

Annual Report 2009



building possibilities



Empire Life®



Contents

4	Our Vision	25	Appointed Actuary's Report
5	Our Mission and Core Values	26	Financial Statements
7	Message from the Chairman of the Board	33	Notes to Financial Statements
8	Message from the President and Chief Executive Officer	65	Dividend Policy
11	Source of Earnings	66	Corporate Governance Over Risk Management
12	Source of Earnings by Line of Business	67	Corporate Information
13	Management's Discussion and Analysis	69	Board of Directors
24	Management's Responsibility for Financial Reporting	70	Corporate Management
25	Auditors' Report		



Our Vision

Our vision is to be the leading, independently owned, Canadian financial services company known for simplicity, being easy to do business with and having a personal touch.

Our Mission

Our mission is to help you build wealth and protect your financial security.

Our Core Values

Integrity

We are honest, fair and respectful, honour our commitments, and take pride in being a good corporate citizen.

Know our customer

We listen to our customers to provide products and services that meet their needs.

Can-do attitude

We are positive, creative and always searching for better ways to do things.

High performance team

We are focused on our priorities, have high expectations and standards and celebrate effort and achievement.



Duncan Jackman
Chairman of the Board

Les Herr
President and Chief Executive Officer

Message from the Chairman of the Board

“I believe strength is demonstrated and possibility is realized by how we manage and adapt through tough times, perhaps more so than when times are good.”

– **Duncan N.R. Jackman**, Chairman of the Board



More than a half century ago, my grandfather, H.R. Jackman, purchased a large block of Empire Life shares and began a 14-year term as the first Chairman of the Board of The Empire Life Insurance Company. In 1968, as Financial Vice-President, my father, Henry (Hal) N.R. Jackman, created E-L Financial Corporation Limited, the first insurance

holding company of its kind in Canada, of which Empire Life and its sister company, The Dominion of Canada General Insurance Company, are subsidiaries.

Today, as for the past seven years, I have the privilege of continuing a long and successful history with this fine company and representing my family and our other shareholders as Chairman of the Board.

As Board members, our job is to find the best people to lead the business. The leaders find the best people to run the business. I recently had the opportunity to spend a full day in Kingston, Ontario, at a special company-wide summit for all employees. I was impressed not only by the energy, enthusiasm and commitment that was evident from the 700+ people in the room, but also by the clarity

and focus of leadership on bringing Empire Life to new levels of excellence by delivering on the expectations of its customers, partners, employees and shareholders.

Our industry has faced some of its most challenging times in recent years and our confidence and faith as consumers, investors, shareholders and employees have been tested. I believe strength is demonstrated and possibility is realized by how we manage and adapt through tough times, perhaps more so than when times are good.

The Empire Life Insurance Company is today, as it has been throughout its more than 87-year history, a solid Canadian financial services organization with a bright future and the complete confidence of its Board of Directors. On a personal note, I am especially proud to be associated with this company and its people.

A handwritten signature in black ink, appearing to read 'Duncan N.R. Jackman'.

Duncan N.R. Jackman
Chairman of the Board
Toronto, Ontario
February 24, 2010

Message from the President and Chief Executive Officer

“We want to be successful at reaching our goals and being the best financial services company in Canada delivering on our promises—on a sustainable basis—to all our stakeholders. We believe we have demonstrated our ability to compete very effectively and profitably.”

– **Les Herr**, President and Chief Executive Officer



At this time last year, we witnessed one of the most dramatic market declines in history followed by an equally dramatic market recovery. We saw governments from around the world implement massive economic stimulus packages to provide stability to financial systems, to kick start economic growth and attempt to reverse the trend of significant unemployment.

The challenges faced by Canadian consumers, investors and financial services companies cannot be minimized. For many of us, the economic conditions we faced have been the most uncertain and unsettling of our lifetimes. During the first two quarters of 2009, consumer confidence remained shaken leaving many Canadians on the sidelines, afraid of making major financial decisions until the environment seemed more certain and safe.

As we approached the second half of 2009, consumer confidence in the markets and the economy overall improved. We do not believe we will face the same magnitude of economic challenges in 2010, and we are beginning to see signs that economic conditions are becoming more positive. We feel that the worst is behind us in terms of the economic crisis, and better times are ahead as conditions continue to stabilize.

I am proud of the way our employees and business partners focused on their work during times of instability and unease. As individuals and as a corporation, we had to dig deeper, be more resourceful and creative, and use our strengths and capabilities to deliver what our stakeholders expect from us. Today, Empire Life remains strong, with a clear vision for the short- and long-term and a commitment to meeting the needs of all our stakeholders: our customers, business partners, employees and shareholders.

Our results

During the first quarter of 2009, we saw further declines in the stock market which affected many aspects of our business. Our assets dropped, customers shied away from investing in equities, group employers were struggling with the lagging economy and the overall economic environment did not look positive. However, following a strong market rally that saw six straight weeks of solid gains, the market recovery began to take hold, which is often the leading indicator of economic recovery. As a result, we began to see improved sales and results.

From an income perspective, we ended 2009 with shareholders' net income of \$53.8 million, compared to \$48.4 million in 2008. Our shareholders' net income was impacted by a favourable tax gain of \$22.2 million in the first quarter, offset by an equity asset impairment write down of \$24.3 million during the second half of the year. After removing large, offsetting, non-recurring items from

both 2009 and 2008, net income was better than 2008 mainly due to improvement in the stock market, strong expense management, lower sales strain, better group claims experience and asset mix changes.

While we started the year well behind last year's sales levels in most product lines, we began to see gradual improvement as the year progressed. During the last quarter of 2009, we exceeded fourth quarter 2008 sales in all major product lines, except for investment deposits on universal life sales, which created exciting momentum.

Our total Wealth Management sales were 7% higher than 2008 results. As with many of our competitors, we saw many customers choosing more conservative investment products over equity funds and, in fact, had a 155% increase in sales of our guaranteed investment products and deferred annuities in 2009. Having a solid fixed interest product offering was a very important complement to our segregated funds and helped us attract wealth dollars at a time when many customers seemed reluctant to invest at all. Towards the end of the year more people started returning to the equity markets which was a positive sign. We ended the year with net segregated fund sales of \$188.1 million.

The Employee Benefits market was understandably affected by the economic recession. As a result, we saw employee benefits product sales decline 11% from 2008 results. This is a highly competitive market subject to regional economic and unemployment pressures. Despite these challenges, we saw a surge in new sales activity in the fourth quarter and particularly in December, which was a very positive sign. Our premium income came under pressure as some businesses went bankrupt or had to reduce their employee benefits. Despite this, we still had respectable levels of persistency considering the environment we were working in and we maintained high levels of service. Favourable claims experience and lower than expected sales strain saw this product line post net income of \$10.3 million.

In our Retail Risk product line, we saw sales drop by 15% as compared to 2008 results, primarily due to decreased investment deposits on universal life sales. However, like our other product lines, we did see a positive increase in sales towards the end of 2009, except for investment deposits on universal life sales. Net income for our risk products was lower than 2008 mainly due to a non-recurring updated approach for establishing the insurance mortality assumption in 2008, that caused our net income for this line to increase by \$29.3 million in 2008. We did make some price adjustments to our term products mid-way through the year. This is an extremely price competitive market and, in our opinion, the prices for many risk products are much too low. We remain cautious about risk product pricing and will

continue to look at ways we can remain competitive in this dynamic marketplace.

Capital and Surplus earnings improved over 2008 levels primarily due to the impact of rising stock markets on realized gains and losses. Our total assets under management, general fund and segregated fund assets, increased by 23% over 2008 to \$8.7 billion.

Staying strong and competitive

Canadians want to know that the companies in which they place their trust and confidence for their financial security needs are solid and will be here to serve them in the long term. Our Minimum Continuing Capital and Surplus Requirements (MCCSR) ratio continues to be strong and at December 31, 2009 was 266%, well above minimum and recommended requirements. To support our continued growth and to build upon our strong capital base we issued \$200 million of subordinated debt financing in May 2009. Of that \$200 million, \$125 million was paid back to our parent company, E-L Financial Corporation Limited, which provided \$125 million of subordinated debt financing in September 2008.

We continue to participate in regulatory and industry affairs. This area has required increased focus and attention as a result of the financial crisis. We have a seat at the table and are working with committees and task forces led by Assuris, Canadian Life and Health Insurance Association (CLHIA), actuarial and other industry and government organizations. Whether it is advisor regulation and market conduct, solvency and equity risk, or regulation pertaining to banking and pensions, among other things, we are taking a more active role in shaping the future of the Canadian financial landscape.

Reaching ahead

Just like many of our customers took time in 2009 to reflect on their goals and objectives from a financial standpoint, our company took the opportunity to reflect on our future to determine what we need to do to remain one of, in my opinion, the best financial services companies in Canada. We completed a full strategic review to learn more about our markets, customers, industry, people and our strengths.

Following that review, we developed a new strategic direction which we believe will allow us to continue to compete in a very effective way and meet the needs and expectations of our stakeholders. Meeting those needs and expectations will help us realize our over-arching objective: to deliver to our shareholders sustainable, profitable growth.

We know we are not one of the biggest players in the financial services marketplace in Canada. We are not aiming to be the biggest. In fact, recent experience has taught us

that being the biggest does not equate with being successful or being the best. We want to be successful at reaching our goals and being the best financial services company in Canada delivering on our promises—on a sustainable basis—to all our stakeholders. We believe we have demonstrated our ability to compete very effectively and profitably.

Our new strategic direction will see the Company focused on achieving profitable growth, becoming more customer-centric and operationally excellent, expanding our current distribution to adopt a multi-dimensional model and increasing our cross-organizational focus and shared services. To do all of this, we need to rethink and simplify our business processes and infrastructure to support our future growth. This is the target state we are reaching for and, with a renewed vision, mission and core values guiding the way, our company has a bright future ahead.

In order to achieve our goals, we need to continually improve the capacity of our people to match our growth objectives. Having the right people in the right roles with necessary tools and skills is critical to us being able to execute our strategies. Over the past year, we have successfully recruited some significant talent to almost all areas of the Company. We strengthened our Investment Management Team when Gaelen Morphet joined our Executive Leadership Team as Chief Investment Officer and Senior Vice-President last fall. I am also very pleased to report that we have promoted a number of internal candidates to leadership roles.

In the past 12 months, I've seen this company begin an amazing transformation and a change in culture. Our people have gained new processes, skills and a momentum that will help us keep reaching our objectives. The changes happening in our world, our marketplace, in technology and in our industry do not go away. If anything, the rate of change continues to go faster. To deal with the growing pace of change, we adopted a company-wide change management program and practice. We introduced new frameworks for our people to use in managing projects and developing cost benefit analyses which result in more targeted and precise planning and effective use of resources. Earlier this year, we adopted a creative problem solving process that equips our employees with the tools they need to find new ways to identify problems and opportunities and new ways to solve and take advantage of them.

We would not be able to deliver on our promises without the support and co-operation of our employees and our distribution partners. We continue to receive very positive feedback from our distribution partners and our customers on our level of service. I personally have heard from customers time and again about how much they appreciate that we are a company that actually has people answering our

phones. We certainly believe in technology, but we also believe that a personal approach is critical to our business and has been a hallmark of our company over its 87-year history. We work hard to find the right solutions for our customers and we will continue to strive to be a company that is easy to do business with and always with a personal touch.

In closing, I want to share with you another highlight of 2009. Even though we've seen some difficult economic realities in this past year, Empire Life and its employees have not turned away from our shared social responsibilities. Our annual United Way campaign reached another record-setting goal, surpassing last year's total by 12%. Our employees and retirees have shown exceptional leadership in their communities by stepping up and giving their time and money to the United Way and to many other worthy causes. They don't back away during tough times and for that, I'm thankful and very proud.

I am proud to be an Empire Life employee and to have the privilege of leading my colleagues at this exciting and dynamic time in the Company's history.



Leslie C. Herr
President and Chief Executive Officer
Kingston, Ontario
February 24, 2010

Source of Earnings

Source of earnings is a methodology for identifying and quantifying the various sources of Canadian generally accepted accounting principles (GAAP) income of a life insurance company. It presents shareholders' net income in a different format from the traditional income statement form and provides a better understanding of the Company's sources of profit for each major product line.

Expected Profit from In-Force Business

This source of earnings represents the profit the Company expects to generate on in-force business if experience is in line with the Company's best estimate assumptions for mortality, morbidity, persistency, investment returns, expenses and taxes.

Impact of New Business

Writing new business typically adds economic value to a life insurance company. However, as of the point of sale, new business may have a positive or negative impact on earnings. A negative impact (new business strain) will result when the provision for adverse deviation included in the actuarial reserves at the point of sale exceeds the expected profit margin in the product pricing. The impact of new business also includes any excess acquisition expenses not covered by product pricing at the point of issue.

Experience Gains and Losses

This item represents gains or losses due to the difference between actual experience and the best estimate assumptions.

Management Actions and Changes in Assumptions

This component includes earnings generated by management actions during the year (e.g., acquisition or sale of a block of business, changes to product price, fees or asset mix, etc.) or the impact of changes in assumptions or methodology used for the calculation of actuarial reserves for in-force business.

Other

This item includes any source of earnings from operations not included above.

Earnings on Surplus

This component represents the pre-tax earnings on the shareholders' capital and surplus funds.

Source of Earnings by Line of Business

For the year ended December 31

(in millions of dollars)	Wealth Management		Employee Benefits		Individual Insurance		Capital & Surplus		Total	
	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Expected profit on in-force business	\$ 13.4	\$ 24.6	\$ 13.5	\$ 13.7	\$ 37.4	\$ 33.9			\$ 64.3	\$ 72.2
Impact of new business	(10.9)	(18.7)	(5.4)	(5.9)	(27.4)	(35.7)			(43.7)	(60.3)
Experience gains & losses	(2.9)	(7.7)	5.6	(2.2)	(26.9)	(14.8)			(24.2)	(24.7)
Management actions and changes in assumptions	25.2	2.3	1.8	0.1	23.1	83.9			50.1	86.3
Other	2.2	5.2	–	–	9.8	15.8			12.0	21.0
Earnings on operations before income taxes	27.0	5.7	15.5	5.7	16.0	83.1	–	–	58.5	94.5
Earnings on surplus	–	–	–	–	–	–	(3.1)	(16.5)	(3.1)	(16.5)
Income before income tax	\$ 27.0	\$ 5.7	\$ 15.5	\$ 5.7	\$ 16.0	\$ 83.1	\$ (3.1)	\$ (16.5)	\$ 55.4	\$ 78.0
Income taxes	4.6	(2.4)	5.2	2.4	0.7	34.0	(8.9)	(4.4)	1.6	29.6
Shareholders' net income	\$ 22.4	\$ 8.1	\$ 10.3	\$ 3.3	\$ 15.3	\$ 49.1	\$ 5.8	\$ (12.1)	\$ 53.8	\$ 48.4

Wealth Management

Earnings on operations was higher than the level this product line achieved in 2008. Most of the increase in income related to management actions and changes to assumptions resulting from achievement of improved investment spreads and favourable results from the annual update of actuarial assumptions related to both annuitant mortality and segregated fund guarantees. In addition income improved due to a decrease in new business strain primarily due to lower segregated fund sales in 2009 relative to 2008. Experience losses were lower in 2009 due to reduced segregated fund guarantee reserves and lower segregated fund guarantee death benefit payments relative to 2008 resulting from improved stock market conditions compared to late 2008. These items were partially offset by a decrease in expected profit on in-force business due to the decline in average segregated funds under management in 2009 versus 2008 resulting from stock market conditions, and a reduction in income from other items due to lower discounted future tax liability reserve releases related to tax law changes in 2009 relative to 2008.

Employee Benefits

Operations' earnings in the Employee Benefits product line increased from the level in 2008 due to favourable claims experience during 2009, and a non-recurring experience gain related to a reinsurance transaction in 2009.

Individual Insurance

The decrease in the Individual Insurance product line's operating earnings overall was primarily attributable to a lower net release of reserves from the annual assumption update during 2009 relative to 2008. 2008 included a \$43.3 million reserve release from an updated approach for establishing the insurance mortality assumption. This is reported in the management actions and changes in assumptions line.

The decrease in Other in 2009 relative to last year is due to a lower reserve release related to the discounted future tax liability component of policy liabilities in order to consider new tax law in 2009, compared to a larger reserve release in 2008 related to existing 2008 tax law and Financial Instrument Accounting rules.

Experience losses were higher than in 2008 primarily due to a write down of impaired equity assets in 2009.

Expected profit on in-force business increased due to growth of the insurance block of business.

The decrease in new business strain was primarily due to lower sales in 2009 relative to 2008.

Management's Discussion and Analysis

This document has been prepared for the purpose of providing Management's Discussion and Analysis (MD&A) of the operating results and financial condition of The Empire Life Insurance Company ("Empire Life" or the "Company") for the years ended December 31, 2009 and 2008. This MD&A should be read in conjunction with the Company's December 31, 2009 financial statements, which form part of The Empire Life Insurance Company 2009 Annual Report dated February 24, 2010. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and unless otherwise noted, the reporting currency for the Company is the Canadian dollar, and all amounts in the financial statements and this MD&A are expressed in Canadian dollars.

MD&A may contain certain forward-looking statements that are subject to risks and uncertainties that may cause the results or events mentioned in this discussion to differ materially from actual results or events. No assurance can be given that results, performance or achievement expressed in, or implied by, any forward-looking statements within this discussion will occur, or if they do, that any benefits may be derived from them.

Use of Non-GAAP Measures

MD&A contains references to annualized premium sales. This term does not have any standardized meaning according to GAAP and therefore may not be comparable to similar measures presented by other companies. The Company believes that this measure provides information useful to its shareholders and policyholders in evaluating the Company's underlying financial results.

The Company

The Empire Life Insurance Company, under the Empire Life name, provides a broad range of life insurance and wealth management products, employee benefit plans and financial services to meet the needs of individuals, professionals and businesses through a network of Independent Financial Advisors (IFA), Managing General Agents (MGA), National Account firms and Employee Benefits brokers and representatives.

Overview

For the year, Empire Life shareholders' net income was \$53.8 million compared to \$48.4 million in 2008. The increase is comprised of a number of large offsetting items. While both years had increased net income from non-recurring tax-related items, the 2009 gain was \$7.2 million after tax higher than the 2008 gain for shareholders, and \$13.0 million after tax higher than the 2008 gain for policyholders. These 2009 and 2008 non-recurring tax-related items are described in the paragraphs below. Capital and Surplus net income in 2009 improved relative to the comparable period in 2008 as the 2008 declines in global stock markets resulted in realized losses on the sale of investments during 2008. This was partly offset by net income from the three major Empire Life product lines (Wealth Management, Employee Benefits and Individual Insurance) which was lower overall relative to 2008 primarily due to a \$29.3 million after-tax reserve release in 2008 that is non-recurring as it related to an updated approach for establishing the insurance mortality assumption. 2009 net income was also lower by \$24.3 million after tax for shareholders and \$1.3 million after tax for policyholders relative to 2008 as losses were reclassified from Other Comprehensive Income (OCI) to net income because of other than temporary impairment write downs of common and preferred shares in 2009. These write downs mainly reduced Individual Insurance and Capital and Surplus net income. Otherwise net income improved in 2009 relative to 2008 due to a strong improvement in Wealth Management and Employee Benefits results.

While write downs of common and preferred shares lowered 2009 shareholders' and policyholders' net income as described above, the Company reported \$93.5 million in shareholders' Other Comprehensive Income (OCI) and \$7.6 million in policyholders' OCI compared to shareholders' Other Comprehensive Loss (OCL) of \$99.2 million and policyholders' OCL of \$7.9 million in 2008. The improvement was primarily due to the recovery of Canadian stock markets in 2009 compared to a large decrease in Canadian stock markets in 2008.

On March 4, 2009, the amendments to the Income Tax Act related to Financial Instruments passed third reading and became substantively enacted. Under these amendments, certain capital losses have been re-characterized to become income losses for tax purposes. These amendments also result in most investments and policy liabilities being taxed on a fair value basis,

Management's Discussion and Analysis

consistent with changes in accounting rules for Financial Instruments adopted in 2007. Based on fair values as of March 4, 2009, the impact of these amendments, which has been recorded in the first quarter of 2009, was a non-recurring after-tax gain of \$22.2 million (\$nil for the first quarter of 2008) for shareholders, and a non-recurring after-tax gain of \$13.6 million (\$nil for the first quarter of 2008) for policyholders.

While there was uncertainty in 2008 regarding the above mentioned new federal income tax rules, there was a 2008 development regarding actuarial guidance. The Canadian Institute of Actuaries (CIA) Committee on Life Insurance Financial Reporting (CLIFR) updated its guidance to Appointed Actuaries with regard to the calculation of the Discounted Future Tax Liability (DFTL) under Financial Instruments Accounting rules. Previously, DFTL was determined using the tax law that existed at the time and pre-2007 Financial Instrument Accounting rules. The 2008 actuarial standards change now permitted recording the more conservative of the following:

- (i) DFTL under the tax law that existed in 2008, and Financial Instrument Accounting rules,
- (ii) DFTL under proposed tax law in 2008, and Financial Instrument Accounting rules.

For Empire Life, item (i) was the more conservative of the two. However it was more favourable than the previous approach and accordingly 2008 shareholders' net income included an after-tax gain of \$15.0 million and policyholders' net income included an after-tax gain of \$0.6 million related to this change in approach. These items were recorded in the third quarter of 2008.

The Company's risk based capital ratio, as measured by Minimum Continuing Capital and Surplus Requirements (MCCSR), at 266% at the end of 2009 (201% as of December 31, 2008), was well above minimum requirements.

Global credit and stock market conditions began to improve in the second quarter of 2009 and this continued for the balance of the year. However, stock market volatility, uncertainty about the global economy and concern regarding the credit quality of certain asset categories continues. Empire Life has no direct exposure to the following: asset backed commercial paper, US mortgages or US mortgage-related derivatives.

Total assets under management increased by 23% during 2009 to \$8.7 billion. Segregated fund assets were up 29% due primarily to the recovery in stock market prices and by positive net sales results throughout the year. General fund assets increased by 17% primarily due to increases in the fair value of invested assets due to lower corporate bond interest rates and rising stock markets, and growth in the deferred annuity business. A rise or fall in stock markets impacts the management fees collected on segregated fund contracts and on index funds within universal life contracts, and policy liabilities particularly in respect of segregated fund guarantees.

Overall premium revenue in 2009 was up 22% from last year's level as annuity premiums increased by 155%. This was partly offset by an insurance premiums decline of 5%, primarily due to a non-recurring transaction that terminated a reinsurance assumed agreement in the Employee Benefits line of business.

The analysis and discussion which follows is focused on the full year 2009 and comparative 2008 line of business net income after tax.

Management's Discussion and Analysis

Financial Analysis

For the year ended December 31

(in millions of dollars)	Wealth Management		Employee Benefits		Individual Insurance		Capital & Surplus		Total	
	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Revenue										
Premium income	\$ 300	\$ 116	\$ 242	\$ 270	\$ 297	\$ 299	\$ –	\$ –	\$ 839	\$ 685
Fee and other income	87	94	6	6	1	2	1	1	95	103
Investment income	55	50	7	6	93	90	29	25	184	171
Realized gain on held for trading investments	4	4	3	1	23	15	1	–	31	20
Realized gain (loss) on available for sale investments including impairment write downs	–	1	–	–	(12)	(5)	(22)	(43)	(34)	(47)
Fair value change in assets	43	(40)	–	(5)	64	(199)	–	–	107	(244)
	489	225	258	278	466	202	9	(17)	1,222	688
Expenses										
Benefits and expenses	463	220	237	267	429	114	12	2	1,141	603
Income and other taxes	4	(3)	11	8	11	40	(10)	(5)	16	40
	467	217	248	275	440	154	2	(3)	1,157	643
Net income (loss) after tax	\$ 22	\$ 8	\$ 10	\$ 3	\$ 26	\$ 48	\$ 7	\$ (14)	\$ 65	\$ 45
Policyholders' portion									11	(3)
Shareholders' net income									\$ 54	\$ 48
Assets under management										
General fund assets	\$ 1,060	\$ 876							\$ 4,399	\$ 3,747
Segregated fund assets	\$ 4,310	\$ 3,349							\$ 4,310	\$ 3,349
Annualized premium sales			\$ 36	\$ 40	\$ 61	\$ 72				

Wealth Management

Assets in Empire Life segregated funds increased by 29% during 2009. The increase was attributable to positive investment returns, as the stock market recovery that began in the second quarter continued for the balance of the year, and positive net sales (gross sales net of withdrawals) in each of the last four quarters. Net sales during 2009 were positive despite decreased gross sales, which were down 15% from 2008. However, fourth quarter gross sales improved 11% relative to the corresponding period in 2008. General fund assets in this product line increased by 21% during the past year, primarily due to strong deferred annuity premium income described below.

Premium income for this product line is comprised solely of new deposits on products with a guaranteed rate of return and excludes deposits on segregated fund products. Premium income in this product line was up 155% for the year compared to 2008 due to increased sales of deferred annuities, as many customers selected fixed interest products over segregated funds due to continuing stock market uncertainty. Fourth quarter premium income in this product line was up 61% compared to 2008. Fee and other income, more than 99% of which is derived from segregated funds, declined 8% in 2009 relative to 2008 as management fees earned on segregated funds declined due to the impact of falling stock markets on assets under management. The fall in stock markets occurred during the second half of 2008 and stock markets remained weak during the first quarter of 2009. However markets recovered during the last three quarters of 2009 resulting in a 38% increase in fourth quarter segregated fund fee revenue relative to the corresponding period in 2008.

This product line's fair value change in assets was a gain in 2009 resulting primarily from a decrease in market interest rates since the beginning of the year versus a loss in 2008 resulting primarily from an increase in market interest rates since the beginning of 2008. However, this product line's realized gains (losses) on held for trading investments and its fair value change in assets were primarily related to gains or losses on bonds matched to policy liabilities resulting in a reduced impact on net income due to the corresponding change in policy liabilities.

Management's Discussion and Analysis

Net income was more than double the level this product line achieved in 2008. Net income improved relative to 2008 by \$9.9 million due to the annual update of actuarial assumptions related to both annuitant mortality and segregated fund guarantees, by \$6.5 million due to a release in guarantee policy liabilities in 2009 resulting from the rise in stock markets versus an increase in guarantee policy liabilities in 2008 resulting from a decline in stock markets, by \$5.8 million due to additional investment spreads, by \$1.2 million due to reduced new business strain due to the decline in segregated fund sales and by \$4.0 million due to favourable expense experience. These favourable items were partially offset by \$6.6 million due to lower net income on in-force business due to the decline in average segregated funds under management in 2009 versus 2008, and by \$3.3 million primarily due to experience losses on segregated fund death benefit guarantees. While both years had increased net income from non-recurring tax-related items, the 2009 gain was \$2.8 million lower than the 2008 gain.

Employee Benefits

Weaker sales during the second and third quarters resulted in annual sales for this product line that were 11% lower than 2008. However, fourth quarter sales improved 15% relative to the corresponding period in 2008. This product line's premium income for the year decreased by 10% relative to 2008 primarily due to a non-recurring transaction that terminated a reinsurance assumed agreement and lowered premium income by 8%. With the termination of this reinsurance agreement, Empire Life assumes only a small amount of risk through one remaining reinsurance agreement. The remaining 2% premium income decline resulted from this product line being negatively impacted by the severity of the economic downturn, particularly in Ontario.

This product line's realized gains (losses) on held for trading investments and its fair value change in assets were primarily related to gains or losses on bonds matched to policy liabilities resulting in a reduced impact on net income due to the corresponding change in policy liabilities.

Earnings for this product line more than tripled the comparable period in 2008. Net income improved relative to 2008 by \$5.5 million due to favourable claims results in 2009 versus unfavourable claims results in 2008 and by \$1.2 million due to the above mentioned 2009 non-recurring reinsurance transaction.

Individual Insurance

Sales in this product line were 15% lower than in 2008, primarily as a result of decreased investment deposits on universal life sales. Sales for the year excluding these investment deposits were 3% lower than in 2008. However, fourth quarter sales excluding these investment deposits were 7% higher relative to the corresponding period in 2008. Premium revenue for this product line was less than 1% lower than 2008 as the impact of the decline in sales for the current year was partially offset by the ongoing premium revenue from the sales during the latter portion of 2008.

This product line's fair value change in assets was a gain in 2009 resulting primarily from a decrease in market interest rates and an increase in common share prices since the beginning of the year versus a loss in 2008 resulting primarily from an increase in market interest rates and a decrease in common share prices since the beginning of 2008. However, this product line's realized gains (losses) on held for trading investments and its fair value change in assets were primarily related to gains or losses on bonds and common shares matched to policy liabilities resulting in a reduced impact on net income due to the corresponding change in policy liabilities.

This product line's 2009 net income decreased relative to 2008. This decrease was primarily a consequence of actuarial assumption updates. During the fourth quarter, the Company completes its annual review and revision of the actuarial assumptions underlying policy liabilities. Current year net income for this line of business was decreased by \$38.7 million relative to last year due to a large release in 2008 resulting from the annual update of assumptions. Of this amount, \$29.3 million for shareholders and \$0.4 million for policyholders related to 2008 is non-recurring as it relates to an updated approach in 2008 for establishing the insurance mortality assumption. The balance of the net decrease in net income from the annual update of assumptions was primarily a result of lower reserve releases related to mortality and reserve strengthening to reflect lower future expected reinvestment rates, and to update expense assumptions. Otherwise, net income declined relative to 2008 by \$10.2 million due to other than temporary impairment write downs reclassified from OCI to net income, and by \$3.5 million due to future investment returns on assets acquired this year versus last year. These unfavourable items were partially offset by

Management's Discussion and Analysis

\$3.3 million due to reduced new business strain due to the decline in sales, by \$2.6 million due to higher profit margins on the in-force block and by \$10.6 million due to improved investment, surrender, mortality, and expense experience. While both years had increased net income from non-recurring tax-related items, the 2009 gain was \$13.6 million higher than the 2008 gain and \$12.0 million of this increase was attributable to policyholders' net income.

Capital and Surplus

In addition to the three major lines of business, the Company maintains distinct accounts for the investment income attributable to Policyholders' Surplus and to Shareholders' Capital and Surplus. 2009 Capital and Surplus earnings increased relative to the comparable period of 2008 by \$31.9 million due to realized gains in 2009 versus realized losses incurred in 2008 on the sale of investments, by \$3.5 million due to higher investment income and by \$7.4 million due to amendments to the Income Tax Act primarily related to Financial Instruments. These favourable items were partially offset by \$15.2 million due to other than temporary impairment write downs reclassified from OCI to net income, and by \$6.5 million due to an increase in interest expense on subordinated debt.

Liquidity and Capital Resources

The Company maintains a high level of liquid assets in its general fund so that cash demands can be readily met. At the end of 2008 and 2009, total liquid assets were more than double total demand liabilities.

During 2009, cash provided by operations was \$327.8 million compared to \$106.6 million in 2008. For 2009, the increase in cash provided by operations relative to 2008 was primarily as a consequence of increased cash inflows related to annuity business, the collection of income taxes receivable, and reduced commission expenses due to lower life insurance and segregated fund sales.

Cash used for investment activities was \$425.2 million in 2009 compared to \$244.1 million in 2008. The increase in cash used for investment activities in 2009 relative to 2008 was primarily due to investment of increased cash provided by operations.

Cash provided from financing activities during 2009 was \$73.9 million versus \$125.0 million in 2008. The change relative to 2008 was the issuance of \$200.0 million principal amount of subordinated debt in 2009 and the 2009 repayment of \$125.0 million of subordinated debt issued to its ultimate parent company, E-L Financial Corporation Limited, in 2008.

The Company has a defined benefit pension plan that moved into a deficit position during 2008 as a result of the declines in global stock markets. The Company estimates that annual pension funding requirements will be \$5.0 million during 2010 and remain at the 2010 level until the next funded position valuation.

The Company continues to maintain a strong balance sheet and capital position. Empire Life's risk based capital ratio, as measured by Minimum Continuing Capital and Surplus Requirements (MCCSR), at 266% as of December 31, 2009 (201% as of December 31, 2008), continued to be well above requirements. Empire Life's MCCSR ratio improvement from December 31, 2008 levels was partially attributable to the issuance of subordinated debt during the second quarter, which increased the principal amount of subordinated debt by \$75 million. The A (Excellent) rating given to Empire Life by A.M. Best Company provides third party confirmation of this strength.

Empire Life's capital has exceeded the requirements of the *Insurance Companies Act (Canada)* and regulations thereunder throughout 2009 and to the date of this report. Capital adequacy is predominantly determined by the Minimum Continuing Capital and Surplus Requirements (MCCSR), a calculation defined by the Office of the Superintendent of Financial Institutions, the solvency regulator of federal financial institutions. The MCCSR is the ratio of regulatory "capital available" divided by regulatory "capital required" and is reported to the federal regulator in a prescribed filing each quarter. The federal regulator has established a supervisory target MCCSR result of 150% to provide a safety buffer above the legally required minimum MCCSR result of 120%. Empire Life does not have a formal MCCSR target or range. Management seeks to maintain capital that is sufficient, based on management's ongoing assessment of risks, to sustain reasonably possible losses or unrealized declines in investment values and remain above the regulator's supervisory target. Declines in common stock values in 2008 had an adverse impact on available capital due to the decline in value of Empire Life's stock portfolio, and on required capital due to Empire Life's segregated fund guarantees. In 2008 and 2009 Empire Life did not declare a dividend

Management's Discussion and Analysis

in order to preserve available capital. In September 2008 and May 2009, Empire Life issued a combined total of \$200 million principal amount of subordinated debt in order to increase the level of available capital. In 2009, the recovery of common stock values caused improvements in both available capital and required capital resulting in a large improvement in Empire Life's MCCSR ratio.

Other Comprehensive Income

Unrealized gains and losses on Capital and Surplus financial assets and on certain financial assets matching policy liabilities are recorded as Other Comprehensive Income (OCI) or Other Comprehensive Loss (OCL). The net unrealized gains on these assets, primarily as a result of the recovery in Canadian stock markets during the fourth quarter coupled with the realized gains and losses and other than temporary impairment write downs reclassified from OCI to net income, resulted in an increase in quarterly and full year OCI relative to the comparable periods last year. After consideration of participating policyholders' interests, the net result for 2009 was OCI of \$21.0 million for the fourth quarter and \$93.5 million for the full year, versus OCL of \$42.3 million for the fourth quarter and OCL of \$99.2 million for the full year for 2008. For policyholders, the net result for 2009 was OCI of \$1.4 million for the fourth quarter and \$7.6 million for the full year, versus OCL of \$3.0 million for the fourth quarter and OCL of \$7.9 million for the full year for 2008.

Industry Dynamics and Management's Strategy

The Company's operations are organized by product line with each line of business having responsibility for product development, marketing, distribution and customer service within their particular markets. This structure recognizes that there are distinct marketplace dynamics in each of the three major product lines. Management believes this structure enables each line of business to develop strategies to achieve the enterprise-wide objectives of business growth and expense management while recognizing the unique business environment in which each operates. The lines of business are supported by corporate units that provide product pricing, administrative and technological services to the lines of business, manage invested assets, and oversee enterprise risk management policies.

Based on general fund and segregated fund assets, Empire Life is among the ten largest life insurance companies in Canada. Empire Life has less than six per cent market share in all three of its product lines. To be priced reasonably competitively in the marketplace while simultaneously providing acceptable long-term financial contribution to shareholders, Empire Life, as a mid-sized company, must find a way to be cost competitive with the larger companies that have some natural economy of scale advantages. In order to improve its unit expenses, management's enterprise-wide strategic focus has been on steady growth in its selected markets and on expense management. Empire Life has focused exclusively on the Canadian marketplace and within it, on particular market segments where management feels there are opportunities to build solid, long-term relationships with independent distribution partners by offering competitive products and more personal service. By focusing on particular market segments and by being seen by these independent advisors as a viable alternative to a shrinking number of broadly focused competitors, we believe these solid relationships will enable sustainable growth at above industry average levels and ultimately result in competitive unit expenses.

The Wealth Management product line at Empire Life is comprised of segregated fund products and guaranteed interest products. These products compete against those offered not only by other life insurers but also by a variety of other financial institutions. A key element of any competitive strategy in this market is providing a competitive rate of return to clients. The value oriented equity investment strategy used by Empire Life has resulted in an above average long-term return track record in the fund marketplace. We are expecting to continue to take advantage of this competitive track record and thus grow our market share through broadened distribution reach coupled with the addition of new funds and fund products.

Within the broader employee benefits marketplace in Canada, Empire Life continues to focus on the small group market comprised of employers with fewer than 200 employees. This niche strategy coupled with an ongoing focus on balancing growth and profit has enabled Empire Life to be cost competitive within this market segment and is expected to enable this product line to continue to grow its market share while generating acceptable returns.

Individual Insurance products are very long-term in nature and consequently can be subject to significant levels of new business strain. New business strain occurs when the provision for adverse deviation included in the actuarial policy liabilities

Management's Discussion and Analysis

exceeds the profit margin in the product pricing. Unless a company opts for increased levels of reinsurance, current price levels in the Canadian marketplace create significant new business strain that has a negative impact on short-term earnings. Rather than give up the future earnings that would emerge if the trend in mortality improvement witnessed in recent decades continues, the Company continues to utilize lower than average levels of reinsurance with the resultant negative impact on short-term earnings. Because of the reasonable long-term returns of this product line, we continue to focus on steady growth, technology development and process improvement in order to continue to improve this product line's unit expenses and maintain a competitive market position while generating acceptable long-term financial contribution.

Risk Management

Empire Life's MCCSR ratio is sensitive to stock market volatility, primarily due to liability and capital requirements related to segregated fund guarantees. As of December 31, 2009 Empire had \$4.3 billion of segregated fund assets. Of this amount, approximately \$4.0 billion have guarantees. As of December 31, 2009, 88.6% (December 31, 2008 94.1%) of the segregated fund assets with guarantees were within contracts with a 75% maturity guarantee and a 100% death benefit guarantee. Empire Life also has small portfolios of contracts with 100% maturity and death benefit guarantees (with a minimum of 15 years between deposit and maturity date) and contracts with a guaranteed minimum withdrawal benefit (GMWB). As of December 31, 2009 these small portfolios of contracts make up 5% (December 31, 2008 4.2%) and 6.4% (December 31, 2008 1.8%) of the contracts with guarantees respectively. All of Empire Life's segregated fund guarantees are policy based (not deposit based), thereby lowering Empire Life's stock market sensitivity. Based on stock market levels on December 31, of the years indicated below, the sensitivity of Empire Life's shareholders' net income to changes in segregated fund guarantee policy liabilities resulting from stock market increases and decreases is as follows:

\$ millions	10% Increase	10% Decrease	20% Increase	20% Decrease
Sensitivity to Segregated Fund Guarantees:				
2009 Shareholders' net income	\$ -	\$ -	\$ -	\$ -
2008 Shareholders' net income	\$ 4.7	\$ (20.3)	\$ 4.7	\$ (42.7)

The sensitivity of shareholders' net income to segregated fund guarantees decreased as of December 31, 2009 relative to December 31, 2008 levels due to the recovery of global stock markets.

Based on stock market levels on December 31 of the years indicated below the sensitivity of Empire Life's MCCSR ratio to stock market increases and decreases for all Empire Life stock market exposures, including segregated fund guarantees, is as follows:

	10% Increase	10% Decrease	20% Increase	20% Decrease
Sensitivity to Stock Markets:				
2009 MCCSR Ratio	2.5%	-7.4%	4.9%	-36.5%
2008 MCCSR Ratio	19.0%	-13.0%	41.0%	-24.0%

Empire Life has not historically hedged or reinsured segregated fund guarantee risk. At the current segregated fund product mix and level of sensitivity to stock markets, Empire Life does not hedge or reinsure segregated fund guarantee risk as of December 31, 2009. In addition, Empire Life does not reinsure any other insurer's segregated fund products.

Management's Discussion and Analysis

The amount at risk related to segregated fund maturity guarantees and segregated fund death benefit guarantees and the resulting actuarial liabilities and MCCSR required capital for Empire Life segregated funds is as follows:

Segregated Funds \$ millions	Guarantee > Fund Value		Death Benefit > Fund Value		Actuarial Liabilities	MCCSR Required Capital
	Fund Value	Amount At Risk	Fund Value	Amount At Risk		
December 31, 2009	\$ 185.9	\$ 22.1	\$ 2,046.1	\$ 315.8	\$ –	\$ –
December 31, 2008	\$ 1,355.4	\$ 191.8	\$ 2,388.4	\$ 850.8	\$ 12.0	\$ 80.5

The amount at risk represents the excess of the future maturity guarantee or future death benefit guarantee amount over the fund value on all segregated fund policies where the future maturity guarantee or future death benefit guarantee is greater than the fund value. The amount at risk is not currently payable. Payment is contingent on future outcomes including fund performance, deaths, deposits, withdrawals and maturity dates. The level of actuarial liabilities and required capital is calculated based on the probability that Empire Life will ultimately have to make payment to the segregated fund policyholders for any fund value deficiency that may exist upon either future maturity of the segregated fund policies, or upon future death of the segregated fund policyholders. The actuarial liabilities and the MCCSR required capital related to segregated fund guarantees are calculated using stochastic projections of future cash flows. These future cash flows not only consider expenses and guarantee benefits, but also future revenues. If, under adverse scenarios, the future management fee revenues are more than enough to cover future benefits and expenses, then the liability amount is set to nil. The amounts at risk, actuarial liabilities and MCCSR required capital decreased in 2009 from December 2008 levels primarily due to the recovery of global stock markets.

In addition to the discussion of risks included in this MD&A, a comprehensive discussion of the material risks that impact Empire Life is included in the Annual Information Form of Empire Life's parent company, E-L Financial Corporation Limited, which is available at www.sedar.com. Additional disclosures of Empire Life's sensitivity to risks are included in Notes 3, 6(e) and 8 to the financial statements.

Critical Accounting Estimates

The Company's significant accounting policies are described in Note 2 to the Financial Statements. Certain of these policies require management to make estimates and assumptions about matters that are inherently uncertain. The most critical of these estimation processes for the Company are the valuation of policy liabilities and the determination of allowances for impaired investments.

Policy Liabilities

The determination of policy liabilities requires best estimate assumptions that cover the remaining life of the policies for mortality, morbidity, investment returns, persistency, expenses, inflation and taxes and include consideration of related reinsurance effects. Due to the long-term risks and measurement uncertainties inherent in the life insurance business, a margin for adverse deviation from best estimates is included in each assumption. These margins allow for possible deterioration in future experience and provide for greater confidence that policy liabilities are adequate to pay future benefits. The resulting provisions for adverse deviations have the effect of increasing policy liabilities and decreasing the income that otherwise would have been recognized at policy inception. A range of allowable margins is prescribed by the Canadian Institute of Actuaries. Assumptions are reviewed and updated at least annually and the impact of changes in those assumptions is reflected in earnings in the year of the change. Empire Life's sensitivity to risks related to policy liabilities are included in Notes 6(e) and 8 to the financial statements.

Provisions for Impaired Investments

The Company maintains a prudent policy in setting the provision for impaired investments. When there is no longer reasonable assurance of full collection of loan principal and loan interest related to a mortgage or policy contract loan,

Management's Discussion and Analysis

management establishes a specific provision for loan impairment and charges the corresponding reduction in carrying value to income in the period the impairment is identified. In determining the estimated realizable value of the investment, management considers a number of events and conditions. These include the value of the security underlying the loan, geographic location, industry classification of the borrower; an assessment of the financial stability of the borrower; repayment history and an assessment of the impact of current economic conditions. Changes in these circumstances may cause subsequent changes in the estimated realizable amount of the investment and thus to the specific provision for impairment.

Available for sale securities are subject to a regular review for losses that are other than temporary. If a security is assessed to have a loss that is other than temporary, the security is written down to fair value in the statement of general fund operations. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been below cost, the financial conditions and near-term prospects of the issuer and the ability and intent to hold the investment for a period of time sufficient to allow for recovery.

Quarterly Results

The following table summarizes various financial results on a quarterly basis for the most recent eight quarters:

(in millions of dollars)	Dec 31 2009	Sept 30 2009	June 30 2009	Mar 31 2009	Dec 31 2008	Sept 30 2008	June 30 2008	Mar 31 2008
Revenue	\$ 197	\$ 390	\$ 396	\$ 239	\$ 204	\$ 71	\$ 199	\$ 214
Shareholders' net income (loss)	\$ 4	\$ (1)	\$ 14	\$ 37	\$ 3	\$ 28	\$ 20	\$ (3)

Revenue for the three months ended December 31, 2009 decreased to \$197 million (2008 \$204 million) due to a negative \$70 million (2008 negative \$13 million) fair value change in assets partially offset by lower realized losses on sale of investments, including impairment write downs, of \$1 million (2008 loss of \$38 million), higher fee revenue of \$26 million (2008 \$19 million) and higher investment income of \$49 million (2008 \$45 million). Fair value change in assets was primarily related to gains or losses on bonds and equities matched to policy liabilities resulting in a reduced impact on net income due to the corresponding change in policy liabilities.

Empire Life reported shareholders' net income of \$4.0 million for the fourth quarter of 2009, compared to \$3.4 million for the fourth quarter of 2008. While the increase in quarterly net income is small, it is comprised of a number of large offsetting items. Capital and Surplus net income improved in 2009 relative to the comparable period in 2008 as the 2008 declines in global stock markets resulted in realized losses on the sale of investments during 2008. This was partly offset by net income from the three major Empire Life product lines (Wealth Management, Employee Benefits and Individual Insurance) which was lower overall relative to the fourth quarter of 2008 primarily due to a \$29.3 million after-tax reserve release in 2008 that is non-recurring as it related to an updated approach for establishing the insurance mortality assumption. 2009 fourth quarter net income was also lower by \$13.5 million after tax for shareholders and \$0.7 million after tax for policyholders relative to the fourth quarter of 2008 as losses were reclassified from Other Comprehensive Income (OCI) to net income because of other than temporary impairment write downs of common and preferred shares in 2009. These write downs mainly reduced Individual Insurance and Capital and Surplus net income. Otherwise, fourth quarter net income improved in 2009 relative to 2008 due to a strong improvement in Wealth Management and Employee Benefits results.

Conversion to International Financial Reporting Standards (IFRS)

IFRS will replace Canadian GAAP for publicly accountable enterprises for fiscal years beginning on or after January 1, 2011. Empire Life, as a federally regulated financial institution, is considered a publicly accountable enterprise. Empire Life will begin to report its financial results, including comparative information, in accordance with IFRS for the quarter ended March 31, 2011.

A steering committee comprised of senior management oversees the project and provides quarterly status reports to Empire Life's Audit Committee. Steering committee members and project staff continue to develop financial reporting expertise in IFRS.

Management's Discussion and Analysis

Significant changes to IFRS accounting standards were issued during 2009 and will continue to be issued throughout the transition period. In addition, regulatory and capital requirements are in the process of being amended to reflect the adoption of IFRS-based financial reporting and are expected to be finalized in March 2010. As greater certainty is gained with respect to the direction of accounting standard setters and regulators, changes may be required to our preliminary accounting policy choices and transition elections.

Empire Life's project plan includes four phases: analysis, design and planning, solution development and implementation. The analysis phase has been completed and the accounting standards that are expected to have a significant impact on Empire Life's recognition, measurement, presentation and disclosure in its financial statements have been identified. The design and planning and solution development phases are currently underway. Accounting policy choices have been made based on the expected accounting requirements in 2011. Financial statement presentation and disclosures are currently being prepared and any resulting changes to systems and business processes are being identified. Potential changes to internal controls over financial reporting and disclosure controls and procedures will also be considered during this phase. The implementation phase will be executed throughout 2010, and will include modifying systems and business processes where necessary, preparing the IFRS opening balance sheet as at January 1, 2010, performing dual accounting under both Canadian GAAP and IFRS, and preparing detailed reconciliations of Canadian GAAP to IFRS financial statements for disclosure purposes.

The most critical area identified to date that could result in significant changes from Canadian GAAP for Empire Life relates to the optional elections available under IFRS 1 "First-Time Adoption of International Financial Reporting Standards." IFRS 1 provides a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRSs. For Empire Life, the two most significant optional exemptions relate to financial instruments and defined benefit plans.

For financial instruments, IFRS 1 permits an entity to redesignate previously recognized financial instruments on transition to IFRS. Empire Life plans to elect to redesignate certain investments held on behalf of insurance operations from the available for sale designation to the fair value through profit or loss designation. The redesignation will result in better matching of fair value changes in insurance liabilities and the assets that support them.

The accumulated unrealized gains and losses on the redesignated investments will be reclassified from accumulated other comprehensive income to opening retained earnings on January 1, 2010. Subsequent unrealized gains and losses will be recorded in the statement of general fund operations.

For defined benefit plans, IFRS 1 provides an election to recognize all cumulative unamortized actuarial gains and losses in opening retained earnings on transition to IFRS, which provides relief from the requirement to retrospectively apply IAS 19 "Employee Benefits" to all defined benefit plans. Empire Life plans to take this election for all of its defined benefit pension and other post-employment benefit plans, as it would be impracticable to restate each plan from its inception date under IAS 19.

Empire Life continues to assess the ongoing financial reporting, presentation and disclosure impacts of reporting under IFRS, including the quantitative impact of accounting policy choices.

Outlook

The 2009 stock market and credit market recovery from the economic turmoil of 2008 mainly improved results for the Company's Wealth Management product line. Looking forward, the improvement of Wealth Management is expected to continue in 2010 as profit margins continue to recover in the segregated fund business. Consumers continue to be cautious about stock market exposure and Empire Life is well positioned with deferred annuity product offerings to satisfy the present preference for low risk investments. The strength of the economic recovery in Canada continues to be uncertain with mixed economic indicators and a concern that much of the improvement in the economy is derived from temporary government stimulus. As a result businesses remain cautious and this is likely to cause continued pressure in the near term on growth prospects for the Employee Benefits product line. However, the Individual Insurance product line is less sensitive to stock market and employment conditions than these two product lines.

Management's Discussion and Analysis

The landscape of the Canadian life insurance marketplace continues to be dominated by the three largest carriers who have in excess of 60% of all major industry segments. In order to compete, Empire Life focuses on personal customer service, relationship management with distribution partners, and prudent technology investment.

The focus at Empire Life in the employee benefits marketplace continues to be on balanced growth and profit, and its demonstrated impact in reducing unit expenses. This, coupled with a focus on building strong relationships with our producing partners, should continue to enhance our strong presence in the small group marketplace while simultaneously achieving acceptable returns. However, much will depend on the severity and duration of the economic weakness we are currently experiencing as the Company's target market is primarily small businesses, and these businesses are being hampered by the current economic conditions.

The individual life insurance marketplace in Canada continues to be competitively priced. This is partly due to the ongoing improvements in mortality and in operating efficiencies, most of which have been passed on to the consumer. It is also partly due to the availability of competitive reinsurance rates that enable companies that use higher levels of reinsurance to reduce new business strain and thus avoid having sales growth suppress short-term earnings. We will continue to take advantage of the growth resulting from the strong relationships that have been built with members of both the IFA and MGA distribution networks, and will continue to broaden our distribution reach into the National Account network. Despite modest overall industry growth in this product line over the last five years, the Company has experienced significant sales growth over the same period despite the decline during 2008 and 2009. This, in turn, has resulted in significant improvements in cost ratios. While expecting to continue to grow this line of business at above the forecast modest industry average rates, this past improvement in unit expenses means that we can continue to take a more balanced approach to growth and profit and focus on those market segments where our core products are both competitive and provide an acceptable rate of return. Aside from the impact of stock market conditions on the outlook for management fee spreads on universal life equity index products, the life insurance business is less sensitive to stock market and employment conditions than the Company's other product lines.

On the Wealth Management side of the business, five straight years of positive returns from Canadian stock markets came to an end in 2008 as markets dropped 35%. But Canada's main stock index recovered almost 31% in 2009. The 2008 downturn and uncertainty and volatility in 2009 continue to hurt segregated fund and mutual fund sales for many players in the Canadian pooled fund marketplace and led to weaker, but still positive net segregated fund sales for the Company in 2009. Our focus continues to be growing our market share in the segregated fund business. During the fourth quarter of 2008, the Company introduced a new Guaranteed Minimum Withdrawal Benefit segregated fund product, invested in risk management capabilities by developing a stochastic model approach and obtained OSFI approval for use of this model in support of this business line. The Company also developed a Tax-Free Savings Account product launched in early 2009. Looking forward, it is expected that the continued development of new product offerings and features coupled with a strong sales account management team will enable a continuation of the market share growth we have experienced in the last several years. The Company believes that segregated fund products will be even more appealing to customers after their personal experiences with market turmoil, and that Empire Life is well positioned to benefit from this. An eventual stabilization of stock markets should reward customers and lead to a continuing recovery of fee revenues for the Company.

The Company remains committed to the distribution of its products through qualified intermediaries who can provide the counsel consumers need to fulfil their financial security and wealth management goals. It is our intention to continually enhance the product, technology and service support that these advisors need to satisfy their clients. We believe that the strengthening of our relationships with our distribution partners and a focus on developing new relationships with quality advisors are the key elements in achieving our growth goals.

Management's Responsibility for Financial Reporting

The financial statements in this annual report have been prepared by management, who is responsible for their integrity, objectivity and reliability. This responsibility includes selecting and applying appropriate accounting policies, making judgements and estimates and ensuring information contained throughout the annual report is consistent with these statements. These financial statements are prepared in accordance with the *Insurance Companies Act (Canada)* which states that, except as otherwise specified by the Office of the Superintendent of Financial Institutions Canada (OSFI), the financial statements are to be prepared in accordance with Canadian generally accepted accounting principles (GAAP).

The accounting systems and related internal controls of the Company are management's responsibility and are designed to provide reasonable assurance that financial records are complete and accurate and form a proper basis for the preparation of the financial statements and, in addition, that assets are safeguarded against loss from unauthorized use or disposition.

The Board of Directors, acting through the Audit Committee which is comprised of directors who are not officers or employees of the Company, oversees management's responsibility for financial reporting and for internal control systems. The Audit Committee is responsible for reviewing the financial statements and annual report and recommending them to the Board of Directors for approval. The Audit Committee meets with management, internal audit and the external auditors to discuss audit plans, internal controls over accounting and financial reporting processes, auditing matters, and financial reporting issues.

The Appointed Actuary is appointed by the Board of Directors and is responsible for ensuring that the assumptions and methods used in the valuation of the policy liabilities are in accordance with accepted actuarial practice and regulatory requirements. The Appointed Actuary is required to provide an opinion regarding the appropriateness of the policy liabilities at the balance sheet date to meet all policyholder obligations of the Company. Examination of supporting data for accuracy and completeness and analysis of Company assets for their ability to support the amount of policy liabilities are important elements of the work required to form this opinion. The Appointed Actuary is also required each year to analyze the financial condition of the Company and prepare a report for the Board of Directors. The analysis tests the capital adequacy of the Company under adverse economic and business conditions for the current year and the next four years.

Deloitte & Touche's responsibility as external auditors is to report to the policyholders, shareholders and OSFI regarding the fairness of presentation of the Company's annual financial statements. The external auditors have full and free access to, and meet periodically with, the Audit Committee to discuss their audit. The Auditors' Report outlines the scope of their examination and their opinion.



Leslie C. Herr
President and Chief Executive Officer
Kingston, Ontario
February 24, 2010



Gary J. McCabe
Senior Vice-President and Chief Financial Officer
Kingston, Ontario
February 24, 2010

Auditors' Report

To the Policyholders and Shareholders of The Empire Life Insurance Company

We have audited the balance sheet of The Empire Life Insurance Company (the "Company") including the balance sheet of its segregated funds as at December 31, 2009 and the statements of general fund operations, comprehensive income, shareholders' equity, policyholders' equity, general fund cash flows and changes in segregated funds for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company and its segregated funds as at December 31, 2009 and the results of its operations, its cash flows and the changes in its segregated funds net assets for the year then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants
Licensed Public Accountants
Toronto, Ontario
February 24, 2010

Appointed Actuary's Report

To the Policyholders and Shareholders of The Empire Life Insurance Company

I have valued the policy liabilities of The Empire Life Insurance Company for its balance sheet as at December 31, 2009 and their change in the statement of operations for the year then ended in accordance with accepted actuarial practice, including selection of appropriate assumptions and methods.

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



J. Edward Gibson, F.S.A., F.C.I.A.
Fellow, Canadian Institute of Actuaries
Kingston, Ontario
February 24, 2010

Balance Sheet

As at December 31

(in thousands of dollars)

	2009	2008
Assets		
General Funds		
Cash and cash equivalents	\$ 149,141	\$ 172,724
Short-term investments (note 3)	37,080	75,895
Bonds (note 3)	2,795,896	2,307,941
Common and preferred shares (note 3)	949,742	633,549
Mortgages (note 3)	223,642	242,678
Real estate (note 3)	15,601	15,355
Loans on policies (note 3)	38,728	37,161
Policy contract loans (note 3)	137,764	142,863
Accrued investment income	17,827	15,002
Premiums receivable	3,914	5,562
Current income taxes receivable (notes 9 and 11)	–	62,995
Other assets (note 17)	29,315	35,081
TOTAL GENERAL FUND ASSETS	\$ 4,398,650	\$ 3,746,806
Segregated Funds		
Cash and cash equivalents	\$ 142,279	\$ 305,043
Short-term investments	230,409	345,878
Bonds	627,045	447,711
Common and preferred shares	3,294,346	2,248,340
Other assets	16,322	1,855
TOTAL SEGREGATED FUND ASSETS	\$ 4,310,401	\$ 3,348,827

On Behalf of the Board of Directors:



Duncan N.R. Jackman
Chairman of the Board



Leslie C. Herr
President and Chief Executive Officer

Balance Sheet

As at December 31

(in thousands of dollars)

	2009	2008
Liabilities		
General Funds		
Policy liabilities (notes 5, 6, 7, 8 and 9)	\$ 3,192,988	\$ 2,807,746
Policyholders' funds on deposit	29,702	30,982
Provision for unpaid and unreported claims	32,606	35,955
Provision for profits to policyholders	18,558	17,186
Accounts payable and other liabilities (note 21)	82,769	79,481
Current income taxes payable (notes 9 and 11)	30,065	–
Future income taxes (note 9)	1,116	4,630
Subordinated debt (notes 18 and 20)	198,980	125,000
	3,586,784	3,100,980
Shareholders' and Policyholders' Equity		
Shareholders' equity (note 13)		
Capital stock (note 12)	985	985
Contributed surplus	19,387	19,387
Retained earnings	697,212	643,410
Accumulated other comprehensive income (loss)	33,470	(60,078)
	751,054	603,704
Policyholders' equity (note 13)		
Retained earnings	57,839	46,715
Accumulated other comprehensive income (loss)	2,973	(4,593)
	60,812	42,122
	811,866	645,826
TOTAL GENERAL FUND LIABILITIES AND EQUITY	\$ 4,398,650	\$ 3,746,806
Segregated Funds		
Policy liabilities	\$ 4,310,401	\$ 3,348,827

Statement of General Fund Operations

Year ended December 31

(in thousands of dollars)

	2009	2008
Revenue		
Insurance premiums	\$ 539,570	\$ 568,473
Annuity premiums	300,306	117,705
Investment income (note 3)	183,964	170,700
Fair value change in held for trading assets	106,699	(244,384)
Realized gain on held for trading assets	30,641	19,920
Realized gain (loss) on available for sale assets including impairment write downs (note 3)	(34,409)	(47,207)
Fee income	95,453	103,171
	1,222,224	688,378
Benefits and Expenses		
Insurance benefits	279,362	293,865
Annuity benefits	199,213	179,299
Policy dividends	17,629	16,681
Increase (decrease) in policy liabilities (notes 5, 6, 7, 8 and 9)	385,242	(151,856)
Operating expenses	103,765	111,822
Commissions	144,530	151,247
Interest expense	11,399	1,943
	1,141,140	603,001
NET INCOME BEFORE TAXES	81,084	85,377
Taxes – premium	11,436	11,620
– investment and capital	3,300	3,200
– income (note 9)	1,422	25,469
	16,158	40,289
NET INCOME	64,926	45,088
Participating policyholders	11,124	(3,282)
Shareholders' Net Income	\$ 53,802	\$ 48,370

Statements of Comprehensive Income

Year ended December 31

(in thousands of dollars)

	2009	2008
Shareholders'		
Net income	\$ 53,802	\$ 48,370
Other comprehensive income (loss), net of income taxes:		
Unrealized fair value change on available for sale investments (note 11)	67,009	(128,203)
Less realized fair value change on available for sale investments including impairment write downs reclassified to net income (notes 3 and 11)	(24,518)	(33,320)
Net unrealized fair value increase (decrease)	91,527	(94,883)
Gain (loss) on derivative investments designated as cash flow hedges (notes 3 and 11)	912	(3,624)
Less gain (loss) on derivative investments designated as cash flow hedges reclassified to net income (notes 3 and 11)	(268)	(145)
Net gain (loss) on derivatives designated as cash flow hedges	1,180	(3,479)
Shareholder portion of policyholder other comprehensive income (loss)	841	(882)
Total other comprehensive income (loss)	93,548	(99,244)
COMPREHENSIVE INCOME (LOSS)	\$ 147,350	\$ (50,874)
Policyholders'		
Net income (loss)	\$ 11,124	\$ (3,282)
Other comprehensive income (loss), net of income taxes:		
Unrealized fair value change on available for sale investments (note 11)	6,757	(12,089)
Less realized fair value change on available for sale investments including impairment write downs reclassified to net income (notes 3 and 11)	(1,650)	(3,267)
Net unrealized fair value increase (decrease)	8,407	(8,822)
Shareholder portion of policyholder other comprehensive income (loss)	(841)	882
Total other comprehensive income (loss)	7,566	(7,940)
COMPREHENSIVE INCOME (LOSS)	\$ 18,690	\$ (11,222)

Statement of Shareholders' Equity

Year ended December 31

(in thousands of dollars)

	2009	2008
Capital stock	\$ 985	\$ 985
Contributed surplus	19,387	19,387
Retained earnings – beginning of year	643,410	595,040
Net income	53,802	48,370
Retained earnings – end of year	697,212	643,410
Accumulated other comprehensive income (loss) – beginning of year	(60,078)	39,166
Other comprehensive income (loss)	93,548	(99,244)
Accumulated other comprehensive income (loss) – end of year <i>(note 14)</i>	33,470	(60,078)
TOTAL SHAREHOLDERS' EQUITY	\$ 751,054	\$ 603,704

Statement of Policyholders' Equity

Year ended December 31

(in thousands of dollars)

	2009	2008
Retained earnings – beginning of year	\$ 46,715	\$ 49,997
Share of net income (loss)	11,124	(3,282)
Retained earnings – end of year	57,839	46,715
Accumulated other comprehensive income (loss) – beginning of year	(4,593)	3,347
Other comprehensive income (loss)	7,566	(7,940)
Accumulated other comprehensive income (loss) – end of year <i>(note 14)</i>	2,973	(4,593)
TOTAL POLICYHOLDERS' EQUITY	\$ 60,812	\$ 42,122

Statement of General Fund Cash Flows

Year ended December 31

(in thousands of dollars)

	2009	2008
Operating Activities		
Net income	\$ 64,926	\$ 45,088
Non-cash items affecting net income		
Increase (decrease) in policy liabilities	385,242	(151,856)
Fair value change in held for trading assets	(106,699)	244,384
Realized (gain) loss on assets including impairment write downs	3,768	27,287
Amortization related to invested assets	(68,325)	(76,614)
Future income taxes	(8,389)	(4,479)
Other items	57,235	22,794
CASH PROVIDED FROM OPERATING ACTIVITIES	327,758	106,604
Investment Activities		
Portfolio investments		
Purchases and advances	(1,046,238)	(800,825)
Sales and maturities	579,985	597,038
Loans on policies		
Advances	(8,073)	(7,507)
Repayments	12,202	11,634
Decrease (increase) in short-term investments	38,815	(41,063)
Other	(1,893)	(3,333)
CASH PROVIDED FROM (USED FOR) INVESTMENT ACTIVITIES	(425,202)	(244,056)
Financing Activities		
Debt issue (note 18)	198,861	125,000
Debt repayment (note 20)	(125,000)	–
CASH PROVIDED FROM FINANCING ACTIVITIES	73,861	125,000
Net change in cash and cash equivalents	(23,583)	(12,452)
Cash and cash equivalents – beginning of year	172,724	185,176
CASH AND CASH EQUIVALENTS – END OF YEAR (note 23)	\$ 149,141	\$ 172,724
Supplementary information:		
Cash disbursements made for:		
Interest on subordinated debt	\$ 11,618	\$ –
Income taxes, net of (refunds)	\$ (42,866)	\$ (8,644)

Statement of Changes in Segregated Funds

Year ended December 31

(in thousands of dollars)

	2009	2008
Segregated funds – beginning of year	\$ 3,348,827	\$ 4,594,300
Additions to segregated funds:		
Amounts received from policyholders	1,024,694	1,261,903
Interest	33,024	53,282
Dividends	81,790	93,817
Net realized gains on sale of investments	167,652	–
Net unrealized increase in market value of investments	572,517	–
	5,228,504	6,003,302
Deductions from segregated funds:		
Amounts withdrawn or transferred by policyholders	830,800	1,023,266
Net realized losses on sale of investments	–	545,095
Net unrealized decrease in market value of investments	–	986,196
Management fees and other operating costs	87,303	99,918
SEGREGATED FUNDS – END OF YEAR	\$ 4,310,401	\$ 3,348,827

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

1. Nature of the Business

The Empire Life Insurance Company (the Company) underwrites life and health insurance policies and annuity contracts for individuals and groups. The Company is a subsidiary of E-L Financial Corporation Limited. As at December 31, 2009 the Company has no separate subsidiaries.

2. Significant Accounting Policies

These financial statements have been prepared in accordance with the *Insurance Companies Act (Canada)* which states that, except as otherwise specified by the Office of the Superintendent of Financial Institutions Canada (OSFI), the financial statements are to be prepared in accordance with Canadian generally accepted accounting principles (GAAP).

The Company's financial statements report general fund and segregated fund results separately. The significant accounting policies, which follow, relate to the general fund unless they are specifically identified as segregated fund related:

(a) Change in Accounting Policies

(i) Goodwill and Intangible Assets

Effective January 1, 2009, the Company adopted CICA Handbook Section 3064, *Goodwill and Intangible Assets*, which established new standards for the recognition, measurement and disclosure of goodwill and intangible assets. The adoption of this accounting standard did not have a material impact on the financial statements.

(ii) Financial Instruments – Disclosures

During 2009, the Accounting Standards Board of Canada (AcSB) issued amendments to CICA Handbook Section, 3862 *Financial Instruments – Disclosures*, which requires expanded disclosures pertaining to the fair value measurements of financial instruments and the management of liquidity risk. These amendments are effective for annual financial statements with fiscal years ending after September 30, 2009, and, as a result, the Company has included these additional disclosures in Notes 2(c) and 3 of these financial statements.

(iii) Financial Instruments – Amendments to Section 3855

In August 2009, the CICA amended Section 3855, *Financial Instruments – Recognition and Measurement*, to harmonize classification and related impairment accounting requirements of Canadian GAAP with IFRS. The amendments allow certain debt securities not quoted in an active market to be classified as loans and measured at amortized cost. The amendments also require the reversal of impairment charges for debt instruments classified as available for sale on the occurrence of specific events. The amendments had no impact on the Company's financial statements.

(iv) Future Accounting Changes

All Canadian publicly accountable enterprises will adopt International Financial Reporting Standards (IFRS) for years beginning on or after January 1, 2011. The Company will begin to report its financial results, including comparative information, in accordance with IFRS for the quarter ended March 31, 2011. While IFRS uses a conceptual framework similar to Canadian GAAP, the transition can result in significant differences in accounting policies and financial statement presentation and disclosures.

The Company's transition project continues to progress in line with its transition plan. The project has identified areas that have the potential to have a significant impact on financial reporting, the most significant relating to the optional elections available under IFRS 1 "First Time Adoption of International Financial Reporting Standards" for redesignation of financial instruments and recognition of cumulative unamortized actuarial gains and losses on defined benefit plans. At this time, the Company plans to redesignate previously recognized financial instruments for certain investments held in support of insurance operations from the available for sale category to the fair value through profit and loss category. The Company also plans to elect under IFRS 1 to recognize the

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

net unamortized actuarial gain on its defined benefit plans in opening retained earnings on transition to IFRS. The quantitative impact of these elections on the Company's financial statements has not yet been determined.

The Company anticipates changes to financial statement presentation and enhanced disclosure requirements upon adoption of IFRS.

(b) Financial Instruments

Most financial assets supporting policy liabilities are classified as held for trading (HFT). These assets may be comprised of cash, short-term investments, bonds and debentures, common and preferred shares, futures, forwards and options. Changes in the fair value of these financial assets are recorded in fair value change in HFT assets in the statement of general fund operations in the period in which they occur.

Most financial assets supporting capital and surplus and certain financial assets supporting policy liabilities are classified as available for sale (AFS). These assets may be comprised of cash, short-term investments, bonds and debentures, or common and preferred shares. AFS assets with a quoted price in an active market are carried at fair value in the balance sheet. Any changes in the fair values are recorded, net of income taxes, in other comprehensive income. Gains and losses realized on disposal of AFS assets are reclassified from other comprehensive income to realized gain (loss) on AFS assets in the statement of general fund operations.

AFS assets are subject to periodic impairment reviews. Upon recognition of an impairment that management has deemed other than temporary, the write down is reclassified from other comprehensive income if applicable and recorded in the statement of general fund operations. Impairment write downs on debt instruments classified as AFS are required to be reversed if objective evidence exists that they are no longer impaired.

Loans and receivables may include mortgage loans, loans on policies, policy contract loans, and premiums receivable. These assets are recorded at amortized cost, using the effective interest method, net of provisions for impairment losses, if any.

Interest income and dividend income are included in investment income in the statement of general fund operations for all financial assets, regardless of classification.

The Company has elected to use an option in Section 3862 *Financial Instruments — Disclosures* to exclude insurance contracts from the requirements of this section and instead apply Section 3861 *Financial Instruments — Disclosure and Presentation* to such contracts.

Related Transaction Costs:

All transactions are recorded on the trade date. Transaction costs are expensed for HFT instruments and capitalized for all others.

(c) Fair Value of Financial Instruments

Fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. When a financial instrument is initially recognized, its fair value is generally the value of the consideration paid or received. Subsequent to initial recognition, the fair value of a financial asset quoted in an active market or based on observable market inputs, is generally the bid price and, for a financial liability quoted in an active market or based on observable market inputs, the fair value is generally the ask price. Due to the short-term nature of accrued investment income and premiums receivable, the carrying value of these instruments approximates fair value. Fair value measurements used in these financial statements have been classified by using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

The three levels of the hierarchy are:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices); and

Level 3 – Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

All of the Company's financial instruments requiring fair value measurements meet the requirements of Level 1 or Level 2 of the fair value hierarchy.

(d) Impaired Loans

To the extent there is no longer reasonable assurance of full collection of loan principal and loan interest related to a mortgage or policy contract loan, the Company establishes a specific allowance for loan impairment which reduces the carrying value of that loan to its estimated realizable amount and charges the reduction directly to income in the period in which the impairment in value is identified.

Any change in the estimated realizable amount subsequent to the initial recognition of impairment is included in income in the period in which the change occurs as a charge or credit for loan impairment.

Events and conditions considered in determining the charge to income during the period include the value of the security underlying the loan, geographic location, industry classification of the borrower, an assessment of the financial stability of the borrower, repayment history and an assessment of the impact of current economic conditions.

The Company ceases to accrue interest on non-performing loans which are 90 days or more in arrears, as well as those which are less than 90 days in arrears but are deemed by management to be impaired. Once loans are classified as non-performing, any accrued but uncollected interest is reversed.

Subsequent payments are recorded in interest income after any prior write-off has been recovered and if management has determined that a specific provision is not required; otherwise, they are recorded as a reduction in carrying value of the loan.

Provisions are also made for anticipated future losses of principal and interest on invested assets. These provisions are included as a component of policy liabilities.

(e) Restructured Loans

If a loan is restructured, its carrying value is reduced as at the date of restructure to an amount, which does not exceed the estimated realizable value under the modified loan terms. The reduction in carrying value is recognized immediately as a charge for loan impairment. When collection of the scheduled future cash flows in accordance with the modified loan terms is reasonably assured, interest income is recognized at the effective interest rate inherent in the loan at the time it was initially recognized as being impaired.

(f) Assets Acquired on Foreclosure

Assets acquired on foreclosure of a mortgage and held for resale are initially measured at fair value less cost to sell. Subsequent to foreclosure, assets held for resale are measured at the lower of their carrying amount or the fair value less cost to sell. Any write-offs or recoveries are recognized immediately as a charge or credit for loan impairment in income in the period.

Assets acquired on foreclosure to be held and used are initially measured at fair value and thereafter are accounted for in the same manner as similar assets acquired in the normal course of business.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(g) Real Estate

Real estate is carried at cost plus unrealized gains and losses amortized to income as described below. Realized gains and losses on real estate are deferred and amortized to income at 3% each quarter. The unamortized realized gains and losses are included in accounts payable and other liabilities in the balance sheet.

Market values for each property are established periodically by qualified independent appraisers and the unrealized appraisal gains and losses are amortized to income at 3% each quarter. The accumulated unrealized gains and losses amortized to income are included in real estate in the balance sheet.

(h) Segregated Funds

Certain policy contracts allow the policyholder to invest in segregated investment funds managed by the Company for the benefit of these policyholders. The assets of these funds are carried at their period-end fair values, which also represents the policy liability. The financial results of the segregated funds are presented separately from the financial results of the general fund. The Company's statement of general fund operations includes fee income earned for management of the segregated funds.

(i) Income Taxes

Future income tax assets and liabilities are recorded for the expected future income tax consequences of events that have been included in the financial statements or income tax returns. Future income taxes are provided for using the asset and liability method. Under the asset and liability method, future income taxes are recognized for all significant temporary differences between the tax and financial statement bases of assets and liabilities and for certain carry-forward items.

Future income tax assets are recognized only to the extent that, in the opinion of management, it is more likely than not that the future income tax assets will be realized. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates, on the date of the enactment or substantive enactment.

(j) Policy Liabilities

Policy liabilities represent an estimate of the amount, which together with estimated future premiums and investment income, will be sufficient to pay future benefits, dividends, expenses and taxes on policies in force. The Company's policy liabilities have been prepared in accordance with GAAP. The Company's policy liabilities were determined using accepted actuarial practices according to the standards established by the Canadian Institute of Actuaries (CIA).

(k) Reinsurance Ceded

The provisions for future policy liabilities, premiums, policy expenses and operating expenses are recorded net of amounts ceded to and recoverable from reinsurers.

Amounts recoverable from reinsurers are estimated in a manner consistent with the policy liability associated with the reinsured policy.

(l) Employee Future Defined Benefit Plans

The Company accrues its obligations for its employee defined benefit plans, net of plan assets. The cost of defined benefit pensions and other retirement benefits earned by employees is actuarially determined using the projected benefit method pro-rated on services and using management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs. For the purpose of calculating the expected return on plan assets, those assets are valued at fair value. Actuarial gains (losses) arise from the difference between actual long-term rate of return on plan assets for a period and expected long-term rate

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

of return on plan assets for that period or from changes in actuarial assumptions used to determine the accrued benefit obligation. The excess of the net accumulated actuarial gain (loss) over 10% of the greater of the accrued benefit obligation and the fair value of plan assets is amortized over the average remaining service period of active employees.

(m) Foreign Currency Translation

Assets and liabilities measured at fair value are translated at period-end exchange rates. Otherwise, assets and liabilities are translated at exchange rates prevailing at the transaction dates. Revenue and expense items are translated at actual rates prevailing during the period.

(n) Deferral of Acquisition Costs

Distribution costs of segregated funds having a deferred sales charge are deferred and amortized over the term of the related deposits or the applicable period of such sales charges, as appropriate. These deferred costs form part of policy liabilities on the balance sheet and the related amortization forms part of the increase in policy liabilities on the statement of general fund operations.

(o) Capital Assets

Capital assets (furniture, equipment, computer software and leasehold improvements) are carried at cost less accumulated depreciation. Depreciation is provided on a straight-line basis over the useful life of the capital assets, which varies from two to five years.

(p) Revenue Recognition

Insurance premiums net of reinsurance and annuity premiums, as well as reinsurance assumed premiums, are generally recorded as revenue when due. Annuity premiums are comprised solely of new deposits on general fund products with a guaranteed rate of return and exclude deposits on segregated fund products.

Fee income earned for investment management and administration of the segregated funds is generally calculated and recorded as revenue daily based on closing segregated funds asset market values.

Dividend income is recognized on the ex-dividend date. Interest income is recognized in the income statement as it accrues and is calculated using the effective interest rate method.

(q) Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (OCI). OCI includes unrealized gains or losses on available for sale financial assets, net of amounts reclassified to the statement of general fund operations, and the effective portion of the change in the fair value of cash flow hedging instruments, net of amounts reclassified to the statement of general fund operations all net of taxes. The balance of shareholders' accumulated other comprehensive income (AOCI) is shown as a separate component of shareholders' equity. The balance of policyholders' AOCI is shown as a separate component of policyholders' equity.

(r) Hedge Accounting

From time to time, the Company enters into hedging arrangements. Where the Company has elected to use hedge accounting, a hedge relationship is designated and documented at inception. The Company evaluates hedge effectiveness at the inception of the relationship and at least on a quarterly basis using a variety of techniques including the cumulative dollar offset method. Both at inception and throughout the term of the hedge, the Company expects that each hedging instrument will be highly effective in achieving offsetting changes in cash flows attributable to the risk being hedged. When it is determined that the hedging relationship is no longer effective, or

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

the hedged item has been sold or terminated, the Company discontinues hedge accounting prospectively. In such cases, if the derivative hedging instrument is not sold or terminated, any subsequent changes in fair value of the derivative is recognized in investment income.

In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging instrument is recorded in OCI while the ineffective portion is recognized in investment income. Gains and losses accumulated in AOCI are reclassified and recognized in investment income during the periods when the variability in the cash flows hedged or the hedged forecasted transactions are recognized in income. Gains and losses on cash flow hedges accumulated in AOCI are reclassified immediately to investment income when either the hedged item is sold or the forecasted transaction is no longer expected to occur. When hedge accounting is discontinued, and the hedged forecasted transaction remains probable of occurring, then the amounts previously recognized in AOCI are reclassified and recognized in investment income in the periods during which variability in the cash flows hedged or the hedged forecasted transaction is recognized in income.

The Company enters into fair value hedging relationships associated with currency risk in available for sale assets. Changes in the fair value of the derivatives used for fair value hedges are recorded in investment income. The change in fair value of these available for sale investments related to the hedged risk is recorded in investment income. As a result, ineffectiveness, if any, is recognized in investment income.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

3. Portfolio Investments

(a) Summary of Invested Assets

The carrying values and fair values of portfolio investments are as follows:

	2009					
Asset category	Required to be Held for Trading	Designated as Held for Trading	Available for Sale	Loans & Receivables and Real Estate	Total Carrying Value	Total Fair Value
Short-term investments						
Canadian federal government	\$ 1,100	\$ 2,999	\$ 12,986	\$ —	\$ 17,085	\$ 17,085
Corporate	—	—	19,995	—	19,995	19,995
TOTAL SHORT-TERM INVESTMENTS	1,100	2,999	32,981	—	37,080	37,080
Bonds						
Bonds issued or guaranteed by:						
Canadian federal government	8,353	118,406	191,664	—	318,423	318,423
Canadian provincial and municipal government	2,952	1,423,457	149,427	—	1,575,836	1,575,836
Other foreign government	153	—	1,418	—	1,571	1,571
Total government bonds issued or guaranteed	11,458	1,541,863	342,509	—	1,895,830	1,895,830
Canadian corporate bonds by industry sector:						
Financial services	6,551	458,469	122,544	—	587,564	587,564
Infrastructure	2,211	85,261	19,109	—	106,581	106,581
Utilities	2,250	116,047	20,108	—	138,405	138,405
Energy	475	9,013	5,252	—	14,740	14,740
Consumer staples	394	38,050	4,176	—	42,620	42,620
Industrials	165	8,664	1,327	—	10,156	10,156
Total Canadian corporate bonds	12,046	715,504	172,516	—	900,066	900,066
TOTAL BONDS	23,504	2,257,367	515,025	—	2,795,896	2,795,896
Preferred shares						
Canadian	—	275,640	124,985	—	400,625	400,625
TOTAL PREFERRED SHARES	—	275,640	124,985	—	400,625	400,625
Common shares						
Canadian	111,548	—	362,133	—	473,681	473,717
U.S.	17,989	—	27,609	—	45,598	45,598
Other	2,065	—	27,773	—	29,838	29,838
TOTAL COMMON SHARES	131,602	—	417,515	—	549,117	549,153
Mortgages	—	—	—	223,642	223,642	225,160
Real estate	—	—	—	15,601	15,601	16,079
Loans on policies	—	—	—	38,728	38,728	38,728
Policy contract loans	—	—	—	137,764	137,764	137,764
TOTAL	\$ 156,206	\$ 2,536,006	\$ 1,090,506	\$ 415,735	\$ 4,198,453	\$ 4,200,485

Common shares Canadian in the above table include AFS at cost assets with a carrying value of \$2,280 and a fair value of \$2,316.

The Company has financial liabilities comprised of subordinated debentures with a carrying value of \$198,980 and a fair value of \$213,420 as of December 31, 2009.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

2008

Asset category	Required to be Held for Trading	Designated as Held for Trading	Available for Sale	Loans & Receivables and Real Estate	Total Carrying Value	Total Fair Value
Short-term investments						
Canadian federal government	\$ –	\$ –	\$ 2,670	\$ –	\$ 2,670	\$ 2,670
Canadian provincial government	–	–	11,993	–	11,993	11,993
U.S. federal government	–	–	2,461	–	2,461	2,461
Corporate	–	–	58,771	–	58,771	58,771
TOTAL SHORT-TERM INVESTMENTS	–	–	75,895	–	75,895	75,895
Bonds						
Bonds issued or guaranteed by:						
Canadian federal government	2,303	46,721	40,015	–	89,039	89,039
Canadian provincial and municipal government	3,918	1,539,252	146,285	–	1,689,455	1,689,455
Other foreign government	205	–	1,474	–	1,679	1,679
Total government bonds issued or guaranteed	6,426	1,585,973	187,774	–	1,780,173	1,780,173
Canadian corporate bonds by industry sector:						
Financial services	6,557	187,502	74,813	–	268,872	268,872
Infrastructure	2,141	71,871	14,421	–	88,433	88,433
Utilities	2,065	104,842	15,097	–	122,004	122,004
Energy	517	11,303	3,336	–	15,156	15,156
Consumer staples	300	24,932	1,875	–	27,107	27,107
Industrials	192	4,756	1,248	–	6,196	6,196
Total Canadian corporate bonds	11,772	405,206	110,790	–	527,768	527,768
TOTAL BONDS	18,198	1,991,179	298,564	–	2,307,941	2,307,941
Preferred shares						
Canadian	–	171,710	76,173	–	247,883	247,883
TOTAL PREFERRED SHARES	–	171,710	76,173	–	247,883	247,883
Common shares						
Canadian	75,816	–	242,914	–	318,730	318,286
U.S.	17,966	–	37,695	–	55,661	55,661
Other	1,367	–	9,908	–	11,275	11,275
TOTAL COMMON SHARES	95,149	–	290,517	–	385,666	385,222
Mortgages	–	–	–	242,678	242,678	242,846
Real estate	–	–	–	15,355	15,355	14,090
Loans on policies	–	–	–	37,161	37,161	37,161
Policy contract loans	–	–	–	142,863	142,863	142,863
TOTAL	\$ 113,347	\$ 2,162,889	\$ 741,149	\$ 438,057	\$ 3,455,442	\$ 3,453,901

Common shares Canadian in the above table include AFS at cost assets with a carrying value of \$2,420 and a fair value of \$1,976.

Due to the nature of reverse mortgages, loans on policies and policy contract loans, the carrying value of these instruments approximates fair value.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(b) Credit Risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss to the other party by failing to discharge an obligation. The Company maintains policies detailing the acceptable levels of credit risk exposure by asset class. Compliance with the policies is monitored and exposures and breaches are reported to the Investment Committee of the Board. The policies are regularly reviewed for relevance and changes in the risk environment. The Company's gross exposure to credit risk is equal to the carrying value of its financial assets.

(i) Concentration of Credit Risk

Mortgages in the province of Ontario represent the largest concentration with \$213,885 (2008 \$231,823) of the total portfolio.

The Company's preferred share investments are all issued by Canadian companies, with 82% (2008 73%) of these investments rated as P1 as at December 31, 2009 and the remaining 18% (2008 27%) rated as P2.

The concentration of the Company's bond portfolio by investment grade is as follows:

	2009		2008	
	Carrying Value	Fair Value	Carrying Value	Fair Value
AAA	\$ 323,732	\$ 323,732	\$ 90,759	\$ 90,759
AA	811,887	811,887	935,933	935,933
A	1,523,876	1,523,876	1,166,574	1,166,574
BBB	130,882	130,882	109,939	109,939
BB	5,519	5,519	4,736	4,736
TOTAL	\$ 2,795,896	\$ 2,795,896	\$ 2,307,941	\$ 2,307,941

As of December 31, 2009, holdings of fixed income securities (which includes bonds and debentures, preferred shares and short term investments) in the ten issuers (excluding federal governments) to which the Company had the greatest exposure were \$2,174,181 (2008 \$2,040,957), which was approximately 50.0% (2008 56.3%) of total cash and investments. The exposure to the largest single issuer of corporate bonds held as of December 31, 2009 was \$88,790 (2008 \$59,847), which was approximately 2.0% (2008 1.6%) of total cash and investments.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(ii) Impairments

The Company's financial assets are subject to a regular review for impairment. Except as provided below, no additional impairments have been recorded in these financial statements.

Investments in individual assets have been reduced by the following specific allowances for impairment:

	2009		
Impaired Loans	Recorded Investment	Allowance for Impairment	Carrying Amount
Mortgages	\$ 10,214	\$ 2,061	\$ 8,153
Policy contract loans	813	578	235
TOTAL	\$ 11,027	\$ 2,639	\$ 8,388

	2008		
Impaired Loans	Recorded Investment	Allowance for Impairment	Carrying Amount
Mortgages	\$ 9,301	\$ 2,341	\$ 6,960
Policy contract loans	813	599	214
TOTAL	\$ 10,114	\$ 2,940	\$ 7,174

The Company holds collateral of \$8,301 in respect of these mortgages and \$235 in respect of these policy loans. Policy loans are secured by life insurance policies.

Continuity of Allowance for Loan Impairment	2009		2008	
Allowance – beginning of year	\$	2,940	\$	3,084
Provision for (recovery of) loan impairment		258		(30)
Write-off of loans		(559)		(114)
ALLOWANCE – END OF YEAR	\$	2,639	\$	2,940

The Company has recorded interest income of \$994 on these assets.

Provisions made for anticipated future losses of principal and interest on investments and included as a component of policy liabilities are \$65,100 (2008 \$59,800).

As at December 31, 2009, financial assets past due, but not impaired are \$9,270 (2008 \$nil). This amount is comprised entirely of mortgages past due less than 90 days.

Management regularly reviews securities classified as available for sale for evidence of impairment. The following table summarizes available for sale assets with unrealized losses recognized in AOCI as at December 31, 2009. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been below cost, the financial conditions and near-term prospects of the issuer, and the ability and intent to hold the investment for a period of time sufficient to allow for recovery. Management has conducted an evaluation of the portfolio and concluded that the unrealized losses on these securities are temporary.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

	2009		2008	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Bonds	\$ 186,873	\$ 3,059	\$ 62,988	\$ 6,452
Preferred shares	20,093	1,803	69,548	12,547
Common shares	—	—	198,391	87,152
TOTAL	\$ 206,966	\$ 4,862	\$ 330,927	\$ 106,151

Changes in the fair value of available for sale assets (AFS) are recorded in unrealized fair value change on available for sale investments in other comprehensive income (OCI). Where there is objective evidence that a decline in fair value is other than temporary, the loss accumulated in AOCI is reclassified to realized gain (loss) on available for sale assets including impairment write downs on the statement of general fund operations. The Company reclassified a pre-tax loss of \$34,970 due to write downs of impaired available for sale common and preferred shares (2008 \$nil). Management considers the impairment of these assets to be other than temporary due to the length of time that the fair value was less than the cost and the extent and nature of the loss.

An impairment review has been performed on all AFS investments carried at cost where there was an unrealized loss at year end. Based on the results of this review, the Company recorded a pre-tax loss of \$140 directly to the statement of general fund operations, due to the write downs of impaired AFS common shares that were carried at cost (2008 \$nil). Management considers the impairment of these assets to be other than temporary due to the length of time that the fair value was less than cost and the extent and nature of the loss.

(c) Liquidity Risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. Liquidity management involves maintaining sufficient cash and marketable securities or an adequate amount of funding to meet financial obligations as they come due. The Company maintains a liquidity policy providing an assessment of the Company's liquidity risk and specific procedures so that liquidity needs are met. Compliance with the policy is monitored and exposures and breaches are reported to the Investment Committee of the Board. The policies are regularly reviewed for relevance and changes in the risk environment. The Company's liquidity position as at December 31 is provided in a table at note 6(k).

Bonds by contractual maturity are as follows:

	2009		2008	
	Carrying Value	Fair Value	Carrying Value	Fair Value
1 year or less	\$ 146,214	\$ 146,214	\$ 70,210	\$ 70,210
1 – 5 years	344,287	344,287	248,115	248,115
5 – 10 years	270,540	270,540	255,607	255,607
Over 10 years	2,034,855	2,034,855	1,734,009	1,734,009
TOTAL	\$ 2,795,896	\$ 2,795,896	\$ 2,307,941	\$ 2,307,941

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(d) Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market price. Market risk comprises three types of risk:

- **Currency risk** – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates;
- **Interest rate risk** – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates; and
- **Other price risk** – the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

The Company maintains policies detailing the acceptable levels of currency risk, interest rate risk and other price risks. Compliance with the policies is monitored and exposures and breaches are reported to the Investment Committee of the Board. The policies are regularly reviewed for relevance and changes in the risk environment.

The financial assets of the life insurance operation are exposed to a variety of market risks including interest rate, foreign currency and other price risk. The life insurance operation's exposure to these risks in its financial assets is generally offset by a corresponding exposure to these risks in its policy obligations. As the policy liability for these policy obligations is calculated based on market value, increases and decreases in these risk variables affect both investment income and the change in policy liabilities.

The impact on net income and other comprehensive income of a reasonably possible change in each of these variables is described below:

- **Interest rate** – A 1% fluctuation in market interest rates would have an impact of approximately \$nil (2008 \$nil) on net income, \$13,906 (2008 \$5,446) on shareholders' other comprehensive income and \$833 (2008 \$299) on policyholders' other comprehensive income. For sensitivity to reinvestment rate assumptions see Measurement Uncertainty, note 6(e).
- **Foreign currency** – The Company's primary foreign currency exposure is the US dollar. A 10% fluctuation in the US dollar would have an impact of approximately \$nil (2008 \$nil) on net income, \$3,573 (2008 \$4,984) on shareholders' other comprehensive income and \$314 (2008 \$444) on policyholders' other comprehensive income. The Company has no significant foreign currency exposure in its financial liabilities.
- **Other price risk** – The following table summarizes the potential impact on the Company of both a 10% and a 20% change in global equity markets. The Company used a 10% increase or decrease in equity markets as a reasonably possible change in equity markets. The Company has also disclosed the impact of a 20% increase or decrease in its equity market sensitivity. For segregated fund guarantee policy liabilities the level of sensitivity is highly dependent on the level of the stock market at the time of performing the estimate. At higher market starting points the sensitivity is reduced, while lower starting points have the opposite effect. The amounts shown below for segregated fund guarantee policy liabilities represent the impact on shareholders' net income.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

2009

	10% Increase	10% Decrease	20% Increase	20% Decrease
Shareholders' net income	\$ 7,047	\$ (7,047)	\$ 14,161	\$ (14,161)
Policyholders' net income	\$ –	\$ –	\$ –	\$ –
Shareholders' other comprehensive income	\$ 26,204	\$ (26,204)	\$ 52,408	\$ (52,408)
Policyholders' other comprehensive income	\$ 2,204	\$ (2,204)	\$ 4,408	\$ (4,408)
Segregated fund guarantee policy liabilities	\$ –	\$ –	\$ –	\$ –

2008

	10% Increase	10% Decrease	20% Increase	20% Decrease
Shareholders' net income	\$ 6,183	\$ (6,183)	\$ 12,021	\$ (12,021)
Policyholders' net income	\$ –	\$ –	\$ –	\$ –
Shareholders' other comprehensive income	\$ 19,707	\$ (19,707)	\$ 39,414	\$ (39,414)
Policyholders' other comprehensive income	\$ 1,564	\$ (1,564)	\$ 3,128	\$ (3,128)
Segregated fund guarantee policy liabilities	\$ 4,740	\$ (20,316)	\$ 4,740	\$ (42,664)

As of December 31, 2009, common equity holdings in the ten issuers to which the Company had the greatest exposure were \$200,399 (2008 \$179,155), which was approximately 4.6% (2008 4.9%) of total cash and investments. The exposure to the largest single issuer of common equities held as of December 31, 2009 was \$42,430 (2008 \$34,361), which was approximately 1.0% (2008 1.0%) of total cash and investments.

- **Other risks** – For sensitivity to mortality and reinvestment rate assumptions see Measurement Uncertainty, note 6(e).

(e) Investment Income

Investment income is comprised of the following:

	2009	2008
Interest income	\$ 155,330	\$ 148,107
Dividend income	29,147	22,523
Real estate net income	1,300	982
Other	(1,555)	(942)
Impaired asset recovery (write down)	(258)	30
INVESTMENT INCOME	\$ 183,964	\$ 170,700

Included in interest income is \$46,262 (2008 \$44,227) relating to assets not classified as held for trading.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(f) Composition of Held for Trading Income

The following amounts have been recognized in the statement of general fund operations:

	2009	2008
Change in fair value of instruments required to be classified as held for trading	\$ 28,576	\$ (39,814)
Change in fair value of instruments designated as held for trading	\$ 78,123	\$ (204,570)

(g) Unrealized Investment Gains

Net unrealized investment gains of \$2,025 (2008 \$2,072) relating to real estate are included in real estate on the balance sheet.

(h) Hedge Accounting

In conjunction with the issuance of unsecured subordinated debentures (note 18), the Company entered into a bond forward derivative with a notional amount of \$75,000 which matured on May 13, 2009. This derivative has been accounted for as a hedging item in a cash flow hedging relationship.

On a year to date basis, the Company recognized a loss of \$1,265 (2008 \$215) related to the ineffective portion of its cash flow hedge in investment income on the statement of general fund operations. The Company expects to reclassify a loss of \$684 from AOCI to investment income on the statement of general fund operations in the next twelve months.

(i) Fair Value of Financial Instruments

The following table presents the financial instruments measured at fair value classified by the fair value hierarchy:

	2009				Total Fair Value
	Level 1	Level 2	Level 3		
Cash and cash equivalents	\$ (12,445)	\$ 161,586	\$ –	\$	149,141
Held for trading:					
Bonds	–	2,280,871	–		2,280,871
Common shares	131,602	–	–		131,602
Preferred shares	275,640	–	–		275,640
Short-term investments	–	4,099	–		4,099
Available for sale:					
Bonds	–	515,025	–		515,025
Common shares	415,235	–	–		415,235
Preferred shares	124,985	–	–		124,985
Short-term investments	–	32,981	–		32,981
Derivatives	–	2,246	–		2,246
TOTAL	\$ 935,017	\$ 2,996,808	\$ –	\$	3,931,825

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

All of the Level 1 fair value measurements represent holdings in domestic and foreign common shares and domestic preferred shares and have been priced using exchange listed prices or broker quotes representing actual transactions in an active market. Level 2 fair value measurements represent domestic bonds and short-term investments and are priced through a vendor supplied evaluated price which is based on observable market information (matrix pricing).

The classification of a financial instrument into a level is based on the lowest level of input that is significant to the determination of the fair value. There were no transfers between Level 1 and Level 2 during the year ended December 31, 2009.

For additional information on the composition of the Company's invested assets, and analysis of the Company's risks arising from financial instruments refer to notes 3(a) through 3(d).

4. Derivative Financial Instruments

In the ordinary course of business, the Company has policy obligations which have a savings component that varies with a variety of indices and currencies. The financial instruments used for matching this liability include various futures contracts and foreign currency forward contracts. In addition, the Company may use futures contracts and foreign currency forward contracts in its shareholders' and policyholders' equity account. The Company may also use other equity derivative contracts as part of a portfolio of assets to match policy liabilities as to duration and amounts. The Company uses bond contracts for cash flow hedging purposes, see Hedge Accounting, note 3(h).

The notional amounts of these financial instruments are not recognized on the balance sheet. Notional amounts are the contract amounts used to calculate the cash flows to be exchanged. They are a common measure of volume of outstanding transactions, but do not represent credit or market risk exposures.

Current replacement costs represent the estimated cost of replacing all contracts with a positive value, at current quoted market prices. For over-the-counter contracts, the current replacement cost represents the estimated current fair values.

Credit equivalent amounts are the current replacement cost plus an amount for future credit exposure associated with the potential future changes in currency and interest rates. The future credit exposure is calculated using a formula prescribed by OSFI in its capital adequacy guidelines.

Risk-weighted balance represents the regulatory capital required to support the Company's derivative activities. The credit equivalent amounts are weighted according to the creditworthiness of the counterparty using factors prescribed by OSFI in its capital adequacy guidelines.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

2009

	Notional Principal	Current Replacement Cost	Fair Value		Credit Equivalent Amount	Risk Weighted Balance
			Positive	Negative		
Exchange-traded						
Equity index futures	\$ 10,128	\$ 66	\$ 66	\$ –	\$ –	\$ –
Equity options	7	3	3	–	3	–
Over-the-counter						
Foreign currency forwards	22,425	124	124	247	349	5
Other equity contracts	15,515	2,300	2,300	–	3,407	55
Bond contracts	–	–	–	–	–	–
TOTAL	\$ 48,075	\$ 2,493	\$ 2,493	\$ 247	\$ 3,759	\$ 60

2008

	Notional Principal	Current Replacement Cost	Fair Value		Credit Equivalent Amount	Risk Weighted Balance
			Positive	Negative		
Exchange-traded						
Equity index futures	\$ 9,312	\$ 206	\$ 206	\$ 44	\$ –	\$ –
Equity options	92	9	9	22	14	–
Over-the-counter						
Foreign currency forwards	8,387	229	229	1,855	312	5
Other equity contracts	15,515	5,302	5,302	–	6,544	105
Bond contracts	75,000	–	–	5,351	–	–
TOTAL	\$ 108,306	\$ 5,746	\$ 5,746	\$ 7,272	\$ 6,870	\$ 110

All contracts mature in less than one year except for other equity contracts which mature in one to five years. Fair value positive amounts and fair value negative amounts are reported on the balance sheet as other assets and accounts payable and other liabilities respectively.

5. Nature and Composition of Policy Liabilities

Policy liabilities represent the amounts which, together with estimated future premiums and investment income, will be sufficient to pay estimated future benefits, dividends, expenses, and taxes on policies in force. Policy liabilities are determined using accepted actuarial practice according to standards established by the CIA.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

The Company is active in most life insurance and annuity product lines across Canada and does not operate in foreign markets. The composition of the policy liabilities is as follows:

		2009	2008
Participating	– Individual Life	\$ 344,725	\$ 334,490
	– Other	483	530
Non-participating Individual	– Life	1,708,422	1,504,492
	– Annuity	988,086	802,212
	– Health	35,186	27,500
Non-participating Group	– Life	17,343	15,332
	– Health	82,097	96,082
	– Annuity	75,581	76,689
Segregated fund deferred acquisition costs		(58,935)	(61,573)
Segregated fund guarantee		–	11,992
POLICY LIABILITIES		\$ 3,192,988	\$ 2,807,746

6. The Valuation of Policy Liabilities

The Company is in the business of measuring and managing risk, as reflected in the valuation of policy liabilities. To the extent that emerging experience is more favourable than assumed in the valuation, income will emerge. If emerging experience is less favourable, losses will result.

The computation of policy liabilities requires “best estimate” assumptions covering the remaining life of the policies including consideration of related reinsurance effects. These assumptions are made for mortality, morbidity, investment returns, persistency, expenses, inflation and taxes. Due to the long-term risks and measurement uncertainties inherent in the life insurance business, a margin for adverse deviations from best estimates is calculated separately for each variable and included in policy liabilities.

The methods for arriving at the most important of these assumptions are outlined below.

(a) Mortality

The Company carries out annual internal studies of its own mortality experience. The valuation mortality assumptions are based on a combination of this experience and recent CIA industry experience.

(b) Investment Returns

The computation of policy liabilities takes into account projected investment income net of investment expenses from the assets supporting policy liabilities, and investment income expected to be earned on reinvestments. The assets supporting the policy liabilities are segmented from the assets backing shareholders’ and policyholders’ equity.

For life and health insurance, the projected cash flows from the matched assets are combined with estimated future reinvestment rates based on both the current economic outlook and the Company’s expected future asset mix. The cash flows are subjected to tests under a wide spectrum of possible reinvestment scenarios, and the policy liabilities are then increased directly where necessary to provide for credible adverse future scenarios.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

In order to match the savings component of policy liabilities that vary with a variety of indices and currencies, the Company maintains certain equity, fixed income and currency financial instruments as part of its general fund assets. Asset-liability mismatch risk is monitored on a daily basis.

For annuities, assets and policy liabilities are closely matched by term and duration and, accordingly, the reinvestment assumption is relatively unimportant. The cash flows are subjected to tests under a wide spectrum of possible reinvestment scenarios, and the policy liabilities are then increased directly where necessary to provide for credible adverse future scenarios.

(c) Expenses

Policy liabilities provide for the future expense of administering policies in force, renewal commissions, general expenses, and taxes. Expenses associated with policy acquisition and issue are specifically excluded. The future expense assumption includes an assumption for inflation and is derived from internal cost studies.

(d) Persistency

Lapse and surrender assumptions are based on a combination of the Company's own internal termination studies and recent CIA industry experience, adjusted for consistency with the expected future economic and mortality environment described above. Separate lapse assumptions are used for permanent cash-value business, for renewable term insurance, and for lapse-supported business (such as term insurance to age 100). In setting lapse rates for renewable term insurance, it is assumed that extra lapses will occur at each renewal point, and that healthy policyholders are more likely to lapse at that time than those who have become uninsurable.

(e) Measurement Uncertainty

The basic assumptions made in establishing policy liabilities are "best estimates" for a range of possible outcomes. Companies are required to include a margin in each assumption to recognize the uncertainty in establishing these "best estimates", to allow for possible deterioration in experience and to provide greater confidence that policy liabilities are adequate to pay future benefits. A range of allowable margins is prescribed by the CIA.

The Company maintains margins near the middle of the allowable range for those assumptions where the best estimate has been calculated rigorously and with a relatively high degree of credibility, and near the high end of the allowable range for assumptions where the measurement uncertainty is greater.

Valuation assumptions are reviewed and updated at least annually, and the impact of changes in those assumptions is reflected in earnings in the year of the change.

Based on recent experience, the Company has estimated that a decrease (or increase) in the individual insurance mortality assumption equal to 3% of the base table would result in an increase (or decrease) of approximately \$27,800 (2008 \$25,700) in shareholders' net income and \$700 (2008 \$900) in policyholders' net income, and that the decrease in reinvestment rates caused by a decrease of 1% in current market interest rates would result in a decrease of approximately \$32,300 (2008 \$29,700) in shareholders' net income and \$800 (2008 \$600) in policyholders' net income, and that net income is not sensitive to likely short term swings in expenses.

For sensitivity to market risk see Market Risk, note 3(d).

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(f) Change in Policy Liabilities

	2009	2008
Policy liabilities – beginning of year	\$ 2,807,746	\$ 2,959,602
Changes in methods and assumptions	(5,056)	(47,741)
Normal changes – new business	310,975	120,834
– in-force business	79,323	(224,949)
POLICY LIABILITIES – END OF YEAR	\$ 3,192,988	\$ 2,807,746

Changes in actuarial assumptions are made based on emerging and evolving experience with respect to major factors affecting estimates of future cash flows and consideration of economic forecasts of investment returns, industry studies and requirements of the CIA and OSFI.

The changes in actuarial methods and assumptions in 2009 include a net decrease of \$28,756 to reflect improving mortality/morbidity experience and a net increase of \$12,072 to reflect decreases in the investment return assumptions. The net impact of other changes amounted to a net increase of \$11,628.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(g) Mix of Assets Allocated to Policy Liabilities and Shareholders' and Policyholders' Equity

2009					
	Insurance Liabilities	Annuity Liabilities	Equity	Total	
Cash & short-term investments	\$ 97,645	\$ 12,897	\$ 75,679	\$ 186,221	
Bonds	1,740,732	505,306	549,858	2,795,896	
Mortgages	–	223,642	–	223,642	
Preferred shares	90,016	254,624	55,985	400,625	
Common shares	282,649	–	266,468	549,117	
Real estate	–	–	15,601	15,601	
Loans on policies	38,728	–	–	38,728	
Policy contract loans	18,921	58,051	60,792	137,764	
Other	(6,649)	5,161	(75,379)	(76,867)	
TOTAL	\$ 2,262,042	\$ 1,059,681	\$ 949,004	\$ 4,270,727	

2008					
	Insurance Liabilities	Annuity Liabilities	Equity	Total	
Cash & short-term investments	\$ 28,449	\$ (7,359)	\$ 227,529	\$ 248,619	
Bonds	1,671,921	406,967	229,053	2,307,941	
Mortgages	–	242,678	–	242,678	
Preferred shares	67,783	152,828	27,272	247,883	
Common shares	169,477	–	216,189	385,666	
Real estate	–	–	15,334	15,334	
Loans on policies	37,161	–	–	37,161	
Policy contract loans	18,295	66,599	57,969	142,863	
Other	18,775	14,649	(12,222)	21,202	
TOTAL	\$ 2,011,861	\$ 876,362	\$ 761,124	\$ 3,649,347	

Real estate is net of deferred gains on disposal of portfolio investments. Other is net of accounts payable and other non-policy liabilities. Specific assets are nominally matched against specific types of liabilities; however all assets are available to pay all liabilities if required.

(h) Interest Rate Risk

The Company's financial position may be affected by its exposure to interest rate risk. Interest rate risk is the risk of economic losses or gains arising from the reinvestment or disinvestment of cash flows. If the assets supporting the policy liabilities do not match the timing and amount of the policy obligations, interest rate losses or gains may occur due to changing interest rates in the future.

For the life insurance business, where the policy liabilities have a longer term than most available bonds and mortgages, the Company's policy is to cover estimated policy liability cash flows rigorously only for a rolling 20-year period. In order to provide a margin that recognizes the longer-term mismatch, the cash flows are subjected to tests under a wide spectrum of possible reinvestment scenarios, and the policy liabilities are then increased directly where necessary to provide for credible adverse future scenarios.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

For annuity business, where the timing and amount of the benefit obligations can be readily determined, the matching of the asset and liability cash flows is tightly controlled. A sudden increase or decrease in interest rates would have a negligible effect on future profits from annuity business currently in force.

(i) Fair Value of Policy Liabilities

In the absence of an active market for the sale of policy liabilities, the actuarially determined values provide a reasonable approximation of fair value of policy liabilities.

(j) Credit Risk

The Company has made provision in its balance sheet for credit losses for those assets which are used to support policy liabilities. Provisions have been made partly through reduction in the value of the assets and partly through a provision in the policy liabilities (see note 3(b)(ii)).

(k) Liquidity

The Company maintains a high level of liquid assets so that cash demands can be readily met. The Company's liquidity position is as follows:

	2009	2008
Assets:		
Cash and short-term paper	\$ 186,221	\$ 248,619
Canada and provincial bonds	1,880,942	1,764,405
Other readily-marketable bonds and stocks	1,822,602	1,144,006
TOTAL LIQUID ASSETS	\$ 3,889,765	\$ 3,157,030
Liabilities:		
Demand liabilities with fixed values	\$ 420,280	\$ 399,054
Demand liabilities with market value adjustments	873,268	640,388
TOTAL LIQUIDITY NEEDS	\$ 1,293,548	\$ 1,039,442

7. Reinsurance

The Company reinsures excess risks with major Canadian regulated reinsurance companies. The Company's retention limit is \$500 on any one life. Policy liabilities are reduced by \$29,291 (2008 \$43,802) on account of reinsurance ceded. The Company enters into reinsurance agreements only with reinsurance companies that have an independent credit rating of "A-" or better.

Reinsurance transactions do not relieve the original insurer of its primary obligation to policyholders.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

8. Exposure to Other Risks

The Company regularly evaluates its exposure to foreseeable risks through Dynamic Capital Adequacy Testing analysis.

The analysis of the Company's future financial position shows that one of the major risks the Company is exposed to is equity market risk. The two other most significant risks faced by the Company are interest rates persisting at levels significantly lower than today's rates and adverse mortality.

The Company's non-participating and universal life products are sensitive to changes in lapse rates, interest rates and renewal pricing.

The Company's non-participating term insurance is more sensitive to mortality trends and competitive pricing levels.

9. Income Taxes

(a) Income Tax Expense

The Company's income tax expense includes provisions for current and future taxes as follows:

	2009	2008
Current income tax expense	\$ 9,811	\$ 29,948
Future income tax expense (benefit)		
– relating to the origination and reversal of temporary differences	(9,372)	(2,564)
– resulting from substantively enacted changes in tax rates	983	(1,915)
INCOME TAX EXPENSE	\$ 1,422	\$ 25,469

During 2009 the Company paid income tax instalments totalling \$3,288 (2008 \$3,090) and paid (recovered) income taxes in respect of prior years totalling \$(46,154) (2008 \$(11,734)).

The Company has unused tax losses of \$69,823 in the province of Ontario related to the harmonization of Ontario and Federal income tax administration that expire in 2013. The amount of income tax recoverable related to this of \$4,099 is included in future income taxes.

(b) Variance from Statutory Provision

Income taxes provided varies from the expected statutory provision as follows:

	2009	2008
Net income before taxes	\$ 81,084	\$ 85,377
Less premium tax	11,436	11,620
Less investment income tax	3,300	3,200
NET INCOME BEFORE INCOME TAXES	66,348	70,557
Income tax provision at statutory rates	21,065	22,776
Increase (decrease) resulting from:		
Substantively enacted changes in income tax rates	983	(1,915)
Tax paid dividends on stocks	(8,439)	(5,469)
Impact of recognizing tax rule changes	(12,565)	8,982
Miscellaneous	378	1,095
INCOME TAX EXPENSE	\$ 1,422	\$ 25,469

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

(c) Future Income Taxes

In certain instances the tax basis of assets and liabilities differs from the carrying amount. These differences will give rise to future income taxes, which are reflected on the balance sheet as follows:

	2009	2008
Policy liabilities	\$ 54,334	\$ 61,416
Portfolio investments	(67,480)	(87,337)
Losses recoverable in future years	10,052	18,681
Other, net	1,978	2,610
FUTURE INCOME TAX ASSET (LIABILITY)	\$ (1,116)	\$ (4,630)

(d) Impact of March 4, 2009 Income Tax Act Amendments

On March 4, 2009, proposed amendments to the Income Tax Act passed third reading causing them to become substantively enacted for accounting purposes. Under these amendments, certain capital losses have been re-characterized to become income losses for tax purposes. These amendments also result in most investments and policy liabilities being taxed on a fair value basis, consistent with changes in accounting rules for financial instruments adopted in 2007. Based on fair values as of March 4, 2009, the impact of these amendments, which were recorded in the first quarter of 2009, were to increase shareholders' net income by \$22,181, increase policyholders' net income by \$13,600, increase the future income taxes asset by \$16,668, reduce current income taxes receivable by \$11,970 and decrease the Discounted Future Tax Liability (DFTL) component of policy liabilities by \$31,083.

10. Employee Future Benefit Plans

Pension benefit plans include defined benefit plans available to employees. The Company also provides for post-retirement health and dental care coverage and other future benefits to qualifying employees and retirees.

Total cash payments by the Company for employee future benefits for 2009, consisting of cash contributed to its funded pension plans, and cash payments directly to beneficiaries under its unfunded other benefit plans was \$10,733 (2008 \$5,946).

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

The following tables present financial information for the Company's defined benefit plans:

	Pension Benefit Plans		Other Benefit Plans	
	2009	2008	2009	2008
Accrued benefit obligation				
Balance – beginning of year	\$ 111,468	\$ 127,633	\$ 12,045	\$ 13,367
Current service cost	2,012	4,357	109	307
Employee contributions	1,856	1,855	–	–
Interest cost	7,332	7,178	667	667
Benefits paid	(7,480)	(7,521)	(665)	(645)
Actuarial loss (gain)	3,266	(24,557)	(1,647)	(1,651)
Special termination benefit cost	–	2,523	–	–
BALANCE – END OF YEAR	\$ 118,454	\$ 111,468	\$ 10,509	\$ 12,045
Plan assets				
Fair value – beginning of year	\$ 105,878	\$ 129,629	\$ –	\$ –
Actual return on plan assets	18,639	(23,386)	–	–
Employer contributions	10,068	5,301	–	–
Employee contributions	1,856	1,855	–	–
Benefits paid	(7,480)	(7,521)	–	–
FAIR VALUE – END OF YEAR	\$ 128,961	\$ 105,878	\$ –	\$ –
Funded status – plan surplus (deficit)	\$ 10,507	\$ (5,590)	\$ (10,509)	\$ (12,045)
Unamortized net actuarial loss (gain)	(2,465)	5,727	(417)	1,157
Unamortized transitional obligation (asset)	(1,798)	(2,158)	69	82
ACCRUED BENEFIT ASSET (LIABILITY)	\$ 6,244	\$ (2,021)	\$ (10,857)	\$ (10,806)
Recorded in the balance sheet as:				
Other assets	\$ 6,244	\$ 2,663	\$ –	\$ –
Accounts payable and other liabilities	–	(4,684)	(10,857)	(10,806)
ACCRUED BENEFIT ASSET (LIABILITY)	\$ 6,244	\$ (2,021)	\$ (10,857)	\$ (10,806)

Included in the previous figures are defined benefit obligations in excess of plan assets as of December 31:

	Pension Benefit Plans		Other Benefit Plans	
	2009	2008	2009	2008
Accrued benefit obligation	\$ –	\$ 101,392	\$ 10,509	\$ 12,045
Plan assets at fair value	\$ –	\$ 93,127	\$ –	\$ –

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

The employee future benefit costs for the Company's defined benefit plans included in the Company's statement of general fund operations is as follows:

	Pension Benefit Plans		Other Benefit Plans	
	2009	2008	2009	2008
Annual net benefit cost (income)				
Current service cost	\$ 2,012	\$ 4,357	\$ 109	\$ 307
Interest cost	7,332	7,178	667	667
Actual return on plan assets	(18,639)	23,386	–	–
Actuarial loss (gain)	3,266	(24,557)	(1,647)	(1,651)
Special termination benefit cost	–	2,523	–	–
Employee future benefit cost (income) prior to adjustments to recognize long-term nature	(6,029)	12,887	(871)	(677)
Adjustments to recognize long-term nature:				
Difference between expected return and actual return on plan assets	11,486	(31,939)	–	–
Difference between net actuarial loss (gain) recognized and actual actuarial loss (gain)	(3,293)	24,713	1,574	1,840
Amortization of transitional obligation (asset)	(360)	(360)	13	13
NET BENEFIT COST RECOGNIZED FOR THE PERIOD	\$ 1,804	\$ 5,301	\$ 716	\$ 1,176

For pension benefit plans, the net benefit cost recognized for the period includes a special termination benefit of \$nil (2008 \$2,523) in connection with a voluntary early retirement offered to eligible employees.

The Company measures its accrued benefit obligations and the fair value of plan assets for accounting purposes as at December 31 of each year. The most recent and next required actuarial valuation of the Company's employee future benefit plans for funding purposes is as follows:

	Recent Valuation Date	Next Valuation Date
Staff Pension Plan	December 31, 2008	December 31, 2011
Supplemental Employee Retirement Benefit Plan	December 31, 2009	December 31, 2010
Retiree Health Benefits	December 31, 2008	December 31, 2011

The average remaining service period of the active employees covered by the pension benefit and other benefit plans as at December 31 is as follows:

	2009	2008
Staff Pension Plan	12 Years	22 Years
Supplemental Employee Retirement Benefit Plan	10 Years	14 Years
Retiree Health Benefits	9 Years	8 Years

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

The following weighted average assumptions were used in actuarial calculations:

	Pension Benefit Plans		Other Benefit Plans	
	2009	2008	2009	2008
Accrued benefit obligation as of December 31:				
Discount rate	6.3%	7.3%	6.3%	7.3%
Rate of compensation increase	3.5%	3.5%	N/A	N/A
Benefit costs for years ended December 31:				
Discount rate	7.3%	5.5%	7.3%	5.5%
Expected long-term rate of return on plan assets	6.7%	6.5%	N/A	N/A
Rate of compensation increase	3.5%	4.0%	N/A	N/A
Assumed health care cost trend rates at December 31:				
Initial health care cost trend rate	N/A	N/A	7.3%	7.3%
Cost trend rate declines to	N/A	N/A	4.5%	4.5%
Year ultimate rate reached	N/A	N/A	2026	2026

A one percentage-point change in assumed health care cost trend rates would have the following effects for 2009:

	Increase	Decrease
Annual total service and interest cost	\$ 91	\$ (77)
Accrued benefit obligation	\$ 1,258	\$ (1,061)

Plan assets consist of the following asset categories:

	Percentage of Plan Assets	
	2009	2008
Equity securities	55%	50%
Debt securities	35%	38%
Short-term securities	5%	6%
Other	5%	6%

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

11. Income Taxes Included in Other Comprehensive Income (OCI)

Other comprehensive income (loss) is presented net of income taxes. The following income tax amounts are included in each component of shareholders' OCI:

	2009	2008
Unrealized fair value change on available for sale investments	\$ 33,539	\$ (48,420)
Fair value change on available for sale investments reclassified to net income, including impairment write downs	7,217	9,626
Gain (loss) on derivative investments designated as cash flow hedges	424	(1,727)
Gain (loss) on derivative investments designated as cash flow hedges reclassified to net income	129	69
TOTAL INCOME TAX EXPENSE (RECOVERY) INCLUDED IN OCI	\$ 41,309	\$ (40,452)

The following income tax amounts are included in each component of policyholders' OCI:

	2009	2008
Unrealized fair value change on available for sale investments	\$ 3,272	\$ (4,970)
Fair value change on available for sale investments reclassified to net income, including impairment write downs	883	994
TOTAL INCOME TAX EXPENSE (RECOVERY) INCLUDED IN OCI	\$ 4,155	\$ (3,976)

12. Capital Stock

(a) Authorized

Common shares: 2,000,000 shares with no par value.

(b) Issued and Fully Paid

	2009	2008
No. of Common shares: 985,076	\$ 985	\$ 985

13. Shareholders' Equity Entitlement

Shareholders' entitlement to \$6,757 (2008 \$4,680) of shareholders' equity is contingent upon future payment of dividends to participating policyholders.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

14. Accumulated Other Comprehensive Income (Loss)

Shareholders' accumulated other comprehensive income (loss) is comprised of unrealized gains (losses) net of income tax on available for sale assets of \$35,769 (2008 (\$56,599)) and unrealized gains (losses) net of income tax on derivatives designated as cash flow hedges of (\$2,299) (2008 (\$3,479)).

Policyholders' accumulated other comprehensive income (loss) is comprised of unrealized gains (losses) net of income tax on available for sale assets of \$2,973 (2008 (\$4,593)).

15. Operating Lease Commitments

The Company has contractual obligations in respect of rents payable on leased premises and equipment as follows:

2010	\$	1,976
2011		1,523
2012		1,304
2013		1,019
2014		874
Thereafter		3,275
	\$	9,971

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

16. Segmented Information

The Company operates in the Canadian life insurance industry and follows a product line management approach for internal reporting and decision making. Accordingly, operating results are segmented into three product lines along with the Company's capital and surplus segment as follows:

	2009				
	Wealth Management	Employee Benefits	Individual Insurance	Capital & Surplus	Total
Premiums from external customers	\$ 300,306	\$ 241,916	\$ 297,654	\$ –	\$ 839,876
Investment income	55,330	6,603	92,890	29,141	183,964
Fair value change in held for trading assets	43,511	498	62,690	–	106,699
Realized gain (loss) on held for trading assets	3,866	2,886	23,279	610	30,641
Realized gain (loss) on available for sale assets including impairment write downs	(47)	(79)	(11,794)	(22,489)	(34,409)
Fee income from external customers	86,854	5,884	1,423	1,292	95,453
Benefits	199,213	193,887	85,475	–	478,575
Policy dividends	–	–	17,629	–	17,629
Increase (decrease) in policy liabilities	175,367	(11,973)	221,848	–	385,242
Income tax expense (recovery)	4,561	5,163	1,785	(10,087)	1,422
Segment net income (loss)	22,380	10,335	25,740	6,471	64,926
Segment invested assets	1,059,681	121,806	2,140,236	949,004	4,270,727

	2008				
	Wealth Management	Employee Benefits	Individual Insurance	Capital & Surplus	Total
Premiums from external customers	\$ 117,705	\$ 269,561	\$ 298,912	\$ –	\$ 686,178
Investment income	48,717	6,393	90,302	25,288	170,700
Fair value change in held for trading assets	(39,621)	(5,201)	(199,341)	(221)	(244,384)
Realized gain (loss) on held for trading assets	4,122	1,032	14,760	6	19,920
Realized gain (loss) on available for sale assets including impairment write downs	(1)	(1)	(4,595)	(42,610)	(47,207)
Fee income from external customers	94,854	5,521	1,569	1,227	103,171
Benefits	179,302	198,943	94,919	–	473,164
Policy dividends	–	–	16,681	–	16,681
Increase (decrease) in policy liabilities	(52,742)	10,963	(110,077)	–	(151,856)
Income tax expense (recovery)	(2,583)	2,408	30,592	(4,948)	25,469
Segment net income (loss)	8,137	3,326	47,521	(13,896)	45,088
Segment invested assets	876,362	135,850	1,876,011	761,124	3,649,347

Invested assets reported by segment are net of certain liability items.

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

	2009	2008
Total invested assets reported for product lines	\$ 4,270,727	\$ 3,649,347
Liability items included above	127,923	97,459
TOTAL COMPANY GENERAL FUND ASSETS	\$ 4,398,650	\$ 3,746,806

A description of the product lines is as follows:

Wealth Management includes both segregated funds and general fund investment products offered primarily to individual policyholders.

Wealth Management's segregated funds are pooled investments beneficially owned by unit holders of the funds. Accordingly, the assets and liabilities of these funds are not included in the Company's assets and liabilities. The Company earns a management fee in consideration of professional investment management and administration of the funds. The segregated fund assets under management are reported on the segregated funds portion of the balance sheet as total segregated fund assets.

Wealth Management's general fund investment products are primarily guaranteed investment policies and annuities providing income for life. The amount of investment product liability owing to policyholders is included in the Company's policy liabilities. Policy liability valuation for annuities providing income for life includes an assumption for annuitant mortality. The Company invests investment product premiums received from the policyholder into matching assets of appropriate quality, term and yield. The Company earns income, after covering expenses and taxes, based on the difference between investment income earned on these assets and interest credited to the policyholder. Emerging mortality experience on annuities providing income for life also affects income.

The **Employee Benefits** product line offers group benefit plans to employers for medical, dental, disability, and life insurance coverage of their employees.

The **Individual Insurance** product line includes both non-participating and participating individual life and health insurance products.

The **Capital and Surplus** segment is made up of assets held in the shareholders' and policyholders' equity accounts. The segment earns investment income on these assets.

While specific general fund assets are nominally matched against specific types of general fund liabilities or held in the shareholders' and policyholders' equity accounts, all general fund assets are available to pay all general fund liabilities if required.

Segment net income was determined by using allocation methods for certain expenses.

17. Other Assets

Other assets consist of the following:

	2009	2008
Capital assets (net of depreciation of \$47,052 (2008 \$47,751))	\$ 8,060	\$ 10,623
Pension asset	6,244	2,663
Accounts receivable from reinsurers	5,311	8,599
Other receivables	9,700	13,196
OTHER ASSETS	\$ 29,315	\$ 35,081

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

18. Subordinated Debt

On May 20, 2009, the Company issued \$200,000 principal amount of unsecured subordinated debentures with a maturity date of May 20, 2019. The interest rate from May 20, 2009 until May 20, 2014 is 6.73%, and the rate from May 20, 2014 until May 20, 2019 will be equal to the 3-month Canadian Deposit Offering Rate plus 5.75%. Interest is payable semi-annually at May 20 and November 20 until May 20, 2014, quarterly thereafter with the first such payment on August 20, 2014. The debenture has been classified as other liabilities and recorded at amortized cost using the effective interest rate method.

The debt is subordinated in right of payment to all policy liabilities of the Company and all other senior indebtedness of the Company. The Company may call for redemption of the issue at any time subject to the approval of the Office of the Superintendent of Financial Institutions. The holder has no right of redemption.

19. Regulatory Capital

The Company aims to manage its capital in order to meet the capital adequacy requirements of the *Insurance Companies Act (Canada)* as established and monitored by the Office of the Superintendent of Financial Institutions (OSFI). Under the guidelines established by OSFI, the Company's capital consists of two tiers. The Company's Tier 1 Capital includes common shares, contributed surplus, retained earnings and participating policyholders' equity. Tier 2 capital includes the accumulated unrealized gains on AFS equity securities, net of tax, negative reserves on policy liabilities and subordinated debt. OSFI's target Tier 1 and total capital ratios for Canadian life insurance companies are 105% and 150% respectively. As at December 31, 2009, the Company was in compliance with these ratios.

	As at December 31, 2009	As at December 31, 2008
Tier 1 Capital	\$ 707,141	\$ 584,315
Tier 2 Capital	300,527	226,192
TOTAL REGULATORY CAPITAL	\$ 1,007,668	\$ 810,507

20. Related Party Transactions

On May 22, 2009 the Company repaid a \$125,000 subordinated debenture issued to its ultimate parent, E-L Financial Corporation Limited. On a year to date basis, interest expense on this debenture of \$2,946 (2008 \$1,943) is included in the statement of general fund operations.

The Company provides investment management services to other companies under common shareholder control. The fees charged for these services are \$1,337 (2008 \$1,329).

Notes to Financial Statements

Year ended December 31, 2009 (all amounts are expressed in thousands of dollars)

21. Accounts Payable and Other Liabilities

Accounts payable and other liabilities consist of:

	2009	2008
Accounts payable	\$ 28,020	\$ 31,946
Employee future benefit accrued obligation	10,857	10,806
Premiums collected in advance	2,608	2,533
Accrued interest on subordinated debt	1,604	1,943
Pension liability	–	4,684
Other	39,680	27,569
ACCOUNTS PAYABLE AND OTHER LIABILITIES	\$ 82,769	\$ 79,481

22. Guarantees and Other Contingencies

The Company by-laws provide indemnification to its current and former directors, officers and employees to the extent permitted by law, against liabilities arising from their service to the Company. The broad general nature of these indemnification by-laws does not permit a reasonable estimate of the maximum potential amount of any liability.

In connection with its operations, the Company is from time to time named as defendant in actions for damages and costs allegedly sustained by plaintiffs. While it is not possible to estimate the outcome of the various proceedings at this time, the Company does not believe that it will incur any material loss or expense in connection with such actions.

In certain cases, the Company would have recourse against third parties with respect to the foregoing items and the Company also maintains insurance policies that may provide coverage against certain of these items.

23. Supplementary Cash Flow Information

Cash and cash equivalents are defined as follows:

	2009	2008
Outstanding cheques	\$ (12,445)	\$ (14,519)
Short-term investments with maturities of three months or less from the date of acquisition	161,586	187,243
CASH AND CASH EQUIVALENTS	\$ 149,141	\$ 172,724

24. Comparative Figures

Certain comparative figures have been reclassified to conform with financial statement presentation adopted in 2009.

Dividend Policy

The Board of Directors of The Empire Life Insurance Company has approved the following policy:

“The dividend policy of the Company is to distribute dividends on participating policies on the basis of the expected margins available for the payments of dividends included in the original product pricing, adjusted periodically to reflect emerging experience.

Dividends must also reflect changing requirements as to long-term levels of required surplus in the participating fund and interest earned on that surplus.

A fundamental objective in the distribution of dividends is the maintenance of reasonable equity between classes of policyholders and between generations of policyholders. It is, therefore, important that the emerging versus the pricing experience be extracted and applied consistently for all policies classified as participating.

All policies defined as participating by contractual provisions including life, disability and annuity plans are credited with dividend payments on a regular basis. Most plans are credited with dividends annually, while a few older plans receive the dividends quinquennially, as per contractual provisions.

The Company’s current practice, so long as the participating account in aggregate remains below \$250 million, is to transfer an amount equal to 1/9 of the dividends credited to participating policyholders, from the participating account to the shareholders account.”

Corporate Governance Over Risk Management

The Empire Life Insurance Company (the Company) is a stock company that has both shareholders and participating policyholders. Pursuant to the *Insurance Companies Act (Canada)* (the Act) each holder of one or more participating policies is entitled to one vote in the election of policyholders' directors, and each shareholder is entitled to one vote per share held in the election of shareholders' directors. At least one-third of directors are elected as policyholder directors and the balance are elected as shareholder directors. The Company is governed by the Act, which contains provisions concerning corporate governance. The Company's governance system is supported by internal audit, corporate compliance, external audit by an independent chartered accountants firm, and examination by the Office of the Superintendent of Financial Institutions Canada (OSFI).

Management is responsible for identifying risks and determining their impact upon the Company. Management is also responsible for establishing appropriate policies, procedures, and controls to mitigate risks. An internal audit function is responsible for assessing the adequacy and adherence to the systems of internal control. The results of internal audit's reviews are reported to management and to the Audit Committee of the Board of Directors regularly throughout the year.

Management is supervised in the completion of these responsibilities by the Board of Directors and its Committees. Senior management of the Company reports regularly to the Board on its risk management policies and procedures.

The **Board of Directors** has plenary power. The Board's responsibility is to oversee the conduct of the business and affairs of the Company including oversight and monitoring of the Company's risk management. The Board discharges these responsibilities directly and through delegation to Board Committees and management. The Board met eight times in 2009 and is scheduled to meet six times in 2010.

The risk management functions overseen by the Board include those relating to interest rate risk, credit risk, foreign exchange risk, reinsurance risk, liquidity risk, other risks associated with policy liabilities, regulatory risk, and operational risk. Primary responsibility for oversight of some of these risks is delegated to four standing Committees of the Board, whose roles and responsibilities are specifically defined. The following is a brief summary of some of the key responsibilities of the four Committees.

The **Audit Committee** is a committee charged with statutory responsibility under the Act to oversee, on behalf of the Board, the Company's financial reporting, accounting and financial reporting systems and internal controls.

The **Investment Committee** assists the Board in monitoring the Company's investment and lending policies, standards and procedures and in monitoring the Company's investment activities and portfolios. Some of the activities of the Investment Committee are prescribed by the Company's Investment Guidelines, which reflect the requirements of the Act.

The **Human Resources Committee** is responsible for reviewing and monitoring the Company's human resources practices, including employee and executive compensation, manpower and pension and benefit plans.

The **Conduct Review Committee** is responsible for oversight of procedures established to identify material related party transactions pursuant to the Act. The Committee also monitors certain corporate policies, including procedures with respect to conflicts of interest, confidentiality of information and outsourcing.



Corporate Information

Corporate Head Office

259 King Street East
Kingston, Ontario
Canada K7L 3A8
Telephone: 1 877 548-1881
www.empire.ca

The Empire Life Insurance Company is a member of Assuris, the organization that protects Canadian insurance policyholders from loss of benefits due to the financial failure or insolvency of a member company.

Policyholders and prospective policyholders can learn more about Assuris and the protection it provides by visiting www.assuris.ca or calling the Assuris Information Centre at 1 866 878-1225.

Retail Sales Offices

Western Canada

Vancouver Retail Sales Office

602-5811 Cooney Road, North Tower
Richmond, British Columbia V6X 3M1
604 232-5557
I 888 627-3591

Calgary Retail Sales Office

305-1240 Kensington Road N.W.
Calgary, Alberta T2N 3P7
403 269-1000
I 800 656-2878

Regina Retail Sales Office

Box 1, Suite 283
1919 Rose Street
Regina, Saskatchewan S4P 3P1
306 949-1445
I 877 949-1445

Saskatoon Retail Sales Office

1000-201 21st Street E.
Saskatoon, Saskatchewan S7K 0B8
306 934-3899
I 800 667-7775

Winnipeg Retail Sales Office

200-5 Donald Street
Winnipeg, Manitoba R3L 2T4
204 452-9138
I 866 204-1001

Ontario

London Retail Sales Office

One London Place
1030-255 Queens Avenue
London, Ontario N6A 5R8
519 438-2922
I 888 548-4729

Waterloo Retail Sales Office

250-180 King Street S.
Waterloo, Ontario N2J 1P8
519 569-7002
I 888 548-4729

Burlington Retail Sales Office

402-5500 North Service Road
Burlington, Ontario L7L 6W6
905 335-6558
I 888 548-4729

Toronto Retail Sales Office

500-2550 Victoria Park Avenue
Toronto, Ontario M2J 5A9
416 494-0900
I 888 548-4729

Kingston Retail Sales Office

259 King Street E.
Kingston, Ontario K7L 3A8
613 540-7506
I 888 548-4729

Ottawa Retail Sales Office

102-9 Gurdwara Road
Nepean, Ontario K2E 7X6
613 225-7530
I 888 548-4729

Quebec

Montréal Retail Sales Office

1600-600 de Maisonneuve Boulevard W.
Montréal, Québec H3A 3J2
514 842-9151
I 800 371-9151

Québec Retail Sales Office

100-1220 Lebourgneuf Boulevard
Québec, Québec G2K 2G4
418 628-1220
I 888 816-1220

Atlantic Canada

Halifax Retail Sales Office

101-647 Bedford Highway
Bedford, Nova Scotia B3M 0A5
902 832-1403
I 888 548-4729

Group Sales Offices

Western Canada

Vancouver Group Sales Office

602-5811 Cooney Road, North Tower
Richmond, British Columbia V6X 3M1
604 232-5558
I 800 547-0628

Calgary Group Sales Office

304-1240 Kensington Road N.W.
Calgary, Alberta T2N 3P7
403 262-6386
I 888 263-6386

Edmonton Group Sales Office

950-10020 101 A Avenue
Edmonton, Alberta T5J 3G2
780 482-4241
I 866 990-9925

Ontario

London Group Sales Office

1030-255 Queens Avenue
London, Ontario N6A 5R8
519 438-1751
I 800 268-3403

Waterloo Group Sales Office

250-180 King Street S.
Waterloo, Ontario N2J 1P8
519 569-7002
I 866 569-7002

Burlington Group Sales Office

402-5500 North Service Road
Burlington, Ontario L7L 6W6
905 335-6558
I 800 663-9984

Toronto Group Sales Office

500-2550 Victoria Park Avenue
Toronto, Ontario M2J 5A9
416 494-6834
I 800 361-7980

Ottawa Group Sales Office

102-9 Gurdwara Road
Nepean, Ontario K2E 7X6
613 225-1173
I 800 387-4123

Quebec

Montréal Group Sales Office

1600A-600 de Maisonneuve Boulevard W.
Montréal, Québec H3A 3J2
514 842-0003
I 800 561-3738

Board of Directors

Shareholders' Directors

Edward M. Iacobucci ^{1,4}
Professor of Law
University of Toronto

Duncan N.R. Jackman ^{1,2,3,4}
Chairman of the Board
The Empire Life Insurance Company

Robert G. Long, F.C.A. ^{1,4}
Corporate Director

Deanna Rosenswig, B.Com., M.B.A. ^{1,3}
Corporate Director

Clive P. Rowe ²
Partner
SLS Capital

Stephen J.R. Smith ^{2,3}
Chairman and President
First National Financial LP

Mark M. Taylor ²
Executive Vice-President and Chief Financial Officer
E-L Financial Corporation Limited

Paul R. Weiss, F.C.A. ^{1,4}
Corporate Director

Policyholders' Directors

Mark J. Fuller, LL.B. ^{2,4}
President and Chief Executive Officer
Ontario Pension Board

Leslie C. Herr ²
President and Chief Executive Officer
The Empire Life Insurance Company

Richard E. Rooney, C.A., F.C.A. ^{2,3}
President
Burgundy Asset Management

Douglas C. Townsend, F.S.A., F.C.I.A. ^{1,3}
President
Townsend Actuarial Consulting Ltd.

Honorary Chairman

The Honourable Henry N.R. Jackman
Honorary Chairman
The Empire Life Insurance Company

Honorary Director

The Right Honourable John N. Turner, P.C., C.C., Q.C.
Partner
Miller Thomson LLP

¹ Member of Audit Committee

² Member of Investment Committee

³ Member of Human Resources Committee

⁴ Member of Conduct Review Committee



Corporate Management

*Back Row: (left to right) Gaelen Morphet, Richard Cleaver, Drew Wallace, Gary McCabe, Edward Gibson, Timo Hytonen
Front Row: (left to right) Les Herr, Anne Butler, Steve Pong*

Leslie C. Herr, M.B.A., C.F.P., C.L.U., Ch.F.C., E.P.C.
President and Chief Executive Officer

Drew E. Wallace
Executive Vice-President, Retail

Anne E. Butler, B.A., LL.B.
Senior Vice-President, General Counsel and Corporate Secretary

Richard Cleaver
Senior Vice-President, Information Technology

J. Edward Gibson, F.S.A., F.C.I.A.
Senior Vice-President and Chief Actuary

Timo J. Hytonen, M.B.A., C.H.R.P., F.C.I.P., C.R.M., C.Dir.
Senior Vice-President, Strategy, Human Resources and Corporate Initiatives

Gary J. McCabe, C.A.
Senior Vice-President and Chief Financial Officer

Gaelen Morphet, C.F.A.
Senior Vice-President and Chief Investment Officer

Steve S. Pong, B.A.Sc.
Senior Vice-President, Group Products

Annual Report 2009

The Empire Life Insurance Company (Empire Life) offers competitive individual and group life and health insurance, investment and retirement products to help you build wealth and protect your financial security. We manage investments and funds for our customers following a conservative, value-oriented philosophy that helps grow and preserve wealth.

We are among the top 10 life insurance companies in Canada¹ and are rated A (Excellent) by A.M. Best Company². Our vision is to be the leading independently owned Canadian financial services company committed to simplicity, being easy to do business with and having a personal touch.

¹ Based on general and segregated fund assets reported in 2008 company annual reports

² As at June 12, 2009

www.empire.ca



Empire Life®

® Registered trademark of **The Empire Life Insurance Company**. Policies are issued by The Empire Life Insurance Company.