on the estimated payout under the Plan at the end of the vesting period, with a corresponding financial liability recorded in "Accounts payable and other liabilities". The Company re-estimates the value of awards that are expected to vest at each reporting period. The ultimate liability for any payment of RUs and PUs is dependent on the book value of the Company at the vesting date. For PUs, the liability is also dependent on the Company's performance relative to the performance criteria.

(l) Provisions

Provisions, including restructuring provisions, are recognized when the Company determines that there is a present legal or constructive obligation as a result of a past event or decision, it is more likely than not that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the obligation.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

(m) Foreign currency translation

Functional and presentation currency

The consolidated financial statements are presented in thousands of Canadian dollars, which is also the functional currency of the Company. Each entity within the consolidated group determines its own functional currency based upon the currency used in the entity's primary operating environment, and measures financial results based on that functional currency.

Translation of foreign subsidiaries' accounts

Assets and liabilities of the Company's foreign subsidiaries are translated from their functional currencies into Canadian dollars at the exchange rate in effect at the reporting date, except for goodwill acquired prior to the IFRS transition date of January 1, 2010 ("transition date").

Any goodwill arising on the acquisition of a foreign operation subsequent to the transition date and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition are treated as assets and liabilities of the foreign operation and translated at the closing rate.

Revenues and expenses are translated at the monthly weighted average rate prevailing during the year. On consolidation, exchange differences arising from the translation of the net investment in foreign entities are recorded in OCI. On the disposal of a foreign operation, the cumulative amount of exchange differences relating to that operation is recognized in net income (loss).

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 reporting date. Unrealized foreign currency gains and losses on AFS financial instruments are included in OCI. All other foreign currency gains and losses are included in net income (loss).

3. STANDARDS ISSUED BUT NOT YET EFFECTIVE

The following IFRS standards have been issued but are not yet effective.

(a) Insurance Contracts

In May 2017, the International Accounting Standards Board ("IASB") issued IFRS 17 – *Insurance Contracts* ("IFRS 17"), which replaces IFRS 4 – *Insurance Contracts* ("IFRS 4"). IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts. There are two measurement methodologies under IFRS 17, the general model and the premium allocation approach. The general model requires insurance contracts to be measured using current estimates of discounted future cash flows, an adjustment for risk and a contractual service margin representing the profit expected from fulfilling the contracts. The premium allocation approach is a simplified model that can be applied to insurance contracts with coverage periods of one year or less (which is the coverage period of many P&C insurance contracts), or where the premium allocation approach approximates the general model. Presentation changes in the consolidated balance sheet and the consolidated statement of comprehensive income (loss) are required in addition to new disclosures.

In November 2018, the IASB proposed deferring the effective date of IFRS 17 by one year, which would now be effective for annual periods beginning on or after January 1, 2022. Retrospective application is required. The Company plans to adopt the new standard on the required effective date together with IFRS 9 – *Financial Instruments* ("IFRS 9"). The Company expects to apply the premium allocation approach to its insurance contracts, and is currently analysing the impact these standards will have on its consolidated financial statements.

(b) Financial Instruments: Classification and Measurement

In July 2014, the IASB issued the final version of IFRS 9, which reflects all phases of the financial instruments project and replaces IAS 39 – *Financial Instruments: Recognition and Measurement* ("IAS 39") and all previous versions of IFRS 9. IFRS 9 sets out the requirements for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This single, principle-based approach replaces existing rule-based requirements and is intended to improve and simplify the reporting for financial instruments.

Debt instruments are classified as amortized cost, fair value through other comprehensive income ("FVOCI") or FVTPL based upon the entity's business model, contractual cash flow characteristics of the instrument and the entity's election, if any, on classification. Equity instruments are classified as FVTPL unless the entity qualifies and elects them as FVOCI. Gains or losses on equity instruments classified as FVOCI are not reclassified to profit and loss, and are therefore not required to be reviewed for impairment. Impairment requirements for debt instruments classified as amortized cost or FVOCI are based on the expected credit loss model which is intended to recognize credit losses earlier compared to IAS 39. IFRS 9 is effective for annual periods beginning on or after January 1, 2018. Retrospective application is required with certain exceptions.

3. STANDARDS ISSUED BUT NOT YET EFFECTIVE (continued)

(b) Financial Instruments: Classification and Measurement (continued)

In September 2016, the IASB issued amendments to IFRS 4 to address issues arising from the different effective dates of IFRS 9 and the new insurance contracts standard (IFRS 17). The amendments introduce two alternative options of applying IFRS 9 for entities issuing contracts within the scope of IFRS 4: an overlay approach and a temporary exemption. The overlay approach permits an entity applying IFRS 9 to remove from profit or loss and present instead in OCI, the impact of measuring qualifying financial assets at FVTPL under IFRS 9 when they would not have been so measured under IAS 39. The temporary exemption permits eligible entities to defer the implementation date of IFRS 9 until annual periods beginning on or after January 1, 2021. In November 2018, the IASB proposed deferring the effective date of IFRS 17 by one year, and as a result proposed extending the implementation date of IFRS 9 under the temporary exemption by one year, to annual periods beginning on or after January 1, 2022. An entity whose activities are predominantly connected with insurance at its annual reporting date that immediately precedes April 1, 2016 is eligible to apply the temporary exemption. As the Company's activities were predominantly connected with insurance as at December 31, 2015 and there have not been any changes to its activities since that date that require it to reassess its eligibility, the Company is eligible to apply the temporary exemption. The Company has chosen to apply the temporary exemption from IFRS 9 to defer the application of IFRS 9 until the effective date of IFRS 17.

(c) Leases

In January 2016, the IASB issued IFRS 16 – *Leases* ("IFRS 16"), which replaces IAS 17 – *Leases* ("IAS 17") and IFRIC 4 – *Determining Whether an Arrangement Contains a Lease* ("IFRIC 4"). IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases. The standard provides a single lessee accounting model, requiring lessees to recognize assets and liabilities for all leases, unless the lease term is twelve months or less or the underlying asset has a low value. At the commencement date of a lease, a lessee will recognize a liability to make lease payments and an asset representing the right to use the underlying asset during the lease term. Lessees will be required to separately recognize the interest expense on the lease liability and the depreciation expense on the right-of-use asset. The standard is effective for annual periods beginning on or after January 1, 2019 and is to be applied using either a full retrospective or a modified retrospective approach.

The Company plans to adopt IFRS 16 using the modified retrospective approach and, therefore, the cumulative effect of adopting IFRS 16 will be recognized as an adjustment to the opening balance of retained earnings at January 1, 2019, with no restatement of comparative information. The Company will elect to apply the practical expedient available on transition to IFRS 16 not to reassess whether a contract is or contains a lease. Accordingly, the definition of a lease in accordance with IAS 17 and IFRIC 4 will continue to apply to those leases entered or modified before January 1, 2019. The Company will elect to use the exemptions in the standard on lease contracts for which the lease term ends within twelve months as of the date of initial application, and lease contracts for which the underlying asset is of low value. The Company has leases of certain office equipment that are considered of low value. The Company's consolidated financial statements will be impacted mainly by the Company's building leases, which we expect will increase the Company's assets and liabilities by approximately $28 million as at January 1, 2019.

4. SIGNIFICANT ACCOUNTING JUDGMENTS, ESTIMATES AND ASSUMPTIONS

The preparation of the Company's consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, and the disclosure of contingent assets and liabilities as at the reporting date and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates. Although some variability is inherent in these estimates, management believes that the amounts provided are reasonable. The most complex and significant judgments, estimates and assumptions used in preparing the Company's consolidated financial statements are discussed below.

Judgments

In the process of applying the Company's accounting policies, management has made the following judgments which have the most significant effect on the amounts recognized in the consolidated financial statements.

The Company has applied judgment in its assessment of control or significant influence over investees, of the identification of objective evidence of impairment for financial instruments, the recoverability and recognition of tax losses, the determination of CGUs, the evaluation of current obligations requiring provisions and the identification of the indicators of impairment for property and equipment, goodwill and intangible assets.

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are discussed below.

4. SIGNIFICANT ACCOUNTING JUDGMENTS, ESTIMATES AND ASSUMPTIONS (continued)

(a) Valuation of claim liabilities

The Company is required by applicable insurance laws, regulations and IFRS to establish liabilities for payment of claims and claims adjustment expenses that arise from the Company's insurance products. These liabilities represent the expected ultimate cost to settle claims occurring prior to, but still outstanding as of, the reporting date. The Company establishes its claim liabilities by geographic region, product line, type and extent of coverage, and year of occurrence.

Claim liabilities fall into two categories: reserves for reported claims and provision for IBNR losses. Additionally, liabilities are held for claims adjustment expenses, which contain the estimated legal and other expenses expected to be incurred to finalize the settlement of the losses.

Determining the provision for unpaid claims and adjustment expenses and the related reinsurers' share involves an assessment of the future development of claims. The estimates are principally based on the Company's historical experience. Methods of estimation have been used which the Company believes produce reasonable results given current information. This 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. Claim liabilities include estimates subject to variability, which could be material. 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 greater the potential for variability in the estimate. Any future changes in estimates would be reflected in the consolidated statement of comprehensive income (loss) in the year in which the change occurred. Note 8 contains additional analysis of the impact of the key assumptions on claim liabilities.

The principal assumptions made in establishing claim liabilities are best estimates. Claim liabilities have been discounted to reflect future investment income in accordance with Canadian accepted actuarial practice. The rate used to discount the claim liabilities is based on the fair value yield of the bond portfolio supporting the claim liabilities. To increase the likelihood that the claim liabilities are adequate to pay future benefits, margins for adverse deviation are required to be included for assumptions regarding future claims development, interest rates and reinsurance recoverables. The Canadian Institute of Actuaries recommends a range of appropriate margins for each of these variables. The combined effect of all the margins produces the PfAD.

Reinsurance recoverables include amounts for expected recoveries from reinsurers related to claim liabilities. Amounts recoverable from reinsurers are evaluated in a manner consistent with the provisions of the reinsurance contracts. The failure of reinsurers to honour their obligations could result in losses to the Company, as the ceding of insurance does not relieve the Company of its primary liability to its insured parties.

(b) Impairment of goodwill and intangible assets

The Company determines whether goodwill and intangible assets are impaired on an annual basis or more frequently if there are indicators of potential impairment. Impairment testing of goodwill and intangible assets requires an estimation of the recoverable amount of the CGUs to which the assets are allocated.

(c) Impairment of financial assets

The Company assesses its AFS financial instruments for objective evidence of impairment at each reporting date. Objective evidence of impairment includes a significant or prolonged decline in the fair value or net asset value below cost, or when a loss event that has a reliably estimable impact on the future cash flows of the financial instrument has occurred. Significance of the decline is evaluated against the original cost of the investment and prolonged decline is measured against the period in which the fair value has been below its original cost. The determination of what is significant or prolonged requires judgment. In making this judgment, the Company evaluates, among other factors, a decline in current financial position, defaults on debt obligations, failure to meet debt covenants, significant downgrades in credit status, and severity and/or duration of the decline in value.

(d) Control or significant influence over investees

The Company presumes that control or significant influence over an investee is evidenced primarily by the ownership percentage held of the investee, unless there are other factors which indicate the level of control is not aligned with the ownership percentage. Currently, there are no material investments in investees for which the assessment of control or significant influence is not aligned with the ownership percentage.

(e) Valuation of post-employment benefits obligation

The projected cost of defined benefit pension plans and other non-pension future benefits is determined using actuarial valuations performed by external pension actuaries. The actuarial valuation involves making assumptions about discount rates, future salary increases, mortality rate, expected health care costs, inflation and future pension increases. The details of the assumptions are disclosed in note 16. Due to the long-term nature of these plans, such estimates are subject to significant uncertainty. Actual experience that differs from the assumptions will affect the amounts of the benefit obligation recognized in

4. SIGNIFICANT ACCOUNTING JUDGMENTS, ESTIMATES AND ASSUMPTIONS (continued)

(e) Valuation of post-employment benefits obligation (continued)

the consolidated balance sheet, the expense recognized in net income (loss) and actuarial gains or losses recognized in OCI in the consolidated statement of comprehensive income (loss). No estimation is required for the defined contribution pension plan given the plan structure.

(f) Measurement of income taxes

The Company is subject to income tax laws in various federal and provincial jurisdictions where it operates. Various tax laws are potentially subject to different interpretations by the taxpayer and the relevant tax authority. To the extent that the Company's interpretations differ from those of tax authorities or the timing of realization is not as expected, the provision for income taxes may increase or decrease in future periods to reflect actual experience. The Company maintains provisions for uncertain tax positions that it believes appropriately reflect the risk of tax positions under discussion, audit dispute or appeal with tax authorities or which are otherwise considered to involve uncertainty.

5. INVESTMENTS

(a) Investment income and balances

Investment income by financial instrument classification is as follows:

(in thousands of dollars)		2018			
	Notes	**FVTPL**	**AFS**	**Loans and receivables**	**Total**
Interest		**$ 34,249**	**$ 33,332**	**$ 4,194**	**$ 71,775**
Dividends		**–**	**35,419**	**–**	**35,419**
Realized (losses) gains on sale of investments		**(22,420)**	**74,645**	**–**	**52,225**
Net impairment losses on AFS investments	5(c)	**–**	**(15,681)**	**–**	**(15,681)**
Unrealized gains on FVTPL financial instruments		**22,387**	**–**	**–**	**22,387**
Recognized (losses) gains on investments		**(33)**	**58,964**	**–**	**58,931**
		$ 34,216	**$ 127,715**	**$ 4,194**	**$ 166,125**

(in thousands of dollars)		2017			
	Notes	FVTPL	AFS	Loans and receivables	Total
Interest		$ 26,350	$ 30,017	$ 3,086	$ 59,453
Dividends		–	38,480	–	38,480
Realized (losses) gains on sale of investments		(8,066)	79,514	–	71,448
Net impairment losses on AFS investments	5(c)	–	(11,381)	–	(11,381)
Unrealized losses on FVTPL financial instruments		(18,891)	–	–	(18,891)
Recognized (losses) gains on investments		(26,957)	68,133	–	41,176
		$ (607)	$ 136,630	$ 3,086	$ 139,109

The fair value yield as at December 31, 2018 for the FVTPL bond portfolio was 2.33% (2017: 2.17%) and for the AFS bond portfolio was 3.02% (2017: 2.65%).

Investment carrying values by financial instrument classification are as follows:

(in thousands of dollars)	2018			
	FVTPL	**AFS**	**Loans and receivables**	**Total**
Short-term investments	**$ –**	**$ 329,708**	**$ –**	**$ 329,708**
Bonds	**1,779,797**	**1,012,653**	**–**	**2,792,450**
Preferred stocks	**–**	**334,029**	**–**	**334,029**
Common stocks	**–**	**329,852**	**–**	**329,852**
Pooled funds	**–**	**53,172**	**–**	**53,172**
Commercial loans	**–**	**–**	**101,504**	**101,504**
	$ 1,779,797	**$ 2,059,414**	**$ 101,504**	**$ 3,940,715**

5. INVESTMENTS (continued)

(a) Investment income and balances (continued)

(in thousands of dollars)	2017			
	FVTPL	AFS	Loans and receivables	Total
Short-term investments	$ –	$ 19,582	$ –	$ 19,582
Bonds	1,671,540	1,015,563	–	2,687,103
Preferred stocks	–	384,121	–	384,121
Common stocks	–	701,182	–	701,182
Pooled funds	–	107,802	–	107,802
Commercial loans	–	–	96,210	96,210
	$ 1,671,540	$ 2,228,250	$ 96,210	$ 3,996,000

The commercial loans have an amortized cost of $101.5 million (2017: $96.2 million) and fair value of $94.2 million (2017: $85.9 million).

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

(in thousands of dollars)	**2018**			
	Cost/ amortized cost	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**
Short-term investments	**$ 328,920**	**$ 788**	**$ –**	**$ 329,708**
Bonds:				
Government	**174,737**	**2,624**	**(287)**	**177,074**
Corporate	**843,494**	**1,152**	**(9,067)**	**835,579**
	1,018,231	**3,776**	**(9,354)**	**1,012,653**
Canadian preferred stocks	**390,088**	**88**	**(56,147)**	**334,029**
Common stocks:				
Canadian	**265,892**	**11,412**	**(12,187)**	**265,117**
Foreign	**36,996**	**28,132**	**(393)**	**64,735**
Foreign pooled funds	**55,788**	**198**	**(2,814)**	**53,172**
	358,676	**39,742**	**(15,394)**	**383,024**
	$ 2,095,915	**$ 44,394**	**$ (80,895)**	**$ 2,059,414**

(in thousands of dollars)	2017			
	Cost/ amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Short-term investments	$ 19,582	$ –	$ –	$ 19,582
Bonds:				
Government	122,442	52	(1,360)	121,134
Corporate	899,643	1,377	(6,591)	894,429
	1,022,085	1,429	(7,951)	1,015,563
Canadian preferred stocks	392,224	3,857	(11,960)	384,121
Common stocks:				
Canadian	495,177	64,726	(3,882)	556,021
Foreign	83,547	61,803	(189)	145,161
Foreign pooled funds	102,848	4,954	–	107,802
	681,572	131,483	(4,071)	808,984
	$ 2,115,463	$ 136,769	$ (23,982)	$ 2,228,250

5. INVESTMENTS (continued)

(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 Company recognizes transfers between the levels of the fair value hierarchy at the end of the reporting period during which the change has occurred. 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, except the pooled funds.

(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 which are valued on a discounted cash flow basis, the pooled funds which are valued based on quoted prices of the underlying securities in an active market and short-term investments which are valued on a discounted cash flow basis. The inputs into the discounted cash flow model for the bonds and short-term investments are an estimate of the expected cash flows discounted at a pre-tax risk-free rate plus an appropriate adjustment for credit risk.

(iii) Level 3 fair value measurements use significant non-market observable inputs, including assumptions about risk or liquidity. As at December 31, 2018, the Company has no financial instruments in this category (2017: nil).

Commercial loans are measured at cost but fair value is disclosed. The fair value is measured on a discounted cash flow basis. The inputs into the discounted cash flow model are an estimate of the expected cash flows discounted at a pre-tax risk-free rate plus an appropriate adjustment for credit risk.

Distribution of financial instruments measured at fair value in the three-level hierarchy is as follows:

(in thousands of dollars)		2018		
	Level 1	**Level 2**	**Level 3**	**Total**
Short-term investments	**$ –**	**$ 329,708**	**$ –**	**$ 329,708**
Bonds	**–**	**2,792,450**	**–**	**2,792,450**
Preferred stocks	**334,029**	**–**	**–**	**334,029**
Common stocks	**329,852**	**–**	**–**	**329,852**
Pooled funds	**–**	**53,172**	**–**	**53,172**
	$ 663,881	**$ 3,175,330**	**$ –**	**$ 3,839,211**

(in thousands of dollars)		2017		
	Level 1	Level 2	Level 3	Total
Short-term investments	$ –	$ 19,582	$ –	$ 19,582
Bonds	–	2,687,103	–	2,687,103
Preferred stocks	384,121	–	–	384,121
Common stocks	701,182	–	–	701,182
Pooled funds	–	107,802	–	107,802
	$ 1,085,303	$ 2,814,487	$ –	$ 3,899,790

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

(c) Impairment review

Impairment reclassification of unrealized losses from AOCI to net loss is as follows:

(in thousands of dollars)	**2018**	2017
Common stocks:		
Canadian	**$ 15,217**	$ 10,344
Foreign	**464**	1,037
	$ 15,681	$ 11,381

5. INVESTMENTS (continued)

(c) Impairment review (continued)

The remaining gross unrealized losses of $80.9 million (2017: $24.0 million) on the AFS investments have not been recognized in net loss as the Company does not believe there is currently objective evidence of impairment.

The Company has determined that there is no evidence of significant 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 amounts of principal and interest.

(d) Securities lending

The Company participates in a securities lending program managed by a major financial institution, whereby the Company lends securities it owns to other financial institutions to allow them to meet delivery commitments. The lending agents assume the risk of borrower default associated with the lending activity. As at December 31, 2018, securities with an estimated fair value of $591.6 million (2017: $569.4 million) have been loaned and securities with an estimated fair value of $608.5 million (2017: $585.8 million) have been received as collateral from the financial institutions. Lending collateral as at December 31, 2018 was 100.0% (2017: 100.0%) held in cash and government-backed securities. The securities loaned 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, amounting to $0.8 million (2017: $0.8 million), is reflected in the consolidated statement of comprehensive loss in “Interest”.

(e) Embedded derivatives

At least annually, the Company conducts a search for embedded derivatives within its significant contracts. No material embedded derivatives were identified that required bifurcation.

6. NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS

The Company’s financial instruments, including investments, are exposed to interest rate risk (including the impact of credit spreads), equity market price risk and preferred stock price risk, credit risk, foreign exchange risk and liquidity risk. The Company’s Statement of Investment Policies and Procedures (“SIP&P”) establishes asset mix parameters and risk limits which minimize undue exposure to these risks in the investment portfolio. The SIP&P is reviewed at least annually by the Investment Committee of the Board of Directors. Compliance with the SIP&P is monitored quarterly by the Investment Committee.

(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. Changes in interest rates can occur from both changes in the Government of Canada yield curve and changes in relevant market credit spreads. Typically, interest income will be reduced during sustained periods of declining 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.

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 FVTPL financial assets which, together with a portion of AFS bonds, is managed to offset the effect that interest rate changes have on the Company’s claim liabilities. The effect of interest rate risk associated with discounting claim liabilities is disclosed in note 8.

The impact of an immediate hypothetical 1 percentage point change in interest rates (assuming a parallel shift across the yield curve), on the FVTPL and AFS bond portfolios, with all other variables held constant is as follows:

(in thousands of dollars)	**2018**		2017	
Impact on:	**+1**	**-1**	+1	-1
Fair value of FVTPL bonds and income before income taxes	**$ (68,754)**	**$ 77,392**	$ (69,336)	$ 77,960
Fair value of AFS bonds and OCI before income taxes	**$ (44,274)**	**$ 50,564**	$ (48,639)	$ 58,627

The estimated impact on income taxes would be calculated at the statutory rate of 26.9% (2017: 26.7%).

(b) Common equity market price risk and preferred stock price risk

Economic trends, the political environment and other factors can positively or adversely impact the equity markets and, consequently, the value of equity investments the Company holds. The Company’s AFS portfolio includes Canadian common stocks with fair value movements that are benchmarked against movements in the Toronto Stock Exchange 60 Index, and foreign stocks and pooled funds with fair values that are benchmarked against movements in the MSCI World Index. Also included in the AFS portfolio are the Company’s holdings of preferred stocks. Economic trends, interest rates, credit conditions, regulatory changes and other factors can positively or adversely impact the value of preferred stocks that the Company holds. The fair value sensitivity of the Company’s preferred stocks are assessed against movements in the BMO 50 Resets Sub-Index.

6. NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS (continued)

(b) Common equity market price risk and preferred stock price risk (continued)

The estimated impact of a 10% movement in the aforementioned indices to the value of the Company's equity portfolios, with all other variables held constant, to the extent the Company does not dispose of any of these equities during the year, is as follows:

(in thousands of dollars)	2018		2017	
Impact on:	+10%	-10%	+10%	-10%
Fair value of Canadian stocks and OCI before income taxes	$ 28,333	$ (28,333)	$ 59,584	$ (59,584)
Fair value of foreign stocks, pooled funds and OCI before income taxes	$ 11,872	$ (11,872)	$ 25,471	$ (25,471)
Fair value of preferred stocks and OCI before income taxes	$ 28,464	$ (28,464)	$ 34,334	$ (34,334)

The estimated impact on income taxes would be calculated at the statutory rate of 26.9% (2017: 26.7%).

(c) Credit risk

Credit risk is the risk of financial loss caused by 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, amounts owing from reinsurers and structured settlements. Unless otherwise stated, the Company's credit exposure is limited to the carrying amount of these assets. The Company's principal approach to mitigate credit risk is to maintain high credit quality standards and to diversify credit exposures by limiting single name concentrations. Concentration risk also exists where multiple counterparties may be financially affected by changing economic conditions in a similar manner. As noted below, the Company has a concentration of investments in Canada and within the financial and energy sectors. These risk concentrations are regularly monitored and adjusted as deemed necessary.

Bonds and preferred stocks

The Company's SIP&P requires the Company to invest in bonds and preferred stocks of high credit quality and limit exposure with respect to any one issuer. On a regular basis, the Company also monitors publicly available information referencing the investments held in the investment portfolio to determine whether there are investments which require closer monitoring of the credit risk. Of the bonds held as at December 31, 2018, 92.8% (2017: 90.5%) were rated "A-" or better and 84.3% (2017: 79.5%) of the preferred stocks were rated "P2" or better. "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.

Of the preferred stocks and corporate bonds held, the industry of issuer is as follows:

	2018	2017
Financial services	59.9%	58.0%
Energy	13.2%	13.0%
Industrials	6.6%	3.6%
Utilities	6.3%	9.4%
Real estate	4.6%	2.8%
Consumer staples	1.7%	5.6%
Other	7.7%	7.6%
	100.0%	100.0%

Of the preferred stocks and bonds held, the country of issuer is as follows:

	2018	2017
Canada	98.2%	95.9%
United States	1.5%	3.2%
Other	0.3%	0.9%
	100.0%	100.0%

Securities lending

As disclosed in note 5, the Company participates in a securities lending program. The Company manages credit risk associated with this program by only dealing with counterparties who are rated "A" or higher by independent rating agencies and by obtaining collateral with a fair value in excess of the value of the securities loaned under the program. The ratio of fair value of collateral obtained in excess of the fair value of the securities loaned as at December 31, 2018 is 102.9% (2017: 102.9%).

(c) Credit risk (continued)

Premiums receivable

The Company's credit exposure to any one individual policyholder or broker included in premiums receivable is not significant. The Company regularly monitors amounts due from policyholders and follows up on all overdue accounts. As permitted by regulation, when premiums are overdue for an extended period of time the Company cancels the insurance coverage under the applicable policy. Before a broker is granted a contract, appropriate reviews are conducted by the Company. Delinquent accounts are regularly monitored and the Company takes action against non-payment. The allowance for doubtful accounts in the current and comparative periods is insignificant as overdue receivables are not material.

Commercial loans

The Company periodically issues commercial loans to brokers. Collateral, principally in the form of security over a borrowing brokerage's operating assets, is held to protect the Company against loss in the event of a default of any of these loans. Annually, and where required more frequent, financial reviews are undertaken to determine if the broker is expected to be able to make the payments required by the loan as and when due. The Company's gross credit exposure on these commercial loans is limited to their carrying value as disclosed in note 5. Management does not consider any of these current commercial loans to be impaired as at December 31, 2018.

Reinsurance receivable and recoverable

Credit exposures on the Company's reinsurance receivable and recoverable balances exist to the extent that any reinsurer may not be willing or able to reimburse the Company under the terms of the relevant reinsurance arrangements. The Company has policies which limit the exposure to individual reinsurers and a regular review process to assess the creditworthiness of reinsurers with whom the Company purchases coverage. The Company's reinsurance risk management policy generally precludes the use of reinsurers with credit ratings less than "A-".

Currently, all reinsurers have a credit rating of "A-" or better as determined by independent rating agencies. Where appropriate, the Company obtains collateral for outstanding balances in the form of cash, letters of credit, offsetting balances payable, guarantees or assets held under reinsurance security agreements. The Company has recorded an allowance for losses on reinsurance receivable and recoverable of $0.5 million (2017: $0.5 million).

Structured settlements

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 fulfil their obligations. This risk is managed by acquiring annuities from multiple life insurers with proven financial stability, all of which are rated "A-" or better by independent rating agencies. As at December 31, 2018, 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 was recorded (2017: nil). The original purchase price of the outstanding annuities is $305.8 million (2017: $298.6 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 relative to the Canadian dollar. The Company's foreign exchange risk relates primarily to its foreign common stock and pooled fund holdings in the AFS portfolio which are denominated in various foreign currencies.

The Company's largest foreign currency exposure is to the US dollar. The impact on the fair value of US dollar foreign stocks, pooled funds and OCI before income taxes from a 10% change in the US dollar relative to the Canadian dollar is $6.8 million (2017: $13.2 million). Under this same scenario, the impact on the fair value of non-US dollar foreign stocks, pooled funds and OCI before income taxes is $1.9 million (2017: $4.3 million) assuming historical correlations between currency pairs remain intact. The estimated impact on income taxes would be calculated at the statutory rate of 26.9% (2017: 26.7%).

(e) Liquidity risk

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

As at December 31, 2018, the Company has $135.3 million (2017: $166.4 million) of cash and cash equivalents and short-term investments of $329.7 million (2017: $19.6 million). The Company also has a highly liquid investment portfolio. As at December 31, 2018, Canadian fixed income investments issued or guaranteed by domestic governments, investment-grade corporate bonds, publicly traded Canadian and foreign equities and the pooled funds have a fair value of $3,457.0 million (2017: $3,801.4 million).

6. NATURE AND EXTENT OF RISKS ARISING FROM FINANCIAL INSTRUMENTS (continued)

(e) Liquidity risk (continued)

The table below summarizes the maturity profile of the financial assets and financial liabilities of the Company.

For claim liabilities and reinsurance receivable and recoverable, maturity profiles are determined based on estimated timing of net cash flows on an undiscounted basis. DPAE, UPR and the reinsurers' share of UPR have been excluded from the analysis as they are not of themselves contractual obligations.

(in thousands of dollars)	2018				
	Less than 1 year	**1-5 years**	**6-10 years**	**10 years +**	**Total**
Assets:					
Cash and cash equivalents	**$ 135,288**	**$ –**	**$ –**	**$ –**	**$ 135,288**
Short-term investments	**329,708**	**–**	**–**	**–**	**329,708**
FVTPL bonds	**69,798**	**1,101,261**	**608,738**	**–**	**1,779,797**
AFS bonds	**58,935**	**391,866**	**561,852**	**–**	**1,012,653**
Preferred stocks	**159,116**	**174,913**	**–**	**–**	**334,029**
Commercial loans	**17,206**	**36,536**	**47,762**	**–**	**101,504**
Accrued investment income	**15,502**	**–**	**–**	**–**	**15,502**
Premiums receivable	**834,636**	**2,406**	**–**	**–**	**837,042**
Income taxes receivable	**12,991**	**–**	**–**	**–**	**12,991**
Reinsurance receivable and recoverable	**40,346**	**13,272**	**2,253**	**280**	**56,151**
	$ 1,673,526	**$ 1,720,254**	**$ 1,220,605**	**$ 280**	**$ 4,614,665**
Liabilities:					
Claim liabilities	**$ 813,613**	**$ 1,289,555**	**$ 400,471**	**$ 105,102**	**$ 2,608,741**
Accounts payable and other liabilities	**163,951**	**7,497**	**8,588**	**23,924**	**203,960**
	$ 977,564	**$ 1,297,052**	**$ 409,059**	**$ 129,026**	**$ 2,812,701**

(in thousands of dollars)	2017				
	Less than 1 year	1-5 years	6-10 years	10 years +	Total
Assets:					
Cash and cash equivalents	$ 166,389	$ –	$ –	$ –	$ 166,389
Short-term investments	19,582	–	–	–	19,582
FVTPL bonds	104,490	926,813	640,237	–	1,671,540
AFS bonds	96,623	330,047	520,318	68,575	1,015,563
Preferred stocks	50,223	328,581	5,317	–	384,121
Commercial loans	6,164	42,545	47,501	–	96,210
Accrued investment income	15,294	–	–	–	15,294
Premiums receivable	696,154	3,456	–	–	699,610
Income taxes receivable	45,716	–	–	–	45,716
Reinsurance receivable and recoverable	27,255	20,303	3,426	481	51,465
	$ 1,227,890	$ 1,651,745	$ 1,216,799	$ 69,056	$ 4,165,490
Liabilities:					
Claim liabilities	$ 724,999	$ 1,221,446	$ 400,378	$ 115,181	$ 2,462,004
Accounts payable and other liabilities	171,607	8,143	10,352	42,398	232,500
	$ 896,606	$ 1,229,589	$ 410,730	$ 157,579	$ 2,694,504

Note 16(c) contains the maturity profile for other post-employment benefit obligations.

The Company believes that it currently has the flexibility to obtain the funds needed to meet cash requirements on an ongoing basis.

7. POLICY LIABILITIES

These consolidated financial statements contain an actuarial estimate of the policy liabilities of the Company. Policy liabilities represent the amount of the obligation of the Company on account of policies effective on or before the reporting date and consist of premium and claim liabilities. Claim liabilities are associated with claims that have occurred on or before December 31, 2018, whether the claim has been reported to the Company at that time or not, whereas premium liabilities are associated with claims that may occur in the future on policies in force on December 31, 2018.

(a) Premium liabilities

Premium liabilities are represented by the amount of net UPR less the amount of net DPAE. Generally, the commissions and premium taxes corresponding to the net UPR are deferrable; however, this amount is written down if the resulting expected future net policy costs are greater than the net UPR. No such write-down to DPAE was considered necessary for the year ended December 31, 2018 (2017: nil).

The following changes have occurred in UPR during the year:

(in thousands of dollars)		**2018**			2017		
	Notes	**Gross**	**Ceded**	**Net**	Gross	Ceded	Net
UPR, beginning of year		**$ 1,131,366**	**$ 7,928**	**$ 1,123,438**	$ 1,077,303	$ 8,266	$ 1,069,037
Acquisition of Petline	20	**–**	**–**	**–**	2,135	–	2,135
Premiums written during year	9	**2,456,314**	**75,576**	**2,380,738**	2,286,855	68,768	2,218,087
Premiums earned during year	9	**(2,319,168)**	**(74,538)**	**(2,244,630)**	(2,234,927)	(69,106)	(2,165,821)
UPR, end of year		**$ 1,268,512**	**$ 8,966**	**$ 1,259,546**	$ 1,131,366	$ 7,928	$ 1,123,438

The following changes have occurred in the DPAE during the year:

(in thousands of dollars)	Notes	**2018**	2017
DPAE, beginning of year		**$ 221,172**	$ 216,700
Acquisition of Petline	20	**–**	132
Acquisition costs deferred		**428,214**	411,751
Amortization of acquisition costs		**(419,294)**	(407,411)
DPAE, end of year		**$ 230,092**	$ 221,172

The following table presents the Company's UPR by line of business as at December 31.

(in thousands of dollars)		**2018**	
	Gross UPR	**Ceded UPR**	**Net UPR**
Personal lines:			
Auto	**$ 654,976**	**$ –**	**$ 654,976**
Property	**271,046**	**–**	**271,046**
	926,022	**–**	**926,022**
Commercial lines:			
Auto	**127,246**	**1,892**	**125,354**
Property and liability	**215,244**	**7,074**	**208,170**
	342,490	**8,966**	**333,524**
	$ 1,268,512	**$ 8,966**	**$ 1,259,546**

(in thousands of dollars)		2017	
	Gross UPR	Ceded UPR	Net UPR
Personal lines:			
Auto	$ 534,268	$ –	$ 534,268
Property	233,017	–	233,017
	767,285	–	767,285
Commercial lines:			
Auto	133,519	1,848	131,671
Property and liability	230,562	6,080	224,482
	364,081	7,928	356,153
	$ 1,131,366	$ 7,928	$ 1,123,438

7. POLICY LIABILITIES (continued)

(b) Claim liabilities

Claim liabilities are established to reflect the estimate of the full amount of all liabilities associated with the insurance contracts at the end of the year, including IBNR. The ultimate cost of these liabilities will vary from the best estimate made for a variety of reasons, including additional information with respect to the facts and circumstances of the claims incurred. Note 4 contains additional information on the judgments, estimates and assumptions used in determining claim liabilities. The discount rate as at December 31, 2018 used to discount the claim liabilities was 2.50% (2017: 2.32%).

The following table presents the movement of the Company's claim liabilities during the year.

(in thousands of dollars)	2018		
	Gross claim liabilities	**Ceded claim liabilities**	**Net claim liabilities**
Claim liabilities, beginning of year	**$ 2,527,673**	**$ 54,487**	**$ 2,473,186**
Current year claims incurred	**1,730,864**	**17,419**	**1,713,445**
Prior year (favourable) adverse claims development	**(7,374)**	**11,404**	**(18,778)**
	1,723,490	**28,823**	**1,694,667**
(Decrease) increase due to discounting (including PfAD)	**(4,025)**	**273**	**(4,298)**
Claims and adjustment expenses	**1,719,465**	**29,096**	**1,690,369**
Claims paid during the year	**1,576,560**	**28,192**	**1,548,368**
Claim liabilities, end of year	**$ 2,670,578**	**$ 55,391**	**$ 2,615,187**

(in thousands of dollars)		2017		
	Notes	Gross claim liabilities	Ceded claim liabilities	Net claim liabilities
Claim liabilities, beginning of year		$ 2,399,254	$ 98,234	$ 2,301,020
Acquisition of Petline	20	3,347	–	3,347
Current year claims incurred		1,635,810	9,312	1,626,498
Prior year adverse (favourable) claims development		29,111	(3,471)	32,582
		1,664,921	5,841	1,659,080
Decrease due to discounting (including PfAD)		(39,065)	(1,847)	(37,218)
Claims and adjustment expenses		1,625,856	3,994	1,621,862
Claims paid during the year		1,500,784	47,741	1,453,043
Claim liabilities, end of year		$ 2,527,673	$ 54,487	$ 2,473,186

The following table presents the Company's claim liabilities by line of business as at December 31.

(in thousands of dollars)	2018		
	Gross claim liabilities	**Ceded claim liabilities**	**Net claim liabilities**
Personal lines:			
Auto	**$ 1,609,640**	**$ 9,263**	**$ 1,600,377**
Property	**140,298**	**2,640**	**137,658**
	1,749,938	**11,903**	**1,738,035**
Commercial lines:			
Auto	**443,810**	**9,005**	**434,805**
Property and liability	**476,830**	**34,483**	**442,347**
	920,640	**43,488**	**877,152**
	$ 2,670,578	**$ 55,391**	**$ 2,615,187**

7. POLICY LIABILITIES (continued)

(b) Claim liabilities (continued)

(in thousands of dollars)	2017		
	Gross claim liabilities	Ceded claim liabilities	Net claim liabilities
Personal lines:			
Auto	$ 1,519,224	$ 9,779	$ 1,509,445
Property	115,748	941	114,807
	1,634,972	10,720	1,624,252
Commercial lines:			
Auto	433,202	15,997	417,205
Property and liability	459,499	27,770	431,729
	892,701	43,767	848,934
	$ 2,527,673	$ 54,487	$ 2,473,186

8. NATURE AND EXTENT OF RISKS ARISING FROM INSURANCE CONTRACTS

Insurance risk management

By the very nature of an insurance contract, there is uncertainty as to whether an insured event will occur and the amount of loss that would arise in such an event. In the course of these insurance activities, there are several risks the Company must address by applying appropriate underwriting and claims policies and processes. The following discussion outlines the most significant insurance risks and the practices employed to mitigate these risks.

(a) Underwriting risk

Underwriting risk is the risk of adverse financial exposures arising from various activities integral to the underwriting of insurance products, including: product design, pricing, risk acceptance and claims settlement. The Company's exposure to concentrations of insured risks is mitigated by the use of segmentation, policy issuance and risk acceptance rules, individual limits and reinsurance.

The concentration of gross written premiums, claims and adjustment expenses, and other underwriting expenses (the sum of net commissions, operating expenses, premium taxes, and net of other underwriting revenues) by line of business is as follows:

	Gross written premiums		Claims and adjustment expenses		Other underwriting expenses	
	2018	2017	**2018**	2017	**2018**	2017
Personal auto	**49.8%**	45.5%	**51.5%**	49.7%	**46.8%**	45.8%
Personal property	**22.6%**	21.7%	**18.6%**	16.1%	**24.2%**	22.3%
Commercial auto	**10.3%**	12.3%	**12.6%**	16.2%	**9.5%**	10.7%
Commercial property and liability	**17.3%**	20.5%	**17.3%**	18.0%	**19.5%**	21.2%
	100.0%	100.0%	**100.0%**	100.0%	**100.0%**	100.0%

The concentration of gross written premiums by geographical region is as follows:

	2018	2017
Ontario	**61.2%**	60.2%
Alberta and Prairies	**14.4%**	14.0%
British Columbia	**10.7%**	12.5%
Atlantic	**7.7%**	7.0%
Quebec	**6.0%**	6.3%
	100.0%	100.0%

8. NATURE AND EXTENT OF RISKS ARISING FROM INSURANCE CONTRACTS (continued)

(a) Underwriting risk (continued)

A financial loss occurs when the liabilities assumed exceed the expectation reflected in the pricing of an insurance product. The Company prices its products by taking into account numerous factors including product design and features, claim frequency and severity trends, product line expense ratios, special risk factors, capital requirements, regulatory requirements, and expected investment returns. These factors are reviewed and adjusted on an ongoing basis to ensure they are reflective of current trends and market conditions. The Company endeavours to maintain pricing levels that produce an acceptable return by appropriately measuring and incorporating these factors into its pricing decisions. Pricing segmentation and risk selection are used together with a view to attracting and retaining risks at acceptable return rates. The process of calculating pricing involves the use of models, which exposes the Company to model risk in the event that actual results differ from those modelled, due to model limitations, data issues, human error, or other factors.

New products and product changes are subject to a detailed review by management, including the Company's actuarial specialists, prior to their launch in order to mitigate the risk that they are priced at an inadequate level. The performance and pricing of all of the Company's products are regularly monitored and corrective action is taken as considered necessary, including re-pricing of the products, modifications of product terms, conditions and eligibility requirements, the level of capacity provided, and the use of reinsurance.

To minimize the risk arising from underwriting, the Company has policies that set out the underwriting risk appetite and criteria, as well as specified tolerances for maximum financial risk retention and management processes to monitor compliance with these limits. The Company utilizes reinsurance in order to manage its exposure to insured risks. Once the retention limits are reached, reinsurance is utilized with the aim of covering the excess risk. The Company reviews the adequacy of its reinsurance programs, at least annually, with the objective of ensuring sufficient reinsurance protection is in place at an appropriate cost.

To control the Company's exposure to unpredictable future developments that could negatively impact claims settlement, the Company promptly responds to new claims and actively manages existing claims, thereby shortening the claims cycle. In addition, the Company's regular detailed review of claims handling procedures, active litigation management, and proactive identification and investigation of possible fraudulent claims seeks to ensure the claims risk exposure does not exceed the claim cost expectations inherent in the pricing of the Company's products.

In the normal course of business, the Company is, from time to time, subject to a variety of legal and regulatory actions relating to its operations. In addition, plaintiffs continue to bring new types of legal claims against insurance and related companies. Current and future court decisions and legislative and regulatory activity may increase the Company's exposure to these types of claims. This risk of potential liability may make reasonable resolution of claims more difficult to obtain.

Quality review procedures seek to ensure that the Company's underwriting and claim activities fall within established guidelines and pricing structures. Head Office and field level reviews are conducted on a test basis. The results of these quality reviews are shared with the appropriate field management staff to ensure any issues identified can be promptly addressed.

The Company uses reinsurance to manage its exposure to insured risks. Reinsurance coverage risk arises because reinsurance terms, conditions, availability and/or pricing may change on renewal, particularly during times of high levels of catastrophe events, either in Canada or globally, or as a result of higher than expected claims activity on non-catastrophe reinsurance treaties. In addition, reinsurers may seek to impose terms that are inconsistent with corresponding terms in the policies written by the Company. Ceding risk to reinsurers does not relieve the Company of the obligation to its policyholders for claims, thereby requiring the Company to manage the level of credit risk associated with reinsurers and the Company's recoverable balances. Senior management reviews the Company's reinsurance program with the intention of ensuring its cost effectiveness and that adequate coverage is obtained, which reflects the Company's risk tolerances, underwriting practices, and financial strength, while at the same time complying with its reinsurance and capital risk management policies.

The P&C industry is subject to significant government regulation. As a result, it is possible that future regulatory changes or changes in interpretations may limit the Company's ability to adjust prices, adjudicate claims or take other actions that would impact operating results. The Company seeks to mitigate this risk through regular discussions with regulators and P&C industry groups to ensure the Company is aware of proposed changes and by providing feedback to regulators on proposed changes. The Company monitors compliance with relevant regulations and considers the implications of potential changes in regulation or interpretation on future results. Note 17 provides information on regulatory capital requirements. Note 19 provides additional details on rate regulation.

(b) Claims reserving risk

Claims reserving risk represents the risk that the Company's estimates of claim liabilities are insufficient to cover future insurance claim payments. The Company's underwriting profitability depends upon the ability to accurately assess the risk associated with the insurance contracts underwritten by the Company. The Company establishes claim liabilities to cover the estimated liability for payment of all claims and claims adjustment expenses incurred with respect to insurance contracts underwritten by the Company. Claim liabilities do not represent an exact calculation of the liability. Rather, they are the Company's best estimates of the expected ultimate future cost of resolution and administration of claims. The process of calculating claim liabilities involves the use of models, which exposes the Company to model risk in the event that actual results differ from those modelled, due to model limitations, data issues, human error, or other factors. To address inflation risk, expected inflation is taken into account when estimating claim liabilities.

(b) Claims reserving risk (continued)

Claim liabilities include an estimate for reported claims, as established by the Company's claims adjusters based on the details of reported claims, plus a provision for IBNR, as established by the Company's corporate actuaries.

Individual claims estimates are determined by claims adjusters on a case-by-case basis in accordance with documented policies and procedures. These specialists apply their experience, knowledge and expertise, after taking into account available information regarding the circumstances of the claim to set individual case reserve estimates. Uncertainty exists on reported claims in that all information may not be available at the valuation date. Uncertainty also exists regarding the number and size of claims not yet reported as well as the timing of when the claims will be reported. Accordingly, the IBNR provision is intended to cover future additional costs emerging on both reported claims and claims that have occurred but have not yet been reported.

The valuation of claim liabilities is based on estimates derived by geographical region and line of business using generally accepted actuarial techniques. Numerous individual assumptions that impact average claim costs or frequency of late reported claims are made for each line of business. The main assumption in the majority of actuarial techniques employed is that future claims development will follow a pattern similar to recent historical experience. However, there are times where historical experience is deemed inappropriate for evaluating future development because there is not enough credible data or because recent judicial decisions, changes to legislation or major shifts in a book of business indicate a departure from historical trends. Such instances can require significant actuarial judgment, often supported by industry benchmarks, in establishing an adequate provision for claim liabilities.

As the outstanding claim liabilities are intended to represent payments that will be made in the future, they are discounted to reflect the time value of money, effectively recognizing that the bonds held to support insurance liabilities will earn a return during that period. The discount rate used to discount the actuarial value of claim liabilities is based on the fair value yield of the Company's bonds that support the claim liabilities (note 5). In assessing the risks associated with investment income and therefore the discount rate, the Company considers the nature of the bond portfolio and the timing of claim payments, and the extent to which they match, to expected investment cash flows. Future changes in the bond portfolio could change the value of claim liabilities by impacting the fair value yield.

The following table presents the interest rate sensitivity analysis for a 1 percentage point change in interest rates on the net claim liabilities:

(in thousands of dollars)	**2018**		2017	
Impact on:	**+1**	**-1**	+1	-1
Net claim liabilities	**$ (71,816)**	**$ 72,655**	$ (69,681)	$ 74,653

Establishing an adequate provision for claim liabilities is an inherently uncertain process and is closely monitored by the Company's corporate actuarial department. Claim liabilities, including the provision for IBNR as established by the Company's corporate actuaries, is subject to an internal and external peer review process to assess the adequacy of the provision for claim liabilities. The sheer volume and diversity of considerations makes it impracticable to measure the impact on the Company's insurance contracts resulting from a change in a particular assumption or group of assumptions. The analysis below demonstrates the impact of changing assumptions for all lines of business and geographical regions in such a way that the average claim severity and frequency is altered significantly. The analysis below also isolates the impact within the average claims severity of a change in internal claims expenses on claim liabilities. The impacts below are on the reported claim liabilities as at December 31.

(in thousands of dollars)	**2018**		2017	
Impact of change in net claim liabilities due to:	**+5%**	**-5%**	+5%	-5%
Change in average claims severity	**$ 123,602**	**$ (123,602)**	$ 116,227	$ (116,227)
Change in frequency on unreported claims	**$ 9,468**	**$ (9,468)**	$ 11,727	$ (11,727)
Change in internal claims expenses	**$ 7,050**	**$ (7,050)**	$ 7,264	$ (7,264)

Assumptions and 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 comprehensive loss in the year in which the change occurred.

The following table shows the development of claims over a period of time. The table reflects development for net claims, which is gross claims less reinsurance recoveries. The triangle in the table ("Estimate of ultimate claims") shows how the ultimate estimates of total claims for each accident year develop over time as more information becomes known regarding individual claims and overall claims frequency and severity. Each column tracks the claims relating to a particular "accident year" which is the year in which such loss events occurred, regardless of when they were reported. The rows reflect the estimates in subsequent years for each accident year's claims. Claims are presented on an undiscounted basis in the triangle. "Cumulative claims paid" in the table presents the cumulative amounts paid for claims for each accident year as at December 31, 2018.

8. NATURE AND EXTENT OF RISKS ARISING FROM INSURANCE CONTRACTS (continued)

(b) Claims reserving risk (continued)

The claims development table excludes the FA, RSP/PRR and the effect of discounting (including PfAD), which are shown as separate reconciling items below the table.

Claims development table, net of reinsurance:

	Accident Year										
(in thousands of dollars)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
Estimate of ultimate claims											
At end of accident year	$ 1,401,630	$ 1,198,256	$ 1,129,584	$ 1,058,577	$ 1,224,981	$ 1,258,496	$ 1,273,526	$ 1,425,491	$ 1,602,560	$ 1,686,879	
1 year later	1,352,544	1,085,810	1,038,734	1,005,550	1,211,859	1,241,147	1,248,044	1,444,990	1,586,299		
2 years later	1,349,179	1,086,656	1,031,543	1,003,497	1,211,541	1,238,117	1,278,937	1,448,896			
3 years later	1,368,331	1,088,028	1,050,942	1,003,389	1,225,102	1,245,156	1,276,975				
4 years later	1,367,656	1,099,605	1,047,484	1,010,459	1,234,644	1,252,673					
5 years later	1,364,157	1,097,641	1,045,845	1,014,567	1,232,894						
6 years later	1,352,093	1,090,703	1,042,173	1,014,984							
7 years later	1,343,588	1,083,390	1,040,386								
8 years later	1,336,246	1,081,250									
9 years later	1,335,000										
(Favourable) adverse development recognized in the year, undiscounted	(1,246)	(2,140)	(1,787)	417	(1,750)	7,517	(1,962)	3,906	(16,261)		$ (13,306)
Adverse development recognized from 2008 and prior accident years											1,953
Favourable development recognized from FA and RSP/PRR ceded and assumed in the year											(7,425)
Total favourable development recognized in the year											$ (18,778)
Reconciliation to the consolidated balance sheet											
Current estimate of ultimate claims	1,335,000	1,081,250	1,040,386	1,014,984	1,232,894	1,252,673	1,276,975	1,448,896	1,586,299	1,686,879	$ 12,956,236
Cumulative claims paid	1,308,617	1,053,170	1,003,371	955,002	1,134,813	1,077,600	1,016,355	1,074,232	1,088,479	803,507	10,515,146
Current unpaid and unreported claims before discounting	26,383	28,080	37,015	59,982	98,081	175,073	260,620	374,664	497,820	883,372	2,441,090
Current unpaid and unreported claims before discounting pertaining to 2008 and prior accident years											82,535
Impact of discounting (including PfAD)											59,957
FA and RSP/PRR ceded and assumed, unpaid and unreported											31,605
Unpaid and unreported claims, net of reinsurance											$ 2,615,187

(c) Catastrophe risk

Catastrophe risk may arise if the Company experiences a considerable number of losses due to human-made or natural catastrophes that result in significant impacts on claims costs. Catastrophes can cause losses in a variety of different lines of business and may have continuing effects which, by their nature, could impede efforts to accurately assess the full extent of the damage they cause on a timely basis. Although the Company evaluates catastrophe events and assesses the probability of occurrence and magnitude of impact through various commonly used, industry accepted modelling techniques and through the aggregation of limits exposed in each geographical territory in which it operates, such events are inherently unpredictable and difficult to quantify. In addition, the incidence and severity of catastrophe events may become increasingly unpredictable as climate patterns change, and severe weather caused by climate change will likely continue to affect the P&C industry and result in higher claims costs.

The Company manages its catastrophe events exposure through the deductibles charged to policyholders, by limitations on policies, by purchasing reinsurance, and monitoring the impact on capital position and overall risk tolerances.

9. REINSURANCE CONTRACTS

The Company follows the policy of underwriting and reinsuring contracts of insurance which limits the liability of the Company for individual large losses and in the event of a series of claims arising out of a single occurrence. These limits were as follows:

(in thousands of dollars)	**2018**	2017
Individual loss		
Property		
Net company retention	**$ 3,000**	$ 3,000
Maximum limit	**60,000**	60,000
Auto and general liability		
Net company retention	**4,000**	4,000
Maximum limit	**40,000**	40,000
Catastrophe – primary		
Net company retentions[1]	**30,000**	30,000
Maximum limit	**1,150,000**	1,150,000

[1] In addition to $30.0 million (2017: $30.0 million) of net retention, the Company had a maximum $63.6 million (2017: $63.6 million) participation in higher layers of the treaty. If a catastrophe breaches the retention level, the Company is required to pay an automatic reinstatement premium commensurate with the reinsurance coverage utilized. Further reinstatement coverage may be sought by the Company at an additional cost.

In addition, the Company has purchased facultative reinsurance coverage as required in line with its underwriting guidelines.

(a) Underwriting impact of reinsurance contracts

The following amounts relate to reinsurance ceded recorded in the consolidated statement of comprehensive loss:

(in thousands of dollars)	Notes	**2018**	2017
Premiums written	7,18	**$ 75,576**	$ 68,768
Premiums earned	7	**74,538**	69,106
Claims and adjustment expenses	7	**28,823**	5,841
Commissions		**3,649**	3,747

The following amounts relate to reinsurance assumed recorded in the consolidated statement of comprehensive loss:

(in thousands of dollars)	Notes	**2018**	2017
Premiums written	18	**$ –**	$ (1,809)
Premiums earned		**–**	(338)
Claims and adjustment expenses		**113**	(2,521)
Commissions		**102**	(336)

(b) Reinsurance receivable and recoverable

The amounts presented under reinsurance receivable and recoverable in the consolidated balance sheet represent the Company's contractual rights under reinsurance contracts and are evaluated in a manner consistent with the gross liabilities.

(in thousands of dollars)	Notes	**2018**	2017
Reinsurers' share of UPR	7	**$ 8,966**	$ 7,928
Reinsurers' share of claim liabilities	7	**55,391**	54,487
Reinsurer receivables		**12,975**	6,885
Reinsurer payables		**(10,452)**	(8,418)
Unearned reinsurance commissions		**(2,159)**	(1,825)
		$ 64,721	$ 59,057

9. REINSURANCE CONTRACTS (continued)

(c) Reinsurance assumed contracts

The Company presents balances related to reinsurance assumed contracts in the same manner as it presents direct insurance business with the exception of reinsurance assumed receivables and payables which are presented in "Reinsurance receivable and recoverable". The portion of assets and liabilities related to assumed contracts is as follows:

Reinsurance assumed assets:

(in thousands of dollars)	**2018**	2017
Reinsurance assumed receivables	**$ 527**	$ 144
	$ 527	$ 144

Reinsurance assumed liabilities:

(in thousands of dollars)	**2018**	2017
Claim liabilities	**$ 7,623**	$ 8,518
Reinsurance assumed payables	**180**	800
	$ 7,803	$ 9,318

10. PROPERTY AND EQUIPMENT

Property and equipment, as presented on the consolidated balance sheet, is composed of the following:

(in thousands of dollars)	**2018**					
	Land and building structure	**Building fixtures**	**Building infrastructure**	**Furniture and equipment**	**Computer equipment**	**Total**
Cost:						
Balance, beginning of year	**$ 31,350**	**$ 10,911**	**$ 14,114**	**$ 27,516**	**$ 15,173**	**$ 99,064**
Additions	**3,405**	**–**	**269**	**667**	**1,140**	**5,481**
Disposals	**(295)**	**–**	**–**	**(89)**	**(600)**	**(984)**
Balance, end of year	**$ 34,460**	**$ 10,911**	**$ 14,383**	**$ 28,094**	**$ 15,713**	**$ 103,561**
Accumulated depreciation:						
Balance, beginning of year	**$ 10,313**	**$ 9,208**	**$ 7,862**	**$ 20,164**	**$ 10,327**	**$ 57,874**
Depreciation charge	**2,051**	**89**	**461**	**2,923**	**2,087**	**7,611**
Depreciation on disposals	**(217)**	**–**	**–**	**(77)**	**(564)**	**(858)**
Balance, end of year	**$ 12,147**	**$ 9,297**	**$ 8,323**	**$ 23,010**	**$ 11,850**	**$ 64,627**
Net book value, end of year	**$ 22,313**	**$ 1,614**	**$ 6,060**	**$ 5,084**	**$ 3,863**	**$ 38,934**

(in thousands of dollars)		2017					
	Notes	Land and building structure	Building fixtures	Building infrastructure	Furniture and equipment	Computer equipment	Total
Cost:							
Balance, beginning of year		$ 27,685	$ 10,519	$ 13,544	$ 24,647	$ 13,299	$ 89,694
Acquisition of Petline	20	1,035	–	–	148	147	1,330
Additions		2,630	392	570	2,846	2,440	8,878
Disposals		–	–	–	(125)	(713)	(838)
Balance, end of year		$ 31,350	$ 10,911	$ 14,114	$ 27,516	$ 15,173	$ 99,064
Accumulated depreciation:							
Balance, beginning of year		$ 8,966	$ 9,006	$ 7,426	$ 16,043	$ 9,170	$ 50,611
Depreciation charge		1,347	202	436	4,217	1,863	8,065
Depreciation on disposals		–	–	–	(96)	(706)	(802)
Balance, end of year		$ 10,313	$ 9,208	$ 7,862	$ 20,164	$ 10,327	$ 57,874
Net book value, end of year		$ 21,037	$ 1,703	$ 6,252	$ 7,352	$ 4,846	$ 41,190

Depreciation charged to "Operating expenses" amounted to $7.6 million (2017: $8.1 million).

11. INCOME TAXES

(a) Income tax recovery

The reconciliation of income tax calculated at the Canadian statutory tax rate to the income tax recovery at the effective tax rate recorded in net loss in the consolidated statement of comprehensive loss is provided in the table below:

(in thousands of dollars)		**2018**		2017
Income tax recovery calculated based on statutory tax rates	**26.9%**	**$ (31,619)**	26.7%	$ (37,106)
Canadian dividend income not subject to tax	**6.9%**	**(8,107)**	6.0%	(8,277)
Effect of change in tax rates	**0.2%**	**(204)**	–	–
Non-deductible expenses	**(0.2%)**	**206**	(0.1%)	87
Rate differential on recognized gains (losses) on AFS equity instruments	**(0.1%)**	**101**	0.3%	(482)
Other	**4.2%**	**(4,925)**	0.4%	(465)
Income tax recovery recorded in net loss	**37.9%**	**$ (44,548)**	33.3%	$ (46,243)

(in thousands of dollars)	**2018**	2017
Current income taxes	**$ (7,101)**	$ (39,156)
Deferred income taxes	**(37,447)**	(7,087)
Income tax recovery	**$ (44,548)**	$ (46,243)

The major components of the current income tax recovery are as follows:

(in thousands of dollars)	**2018**	2017
Income taxes related to current year	**$ (4,051)**	$ (38,621)
Income taxes related to prior years	**(3,050)**	(535)
	$ (7,101)	$ (39,156)

Income taxes included in OCI are as follows:

(in thousands of dollars)	**2018**	2017
Items that may be reclassified subsequently to net loss:		
Net unrealized (losses) gains on AFS investments	**$ (24,297)**	$ 28,848
Reclassification to net loss of net recognized gains on AFS investments	**(15,930)**	(17,715)
	(40,227)	11,133
Items that will not be reclassified subsequently to net loss:		
Post-employment benefit obligation gain (loss)	**6,084**	(2,582)
Income tax (recovery) expense	**$ (34,143)**	$ 8,551

(b) Deferred income taxes

The components comprising net deferred income tax assets are as follows:

(in thousands of dollars)	**2018**	2017
Net claim liabilities	**$ 35,119**	$ 32,984
Post-employment benefit plans	**9,459**	14,873
DPAE	**268**	347
Capital assets	**8,463**	6,913
Intangible assets	**(18,766)**	(26,658)
Investments	**(12)**	(25)
Income tax loss carryforwards	**63,308**	–
Other	**7,134**	4,976
	$ 104,973	$ 33,410

The Company plans to be able to generate sufficient taxable income from ordinary operations to utilize its deferred income tax assets.

11. INCOME TAXES (continued)

(b) Deferred income taxes (continued)

The components comprising deferred income tax recovery are as follows:

(in thousands of dollars)	2018	2017
Net claim liabilities	$ (2,135)	$ (2,254)
Post-employment benefit plans	(670)	165
DPAE	79	(15)
Capital assets	(1,550)	(4,947)
Intangible assets	(7,892)	4,735
Investments	(13)	–
Income tax loss carryforwards	(23,108)	–
Other	(2,158)	(4,771)
	$ (37,447)	$ (7,087)

As at December 31, 2018, $40.2 million (December 31, 2017: nil) of deferred income tax loss carryforwards and deferred tax expense of $6.1 million on the post-employment benefit obligation (December 31, 2017: deferred tax recovery of $2.6 million) are included in the deferred income tax asset pertaining to OCI.

12. GOODWILL AND INTANGIBLE ASSETS

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

(in thousands of dollars)	2018	2017
Goodwill	$ 46,144	$ 46,144
Intangible assets	179,474	183,022
	$ 225,618	$ 229,166

(a) Goodwill

Goodwill has been allocated to two individual CGUs. The carrying amount of goodwill allocated to each of the CGUs is shown below:

(in thousands of dollars)	Notes	2018	2017
Economical Mutual Insurance Company		$ 26,925	$ 26,925
Petline	20	19,219	19,219
		$ 46,144	$ 46,144

Goodwill is subject to an impairment test that is performed at least annually. When testing for impairment, the recoverable amount of the CGU is determined based on VIU calculations using a discounted cash flow model based on financial forecasts approved by management covering a five-year period and an estimate of the terminal values for the period beyond the five-year forecast.

The key assumptions used for the impairment calculations are as follows:

- Growth rates represent the rates used to extrapolate new business contributions beyond the business plan period. The growth rates are based on historic performance adjusted for management expectations. The growth rates used for current year impairment calculations of 2.0% (2017: 2.1%) for Economical Mutual Insurance Company and 4.0% (2017: 4.0%) for Petline do not exceed the historic long-term average growth rates.
- Pre-tax, market adjusted discount rates of 9.4% (2017: 8.7%) for Economical Mutual Insurance Company and its subsidiaries are used to discount expected profits from future new business.

Management does not believe that a reasonable change in these assumptions would result in the carrying value of the CGUs exceeding the recoverable amounts.

The goodwill impairment testing for the current year determined that there was no evidence of impairment (2017: nil).

12. GOODWILL AND INTANGIBLE ASSETS (continued)

(b) Intangible assets

(in thousands of dollars)	2018			
	Brand	**Software**	**Other intangible assets**	**Total**
Cost:				
Balance, beginning of year	**$ 4,200**	**$ 19,000**	**$ 231,840**	**$ 255,040**
Additions	**–**	**2,434**	**29,960**	**32,394**
Disposals	**–**	**(2,371)**	**(45,752)**	**(48,123)**
Balance, end of year	**$ 4,200**	**$ 19,063**	**$ 216,048**	**$ 239,311**
Accumulated amortization:				
Balance, beginning of year	**$ –**	**$ 8,317**	**$ 63,701**	**$ 72,018**
Amortization expense	**–**	**3,837**	**22,972**	**26,809**
Amortization on disposals	**–**	**(2,371)**	**(36,619)**	**(38,990)**
Balance, end of year	**$ –**	**$ 9,783**	**$ 50,054**	**$ 59,837**
Net book value, end of year	**$ 4,200**	**$ 9,280**	**$ 165,994**	**$ 179,474**

(in thousands of dollars)	2017				
	Notes	Brand	Software	Other intangible assets	Total
Cost:					
Balance, beginning of year		$ –	$ 12,821	$ 178,058	$ 190,879
Acquisition of Petline	20	4,200	2,142	11,900	18,242
Additions		–	6,545	41,882	48,427
Disposals		–	(2,508)	–	(2,508)
Balance, end of year		$ 4,200	$ 19,000	$ 231,840	$ 255,040
Accumulated amortization:					
Balance, beginning of year		$ –	$ 6,231	$ 44,493	$ 50,724
Amortization expense		–	4,594	19,208	23,802
Amortization on disposals		–	(2,508)	–	(2,508)
Balance, end of year		$ –	$ 8,317	$ 63,701	$ 72,018
Net book value, end of year		$ 4,200	$ 10,683	$ 168,139	$ 183,022

Included in software and other intangible assets is $1.8 million (2017: $41.3 million) that has not yet commenced being amortized as the assets are still under development. Other intangible assets include a net book value of $156.4 million in capitalized costs associated with the Company's digital direct distribution channel, Sonnet, and the development of the policy administration system for personal lines and individually rated commercial auto, Vyne, and $9.3 million pertaining to the distribution network and customer relationships arising from the acquisition of Petline.

In 2018, the Company wrote-off the remaining carrying value of its legacy policy administration system due to its replacement by the Vyne platform, as disclosed in note 24, which is included in disposals in other intangible assets.

13. OTHER ASSETS

Other assets, as presented on the consolidated balance sheet, are composed of the following:

(in thousands of dollars)	Notes	**2018**	2017
Investments in associates	14, 21	**$ 89,044**	$ 98,708
Pension asset	16	**6,745**	7,185
Prepaid expenses and other		**8,695**	9,020
		$ 104,484	$ 114,913

14. INVESTMENTS IN ASSOCIATES

The Company has only individually immaterial associates. Key financial information about the Company's investments in immaterial associates is shown below, on a gross basis in aggregate:

(in thousands of dollars)	**2018**	2017
Total assets	**$ 491,527**	$ 480,619
Total liabilities	**255,145**	258,432
Total revenue	**178,510**	157,987
Total net income	**25,220**	2,423

The Company's share of the comprehensive income of individually immaterial associates is $4.4 million (2017: $0.2 million).

Impairment testing resulted in an impairment loss of $1.7 million due to the write off of the remaining carrying value of one of the Company's investments in associates, which is recorded in the consolidated statement of comprehensive loss (2017: nil).

All of the Company's investments in associates are private entities that are not traded on a public exchange. Therefore, there are no published price quotations for the fair value of these investments.

15. ACCOUNTS PAYABLE AND OTHER LIABILITIES

Accounts payable and other liabilities, as presented on the consolidated balance sheet, are composed of the following:

(in thousands of dollars)	Notes	**2018**	2017
Pension and non-pension benefit obligations	16	**$ 41,935**	$ 62,868
Commissions payable		**48,471**	50,843
Premium taxes and other taxes payable		**23,012**	20,319
Accounts payable and other		**86,679**	98,470
Restructuring provision	24	**3,863**	–
		$ 203,960	$ 232,500

16. POST-EMPLOYMENT BENEFITS

The Company provides certain pension and other post-employment benefits through defined benefit, defined contribution and other post-employment 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, 2018. The contribution to be paid by the Company is determined each year by the Company's pension actuaries. The Company's funding policy is to make contributions in amounts that are required to discharge the benefit obligations over the life of the plan. Based on the latest actuarial valuations of all its plans, the total required contributions by the Company to the pension plans are expected to be $2.2 million in 2019. The contributions are expected to be made in the form of cash. Discretionary pension contributions for the year ended December 31, 2018 were nil (2017: nil). Pension plan matters are regulated by the Financial Services Commission of Ontario.

Plan assets associated with the pension plans are funded pursuant to a trust agreement through a trust company as selected by the Company. Ultimate responsibility for governance of the plan lies with the Company's Board of Directors and specifically with the Investment Committee, and the Human Resources and Compensation Committee. Regular administration duties are delegated to the Management Pension Committee as appropriate.

Under the defined contribution component of the pension plan, the Company contributes a fixed percentage of an employee's pensionable earnings to the plan. Contributions under the defined contribution component of the pension plan totalled $11.5 million (2017: $11.8 million).

16. POST-EMPLOYMENT BENEFITS (continued)

(a) Plan movements

The following table presents the movement of the Company's pension plan and other benefit plan obligations and plan assets during the year.

(in thousands of dollars)	2018				
	Amounts recognized in net loss	Losses (gains) recognized in OCI	Present value of benefit plan obligations		Fair value of plan assets
			Other benefit plans	Pension plans	Pension plans
Balance, beginning of year			$ 62,868	$ 213,206	$ 220,391
Current service cost	$ 4,268	$ –	370	3,898	–
Interest cost	9,210	–	2,098	7,112	–
Interest income	(7,390)	–	–	–	7,390
Return on plan assets excluding interest income	–	8,211	–	–	(8,211)
Actuarial (gains) losses					
Due to changes in financial assumptions	(335)	(24,416)	(19,180)	(5,571)	–
Due to changes in experience losses	(100)	(6,429)	(2,945)	(3,584)	–
Contributions by employer	–	–	–	–	2,810
Administration cost	574	–	–	–	(574)
Contributions by plan participants	–	–	–	324	324
Benefits paid	–	–	(1,276)	(9,152)	(9,152)
Balance, end of year	$ 6,227	$ (22,634)	$ 41,935	$ 206,233	$ 212,978

(in thousands of dollars)	2017				
	Amounts recognized in net loss	(Gains) losses recognized in OCI	Present value of benefit plan obligations		Fair value of plan assets
			Other benefit plans	Pension plans	Pension plans
Balance, beginning of year			$ 56,718	$ 199,374	$ 209,456
Current service cost	$ 3,839	$ –	383	3,456	–
Interest cost	9,592	–	2,162	7,430	–
Interest income	(7,849)	–	–	–	7,849
Return on plan assets excluding interest income	–	(5,648)	–	–	5,648
Actuarial losses (gains)					
Due to changes in demographic assumptions	–	1,979	509	1,470	–
Due to changes in financial assumptions	(242)	13,825	4,161	9,422	–
Due to changes in experience losses	744	(494)	250	–	–
Contributions by employer	–	–	–	–	5,948
Administration cost	564	–	–	–	(564)
Contributions by plan participants	–	–	–	406	406
Benefits paid	–	–	(1,315)	(8,352)	(8,352)
Balance, end of year	$ 6,648	$ 9,662	$ 62,868	$ 213,206	$ 220,391

Of the amounts recognized in net loss, $6.2 million (2017: $6.6 million) in expenses were recorded in "Operating expenses".

The actual return on plan assets was a loss of $0.8 million (2017: $13.5 million gain).

16. POST-EMPLOYMENT BENEFITS (continued)

(b) Funding status of defined benefit plans

The amounts recognized for pension plans in the consolidated balance sheet in “Other assets” at the reporting date are as follows:

(in thousands of dollars)	2018	2017
Defined benefit obligation	$ (206,233)	$ (213,206)
Fair value of plan assets	212,978	220,391
Net defined benefit asset	$ 6,745	$ 7,185
Actuarial losses (gains) on plan assets	$ 8,211	$ (5,648)
Actuarial (gains) losses on plan liabilities	$ (9,155)	$ 10,892

The amounts recognized for other benefit plans in the consolidated balance sheet in “Accounts payable and other liabilities” at the reporting date are as follows:

(in thousands of dollars)	2018	2017
Defined benefit obligation	$ (41,935)	$ (62,868)
Actuarial (gains) losses on plan liabilities	$ (22,125)	$ 4,920

(c) Maturity analysis of defined benefit obligations

The weighted average duration of the pension plan obligation is 13 years (2017: 16 years) and the weighted average duration of the other benefit plans obligation is 14 years (2017: 16 years).

The expected maturity of the defined benefit obligations are as follows:

(in thousands of dollars)	2018				
	Less than 1 year	1-5 years	6-10 years	10 years +	Total
Pension plans	$ 9,388	$ 46,056	$ 43,432	$ 107,357	$ 206,233
Other benefit plans	1,926	7,497	8,588	23,924	41,935
	$ 11,314	$ 53,553	$ 52,020	$ 131,281	$ 248,168

(in thousands of dollars)	2017				
	Less than 1 year	1-5 years	6-10 years	10 years +	Total
Pension plans	$ 8,419	$ 43,875	$ 44,017	$ 116,895	$ 213,206
Other benefit plans	1,975	8,143	10,352	42,398	62,868
	$ 10,394	$ 52,018	$ 54,369	$ 159,293	$ 276,074

(d) Pension plan asset allocation

The table below shows the allocation of defined benefit pension plan assets:

(in thousands of dollars)	2018		2017	
Cash	$ 8,473	4.0%	$ 1,495	0.7%
Canadian fixed income securities (investment grade)				
Government of Canada	26,516	12.4%	37,368	17.0%
Provincial and municipal	25,038	11.8%	13,176	6.0%
Corporate	35,022	16.4%	37,510	17.0%
Pooled equity funds				
Canadian	36,493	17.1%	43,505	19.7%
Foreign	73,587	34.6%	79,301	36.0%
Other	7,849	3.7%	8,036	3.6%
	$ 212,978	100.0%	$ 220,391	100.0%

16. POST-EMPLOYMENT BENEFITS (continued)

(d) Pension plan asset allocation (continued)

Of the corporate bonds held in the pension plan, the industry of issuer is as follows:

	2018	2017
Financial services	**48.4%**	49.8%
Energy	**15.7%**	9.5%
Industrials	**8.4%**	8.2%
Utilities	**7.4%**	11.0%
Communication services	**6.0%**	4.2%
Consumer staples	**2.8%**	10.6%
Other	**11.3%**	6.7%
	100.0%	100.0%

The Company undertakes an asset-liability study as deemed necessary. The goal of the asset-liability study is to balance the expected long term cost of the plan with the risk tolerance of the Company. To achieve this balance, the assets in the plan are allocated to fixed income securities, foreign equities and Canadian equities.

(e) Assumptions applied

The principal actuarial assumptions used in determining the defined benefit obligations for the Company's pension plans and other benefit plans are as follows:

	Other benefit plans		Pension plans	
	2018	2017	2018	2017
To determine benefit obligation, end of year:				
Discount rate	**3.6%**	3.4%	**3.6%**	3.4%
Future salary increases	**–**	–	**2.5%**	2.5%
Future pension increases	**–**	–	**0.0%**	0.0%
Inflation assumption	**–**	–	**2.0%**	2.0%
Prescription drug cost increase	**6.9%**	7.7%	**–**	–
Medical claims cost increase	**4.0%**	4.5%	**–**	–
To determine benefit expense for the year:	**–**	–	**–**	–
Discount rate	**3.4%**	3.9%	**3.4%**	3.8%
Future salary increases	**–**	–	**2.5%**	3.0%
Future pension increases	**–**	–	**0.0%**	0.0%
Inflation assumption	**–**	–	**2.0%**	2.0%
Prescription drug cost increase	**7.7%**	7.8%	**–**	–
Medical claims cost increase	**4.5%**	4.5%	**–**	–

The mortality assumptions used to assess the Company's defined benefit obligations for the pension and other post-employment benefit plans as of December 31, 2018 are based on the Canadian Pensioners' Mortality – Private Sector mortality tables as established by the Canadian Institute of Actuaries.

The discount rate is the assumption that has the largest impact on the value of these obligations. The impact of a 1% change in this rate is as follows:

(in thousands of dollars)	2018		2017	
Impact on:	**+ 1%**	**- 1%**	+ 1%	- 1%
Defined benefit obligation – pension plans	**$ (24,456)**	**$ 30,142**	$ (28,815)	$ 31,893
Defined benefit obligation – other benefit plans	**$ (4,991)**	**$ 6,140**	$ (9,642)	$ 10,479

This impact is calculated by performing a calculation of the liabilities as at December 31, using a discount rate 1% higher or lower than the discount rate used, holding all other assumptions constant.

16. POST-EMPLOYMENT BENEFITS (continued)

(e) Assumptions applied (continued)

The impact of a 1% change in the health care cost assumption is as follows:

(in thousands of dollars)	2018		2017	
Impact on:	+ 1%	- 1%	+ 1%	- 1%
Defined benefit obligation – other benefit plans	$ 5,593	$ (4,634)	$ 10,355	$ (9,562)
Aggregate of total service cost and interest cost	$ 227	$ (189)	$ 224	$ (150)

This impact is calculated by performing a calculation of the liabilities as at December 31, using a health care cost 1% higher or lower than the health care cost increase used, holding all other assumptions constant.

(f) Risks arising from post-employment benefits

The key risks to which the Company is exposed to as a result of sponsoring the defined benefit pension plans and other post-employment benefit plans are as follows:

(i) Inflation risk – Inflation can increase the cost of benefits provided under post-employment benefits and result in higher benefit obligations. As the return on plan assets is indirectly influenced by inflation, an increase in inflation would not result in a corresponding increase in the value of plan assets.

(ii) Interest rate risk – Changes in interest rates will influence discount rates resulting in an inverse change in benefit obligations. For the defined benefit pension plan, interest rate changes would also have an inverse effect on the fair value of fixed income security assets thereby somewhat offsetting the impact of the change in discounting of the benefit obligations.

(iii) Equity market price risk – Economic trends, the political environment and other factors can positively or adversely impact the equity markets and, consequently, the value of equity investments held by the defined benefit pension plan. If equity market returns exceed or lag behind the discount rates, the net defined benefit obligation will be impacted.

(iv) Foreign exchange risk – Changes in foreign exchange rates will impact the fair value of foreign pooled equity funds held by the defined benefit pension plan. A decrease in the value of foreign currencies relative to the Canadian dollar will decrease the fair value of foreign pooled equity funds, increasing the net defined benefit obligation. An increase in the value of foreign currencies relative to the Canadian dollar will have an inverse effect.

(v) Life expectancy risk – Changes in life expectancy will impact the amount of benefits provided under the post-employment benefit plans resulting in a change in the benefit obligation. An increase in life expectancy will increase the amount of benefits provided under post-employment benefit plans resulting in an increase in the benefit obligation. A decrease in the life expectancy will have an inverse effect.

17. CAPITAL MANAGEMENT

Management develops the capital strategy for the Company and supervises the capital management processes. The Board of Directors is responsible for overseeing management's compliance with the capital management policies. As a federally regulated P&C insurance company, the Company's capital position is monitored by OSFI. OSFI evaluates the Company's capital adequacy through the Minimum Capital Test ("MCT"), which measures available capital against required risk-weighted capital. Available capital comprises total 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, 2018, the Company's capital available is $1,146.4 million and capital required is $504.9 million. The Company's MCT ratio of 227.0% as at the reporting date 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 estimated impact on capital before entering into any significant transactions to seek 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, at least, 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 and more stringent than OSFI's minimum requirements. Management also conducts its own risk and solvency assessment on at least an annual basis and provides regular updates to its Management Risk Committee, the Risk Review Committee and the Board of Directors.

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 9, reinsurance is utilized to cover the excess risk.

On at least an annual basis, the Company performs stress testing, including Dynamic Capital Adequacy Testing, on the Company's capital position to ensure that the Company has sufficient capital to withstand a number of significant adverse scenarios.

18. PREMIUMS

Net written premiums and net earned premiums, as presented on the consolidated statement of comprehensive loss, are composed of the following:

(in thousands of dollars)	Notes	**2018**	2017
Direct written premiums		**$ 2,456,314**	$ 2,288,664
Premiums ceded from other companies		**–**	(1,809)
Gross written premiums		**2,456,314**	2,286,855
Premiums ceded to other companies	9	**(75,576)**	(68,768)
Net written premiums		**2,380,738**	2,218,087
Change in gross unearned premiums		**(137,146)**	(51,928)
Change in ceded unearned premiums		**1,038**	(338)
Net earned premiums		**$ 2,244,630**	$ 2,165,821

19. RATE REGULATION

In common with the P&C insurance industry in general, the Company is subject to regulation in certain jurisdictions whereby rates charged to customers for certain automobile insurance policies must be approved by the applicable regulatory body. This type of business comprises 51.1% (2017: 46.4%) of the Company's total direct written premiums during the year. The Company is subject to three types of regulatory processes as follows:

Category	**Description**
File and use	Insurers file their rates with the regulatory authority and wait for a certain amount of time before implementing them.
File and approve	Insurers file their rates with the regulatory authority and wait for approval before implementing them.
Use and file	Insurers file their rates with the regulatory authority within a specified period after they are implemented.

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 approve
New Brunswick	New Brunswick Insurance Board	File and approve
Nova Scotia	Nova Scotia Utility and Review Board	File and use or file and approve
Ontario	Financial Services Commission of Ontario	File and use or file and approve
Prince Edward Island	Island Regulatory and Appeals Commission	File and use
Quebec	Autorité des Marchés Financiers	Use and file

20. BUSINESS COMBINATION

On January 1, 2017, the Company acquired all of the issued and outstanding shares of Western Financial Insurance Company (renamed Petline Insurance Company), a leading Canadian pet insurance provider. Petline's core brand, Petsecure, offers pet insurance products that provide comprehensive coverage to pet owners in Canada. The acquisition further diversified the Company's business. The purchase price for the acquisition was $46.1 million, which was funded by cash on hand.

The allocation of the purchase price to the fair value of assets acquired and liabilities assumed as at the acquisition date was as follows:

(in thousands of dollars)	Notes	
Net identifiable tangible assets acquired (excluding cash acquired of $1,839)		$ 6,778
Finite life intangible assets acquired:	12(b)	
Customer relationships		6,200
Distribution network		5,700
Software		2,142
Brand	12(b)	4,200
Goodwill	12(a)	19,219
		$ 44,239

The goodwill is attributable to expected growth and profitability contributions of Petline and the workforce of the acquired business. The goodwill arising from this acquisition is not deductible for income tax purposes.

21. ACQUISITIONS

In 2017, the Company purchased interests in strategically aligned brokerages for total consideration of $49.6 million, which were funded by cash on hand. The acquisitions are being accounted for using the equity method.

22. COMMITMENTS AND CONTINGENCIES

Commitments

The Company's commitments include operating lease commitments and certain non-cancellable contractual commitments. The Company's non-owned buildings, motor vehicles, computers and office equipment are supplied through operating leases. The future contractual aggregate minimum lease payments under non-cancellable operating leases and other commitments are as follows:

(in thousands of dollars)	2018	2017
Within 1 year	**$ 33,809**	$ 38,392
Later than 1 year but not later than 5 years	**50,854**	54,127
Later than 5 years	**22,134**	15,273

Operating lease payments included in "Operating expenses" in the consolidated statement of comprehensive loss during 2018 were $19.1 million (2017: $17.8 million).

Total future minimum sublease income under non-cancellable subleases amounted to $0.4 million (2017: $0.8 million).

Under certain circumstances, the Company may be required to acquire outstanding share ownership of various strategically aligned brokers in accordance with the terms of the Company's contracts with those brokers.

Contingencies

In addition to litigation relating to claims made in respect of insurance policies written, the Company is subject to other litigation arising in the normal course of conducting its business. The Company is of the opinion that this non-claims litigation will not have a significant effect on its financial position, results of operations, or cash flows. The Company's process for ensuring appropriate provisions are recorded for reported and unreported claims is discussed in note 8.

23. DEMUTUALIZATION

Demutualization is the process whereby a mutual company converts into a share company. On November 3, 2015, the Company's Board of Directors announced its decision to proceed with demutualization within the federal demutualization regulatory framework. At the first special meeting on demutualization held on December 14, 2015, the Company's eligible mutual policyholders passed a special resolution to authorize the start of negotiations of the allocation of demutualization benefits with eligible non-mutual policyholders. Court-appointed policyholder committees representing eligible mutual policyholders and eligible non-mutual policyholders have negotiated the method of allocating the financial benefits resulting from demutualization, and the Company has prepared a conversion plan that contains the agreed-upon allocation, as well as other particulars to effect demutualization.

Following authorization from the Company's primary regulator, OSFI, the Company announced on January 31, 2019 that its Board of Directors has called the second special meeting on demutualization, to be held on March 20, 2019. A successful outcome from this meeting will allow the Company to continue with the demutualization process, hold a third and final special meeting of all eligible policyholders (assuming authorization from OSFI to do so), and put the Company in the position to apply to the federal Minister of Finance for approval to demutualize. It is only after approval is received from the Minister that the Company can demutualize and proceed with any proposed initial public offering. The Company will continually evaluate market conditions, company performance and other factors to determine the time to complete the process.

Demutualization costs are included in "Other expense" in the consolidated statement of comprehensive loss.

24. RESTRUCTURING EXPENSES

In February 2018, the Company announced that it would be updating its operational structure to optimize efficiency and simplicity for broker partners and customers. The changes to the operational structure include the consolidation of the Company's brands and headcount reductions of approximately 10% of the Company's workforce, aimed at improving future operating results. The Company expects to execute this plan in phases over an 18 month period. The provisions made to date reflect decisions and plans communicated as of December 31, 2018.

The restructuring provision includes employee severance and outplacement services, and decommissioning costs associated with the Company's legacy policy administration system, which is recorded in "Accounts payable and other liabilities" on the consolidated balance sheet. The corresponding expense is recorded in "Restructuring expenses" on the consolidated statement of comprehensive loss.

24. RESTRUCTURING EXPENSES (continued)

A reconciliation of the restructuring provision is provided below:

(in thousands of dollars)		2018		2017
Balance, beginning of year	**$**	**–**	$	–
Provisions made during the year		**6,750**		–
Payments made during the year		**(2,887)**		–
Balance, end of year	**$**	**3,863**	$	–

In addition to the above amounts, $10.5 million of other expenses have been included in "Restructuring expenses" in 2018 related primarily to the write-off of the carrying value of the Company's legacy policy administration system, which was made redundant by the implementation of the new policy administration and billing platform.

25. RELATED PARTY TRANSACTIONS

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

The compensation of key management personnel, defined as the Company's directors, president and chief executive officer, executive vice-presidents, and senior vice-presidents, is as follows:

(in thousands of dollars)		2018		2017
Salaries and severance	**$**	**4,685**	$	5,135
Short-term and medium-term incentive plans		**8,000**		3,265
Retention and signing bonuses		**1,129**		1,524
Post-employment defined benefit pension benefits		**19**		26
Post-employment defined contribution pension benefits		**478**		330
Other post-employment benefits		**30**		8
Other short-term employment benefits		**86**		77
Directors' fees*		**1,475**		1,463
	$	**15,902**	$	11,828

*Directors' fees disclosed above include fees accrued in respect of all controlled entities in the group.

Post-employment benefit plans

The Company makes contributions to post-employment benefit plans on behalf of its employees, including both defined contribution and defined benefit plans. Information regarding transactions with the plans is included in note 16.

Associates

At the reporting date, commercial loans of $23.6 million (2017: $27.3 million) are due from companies subject to significant influence. The loans are included in "Investments" in the consolidated balance sheet and are initially measured at the exchange amount. The loans are subsequently measured in accordance with the accounting policy for loans and receivables (note 2).

The Company previously participated in a quota share reinsurance treaty of a company subject to significant influence under terms consistent with the other reinsurers. Effective January 1, 2017, the Company no longer participates in this quota share reinsurance treaty. The Company's share of reinsurance (ceded) assumed from the associate, including reinsurance assumed contracts (note 9), is as follows:

(in thousands of dollars)	Notes		2018		2017
Premiums written	9,18	**$**	**–**	$	(1,784)
Premiums earned	7,9		**–**		(312)
Claims and adjustment expenses	7,9		**152**		(719)
Commissions	9		**102**		(336)

Reinsurance assumed assets:

(in thousands of dollars)	Notes		2018		2017
DPAE	9	**$**	**–**	$	–
Reinsurance assumed receivables	9		**–**		–
		$	**–**	$	–

25. RELATED PARTY TRANSACTIONS (continued)

Associates (continued)

Reinsurance assumed liabilities:

(in thousands of dollars)	Notes		2018		2017
UPR	9	**$**	**–**	$	–
Claim liabilities	9		**3,002**		3,294
Reinsurance assumed payables	9		**161**		251
		$	**3,163**	$	3,545

26. MEDIUM-TERM INCENTIVE PLAN

Restricted units

The following table shows the outstanding units and current estimated liability pertaining to the RUs issued under the Company's incentive plan as at December 31.

	2018		
Performance cycles	**Number of units**		**Liability** *(in thousands of dollars)*
2016-2018	**58,194**	**$**	**927**
2017-2018	**66,556**		**1,061**
2017-2019	**110,244**		**1,172**
2018-2020	**340,559**		**2,550**
	575,553	**$**	**5,710**

	2017		
Performance cycles	Number of units		Liability *(in thousands of dollars)*
2015-2017	62,271	$	1,062
2016-2018	68,816		836
2017-2018	66,556		574
2017-2019	124,865		770
	322,508	$	3,242

The following table shows the movements in the RUs during the year.

	2018	2017
	Number of units	Number of units
Outstanding, beginning of year	**322,508**	285,040
Awarded	**356,241**	210,001
Cancelled	**(38,244)**	(98,839)
Settled	**(64,952)**	(73,694)
Outstanding, end of year	**575,553**	322,508

A reconciliation of the RU liability is provided below:

(in thousands of dollars)		2018		2017
Balance, beginning of year	**$**	**3,242**	$	3,485
Provisions made during the year		**3,592**		1,084
Payments made during the year		**(1,124)**		(1,327)
Balance, end of year	**$**	**5,710**	$	3,242

26. MEDIUM-TERM INCENTIVE PLAN (continued)

Performance units

The following table shows the outstanding units and current estimated liability pertaining to the PUs issued under the Company's incentive plan as at December 31.

	2018	
Performance cycles	**Number of units**	**Liability** *(in thousands of dollars)*
2016-2018	**87,291**	**$ 1,115**
2017-2018	**99,834**	**1,686**
2017-2019	**145,964**	**1,615**
2018-2020	**186,103**	**1,093**
	519,192	**$ 5,509**

	2017	
Performance cycles	Number of units	Liability *(in thousands of dollars)*
2015-2017	93,406	$ 1,281
2016-2018	103,224	902
2017-2018	99,834	805
2017-2019	167,914	991
	464,378	$ 3,979

The following table shows the movements in the PUs during the year.

	2018	2017
	Number of units	Number of units
Outstanding, beginning of year	**464,378**	427,562
Awarded	**203,656**	295,618
Cancelled	**(51,413)**	(148,260)
Settled	**(97,429)**	(110,542)
Outstanding, end of year	**519,192**	464,378

A reconciliation of the PU liability is provided below:

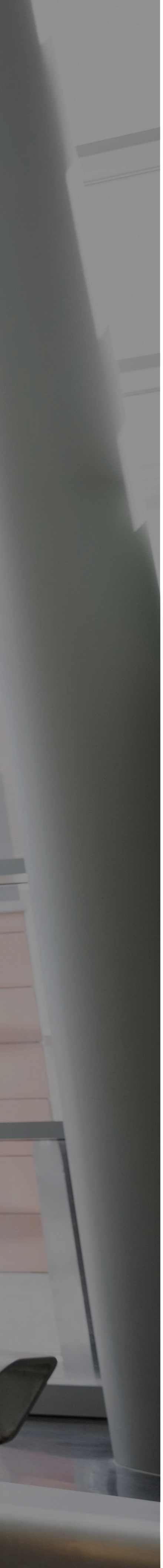
(in thousands of dollars)	**2018**	2017
Balance, beginning of year	**$ 3,979**	$ 5,144
Provisions made during the year	**2,963**	326
Payments made during the year	**(1,433)**	(1,491)
Balance, end of year	**$ 5,509**	$ 3,979

The liability for the RUs and PUs are recorded in "Accounts payable and other". The amount charged to "Operating expenses" for the MTIP was $6.6 million for the year ended December 31, 2018 (2017: $1.4 million).

27. OPERATING SEGMENTS

The Company's management and directors review the results of operations based on one reportable segment, the P&C insurance segment. The operating results of this segment are regularly reviewed by the Company's senior management to make decisions about the allocation of resources and to assess the performance of the Company.

OUR BRANDS



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2. Corporate Governance
3. Human Resources and Compensation
4. Investment
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6. Special
7. Strategic Initiatives

*As of April 1, 2019

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Chief Executive Officer

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Senior Vice-President,
Legal, Risk, and Strategy
Chief Risk Officer

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*As of April 1, 2019

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