

The Alberta Lawyers Insurance Exchange

Financial Statements
December 31, 2017



February 26, 2018

Independent Auditor's Report

To the Directors of the Alberta Lawyers Insurance Exchange

We have audited the accompanying financial statements of the Alberta Lawyers Insurance Exchange, which comprise the statement of financial position as at December 31, 2017 and the statements of net and comprehensive loss and changes in equity and cash flows for the year then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Alberta Lawyers Insurance Exchange as at December 31, 2017 and its financial performance and its cash flows for the year then ended in accordance with with International Financial Reporting Standards.

PricewaterhouseCoopers LLP

Chartered Professional Accountants

PricewaterhouseCoopers LLP
111 5 Avenue SW, Suite 3100, Calgary, Alberta, Canada T2P 5L3
T: +1 403 509 7500, F: +1 403 781 1825, www.pwc.com/ca

"PwC" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

The Alberta Lawyers Insurance Exchange

Statement of financial position

As at December 31, 2017

	2017 \$	2016 \$
Assets		
Cash and cash equivalents (note 2)	4,086,884	37,241
Investments (note 3)	20,828,839	15,893,188
Accrued interest receivable	56,982	32,985
Prepaid expenses	145,350	112,617
Deferred premium tax	108,400	-
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Total assets	25,226,455	16,076,031
Liabilities and Equity		
Accounts payable and accrued liabilities	298,348	235,087
Unearned premiums	2,710,000	2,050,000
Premium deficiency (note 10)	-	85,513
Provision for claims and related costs – Professional liability (note 5)	12,616,000	7,659,000
Provision for claims and related costs – Trust safety (note 5)	717,000	378,000
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Total liabilities	16,341,348	10,407,600
Equity		
Contributed capital (note 4)	9,000,000	5,000,000
Retained (deficit) earnings	(114,893)	668,431
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Total equity	8,885,107	5,668,431
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Total liabilities and equity	25,226,455	16,076,031

Approved by the Advisory Board

Original signed by Steve Raby, QC Director

Original signed by Dale Spackman, QC Director

The Alberta Lawyers Insurance Exchange

Statement of net and comprehensive loss and changes in equity

For the year ended December 31, 2017

	2017 \$	2016 \$
Income		
Premium - Professional liability	4,200,000	3,550,000
Premium - Trust safety	560,000	550,000
Premium ceded	(242,113)	(267,113)
Net premium	4,517,887	3,832,887
Investment income	446,047	390,943
Unrealized gain (loss) on fair market value of investments	196,514	(209,450)
Total income	5,160,448	4,014,380
Expenses		
Provision for claims and related costs - Professional liability (note 5)	4,957,000	4,280,000
Provision for claims and related costs - Trust safety (note 5)	339,000	178,000
Premium deficiency (note 10)	(85,513)	85,513
Management fee (note 6)	308,000	200,000
Premium tax	98,156	233,076
Professional fees	126,940	103,666
Employment services contracts	35,478	78,733
Board expenses	107,392	62,423
Investment counsel fees	40,568	33,254
Administration	16,751	19,108
Total expenses	5,943,772	5,273,773
Net and comprehensive loss	(783,324)	(1,259,393)
Total equity – beginning of year	5,668,431	6,927,824
Contributed capital (note 4)	4,000,000	-
Total equity – end of year	8,885,107	5,668,431

The accompanying notes are an integral part of the financial statements.

The Alberta Lawyers Insurance Exchange

Statement of Cash Flows

For the year ended December 31, 2017

	2017 \$	2016 \$
Cash provided by (used in)		
Operating activities		
Net and comprehensive loss for the year	(783,324)	(1,259,393)
Items not affecting cash		
Realized loss (gain) on sale of investments	10,961	(87,743)
Unrealized (gain) loss on fair market value of investments	(196,514)	209,450
Provision for claims and related costs – Professional liability	4,957,000	4,280,000
Provision for claims and related costs - Trust safety	339,000	178,000
	<u>4,327,123</u>	<u>3,320,314</u>
Changes in non-cash working capital items	<u>472,617</u>	<u>250,740</u>
Cash provided by operating activities	<u>4,799,740</u>	<u>3,571,054</u>
Investing activities		
Sale of investments	25,065,008	20,243,798
Purchase of investments	<u>(29,815,105)</u>	<u>(23,915,165)</u>
Cash provided by investing activities	<u>(4,750,097)</u>	<u>(3,671,367)</u>
Financing activities		
Capital contribution	<u>4,000,000</u>	<u>-</u>
Increase (decrease) in cash	4,049,643	(100,313)
Cash and cash equivalents – beginning of year	<u>37,241</u>	<u>137,554</u>
Cash and cash equivalents – end of year	<u>4,086,884</u>	<u>37,241</u>
Cash and cash equivalents include:		
Cash	64,520	37,241
Treasury bills	<u>4,022,364</u>	<u>-</u>
	4,086,884	37,241
Interest received	230,854	194,423

The accompanying notes are an integral part of the financial statements.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

1 Nature of operations

The Alberta Lawyers Insurance Exchange (the Exchange) is a reciprocal insurance exchange pursuant to the Province of Alberta's *Insurance Act* (the *Act*) formed in accordance with a Subscribers Agreement dated May 14, 2014 among the Law Society of Alberta (the Law Society), the Alberta Lawyers Insurance Association (the Association), and active members of the Law Society in private practice (insured lawyers). The Exchange underwrites coverage under the Alberta Lawyers' Professional Liability and Trust Safety Insurance Group Policy (the Policy). The Exchange commenced operations on July 1, 2014.

The Exchange is licensed in Alberta and regulated by the Superintendent of Insurance of Alberta (the Superintendent) and subject to the *Act* and its regulations. The Exchange is an entity domiciled in Canada and the address of its registered office is Suite 500, 919 11th Avenue, SW, Calgary, Alberta, T2R 1P3.

The financial statements were authorized for issue by the Advisory Board of the Exchange on February 26, 2018.

Professional Liability Insurance

Under the Professional Liability Insurance section (or Part A) of the Policy, insured lawyers have coverage for claims and potential claims arising from negligent acts, errors or omissions for \$1,000,000 per occurrence, with an annual aggregate limit of \$2,000,000 per insured lawyer. The Association pays the first \$500,000 of a professional liability claims and the Exchange pays the next \$500,000.

For the 2017 and 2016 policy years (beginning July 1 to June 30), the Exchange and the Association have obtained stop-loss reinsurance in the amount of \$10,000,000 to cover annual aggregate payments over \$26,000,000 to a maximum of \$36,000,000. This \$10,000,000 coverage layer is co-insured with the reinsurer paying 80% of losses and the Association paying 20%.

Trust Safety Insurance

Effective July 1, 2014, the Trust Safety Insurance section (or Part B) of the Policy provides defined insurance coverage for misappropriation of money or other property entrusted to and received by insured lawyers in their capacity as barristers and solicitors and in relation to the provision of professional services. For the 2017 and 2016 policy years, there is a \$5,000,000 per misappropriation limit and a \$25,000,000 profession-wide annual aggregate limit. This coverage is subject to a \$3,000,000 group deductible with the Association paying the first \$500,000 of a misappropriation claim and the Exchange paying the next \$2,500,000.

For the 2017 and 2016 policy years, the Exchange and the Association have purchased excess insurance in the amount of \$22,000,000 to cover aggregate payments over \$3,000,000.

Claims for trust misappropriation arising before July 1, 2014 are covered under the provisions of the Law Society's Assurance Fund.

2 Summary of significant accounting policies

The principal accounting policies applied in the presentation of these financial statements are set out below. These policies have been consistently applied to the years presented.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

a) Basis of preparation

These financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS). The financial statements have been prepared under the historical cost convention, except for the valuation of certain financial instruments at fair value through profit and loss.

The statement of financial position is presented on a non-classified basis. Assets expected to be realized and liabilities expected to be settled within the Exchange's normal operating cycle of one year would typically be considered as current, including the following balances: cash and cash equivalents, treasury bills included in investments, prepaid expenses, deferred premium taxes, accrued interest receivable, accounts payable and accrued liabilities, and unearned premiums.

The following balances are generally comprised of current and non-current amounts: bonds and equity investments included in investments, and the reserve for claims and related costs. The current and non-current portions of such balances are disclosed, where applicable, throughout the notes to the financial statements.

b) Use of estimates and judgment

The preparation of the financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amount of assets and liabilities as at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from these estimates.

Information about judgments, estimates and assumptions that have the most significant effect on the amounts reflected in the financial statements is included in note 5 – Provision for claims and related costs.

c) Functional and presentation currency

The financial statements are presented in Canadian dollars, which is also the Exchange's functional currency.

d) Financial instruments

The Exchange initially measures financial assets and financial liabilities at cost. It subsequently measures its investments at fair value through profit and loss (FVTPL). The financial assets subsequently measured at amortized cost include cash and cash equivalents, accounts receivable and accrued interest receivable. The financial liabilities subsequently recorded at amortized cost include accounts payable and accrued liabilities.

The Exchange's investments consist of equity securities, corporate bonds, provincial government bonds and federal government bonds. Investments in equity securities which are traded on active markets are recorded at fair value. The Exchange has elected to record the investments in corporate bonds, provincial government bonds and federal government bonds at fair value. Changes in fair value of the investments are recorded in the statement of net and comprehensive income and changes in equity. Investments which are not traded on active markets are recorded at fair value.

Financial assets are tested for impairment at the end of each reporting year and when there are indications that the assets may be impaired.

e) Revenue recognition

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Exchange and it can be reliably measured.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

f) Premium income

The premiums charged to the Association is determined annually prior to July 1st, the commencement of the policy year. Premium revenue is recorded evenly throughout the policy year as the services are rendered.

g) Investment income

Investment income comprises of interest, dividends, fund distributions, and gains and losses realized on the disposal of investments. Interest and dividends earned on investments are included as revenue on an accrual basis.

h) Provision for claims and related costs

The provision for claims and related costs includes provisions for claims incurred but not reported and a provision for adverse deviation. The provision for claims and related costs represents an estimate of the ultimate net cost of all amounts related to the settlement of claims incurred prior to the date of the statement of financial position.

The provision for claims and related costs is based upon the change in the year in the reserve for claims and related costs. The provision liability is the actuarially determined discounted cost of possible claims and related costs as at the end of the fiscal year.

The estimates of loss activity are subject to a high level of uncertainty, and are derived from a wide range of possible outcomes. These estimates are continually reviewed as additional information affecting settlement is obtained.

The Exchange has engaged a third party actuary to provide an annual valuation of the provision for claims and related costs in accordance with the standards of practice adopted by the Canadian Institute of Actuaries. For the purpose of the actuarial valuation, the actuary uses information contained in the Exchange's financial records.

i) Premium ceded

The Exchange enters into reinsurance treaties for contracts with coverage in excess of certain maximum amounts. Estimates of any amounts recoverable from reinsurers on unpaid claims will be recorded separately from other estimated amounts payable. Amounts recoverable from reinsurers are estimated in a manner consistent with the liabilities associated with the reinsurance policy.

Ceded reinsurance arrangements do not relieve the Exchange from its obligations to policyholders.

Reinsurance assets and liabilities are derecognized when the contractual rights are extinguished or expire, or when the contract is transferred to another party.

As of December 31, 2017, no reinsurance assets have been recorded (2016 – NIL).

j) Recoveries

Recoveries for claims and related costs from insurers and other third parties are recorded when they can be reasonably estimated and collectability is reasonably assured. Otherwise, the recovery is recorded when received.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

k) Cash and cash equivalents

Cash includes cash on deposit with banks and other highly liquid short-term investment comprised of treasury bills with an original term to maturity of three months or less.

l) Donated services

A portion of the Exchange's work is dependent on the services of volunteers, in particular the significant contribution of members of the Advisory Board and committees of the Advisory Board. These services are not normally purchased by the Exchange and, due to the difficulty in determining their fair value, donated services are not recognized in these financial statements.

m) Unearned premiums

Insurance premiums for each fiscal year are billed in advance and recognized as revenue on a monthly basis during the fiscal year. Unearned premiums represent the portion of premiums remaining to be earned at the reporting date.

n) Income taxes

As a reciprocal insurance exchange under the *Act*, the Exchange is not subject to income taxes under the *Income Tax Act*. Accordingly, no provision for income taxes has been made in these financial statements.

o) Insurance contracts

Contracts entered into by the Exchange meet the definition of an insurance contract and are accounted for in accordance with IFRS 4, Insurance Contracts (IFRS 4). Insurance contracts are those contracts where the Exchange has accepted significant insurance risk. A contract is considered to have significant insurance risk if, and only if, an insured event could cause an insurer to make significant additional payments in any scenario at the inception of the contract.

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

p) New accounting standards issued but not yet adopted

IFRS 15 Revenue from Contracts with Customers (IFRS 15)

IFRS 15 is a new standard on revenue recognition, superseding International Accounting Standard (IAS) 18, IAS 11, and related interpretations. The objective of IFRS 15 is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within industries, across industries and across capital markets. It contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict that transfer of goods or services to customers at an amount the entity expects to be entitled to in exchange for those goods or services. The standard is effective for annual periods beginning on or after January 1, 2018 and is to be adopted retrospectively. Management has determined that the standard will not have a material impact on the financial statements.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

IFRS 9 Financial Instruments (IFRS 9)

IFRS 9 includes a third measurement category for financial assets – fair value through other comprehensive income and a single, forward-looking expected loss impairment model. IFRS 7 was amended to require additional disclosures on transitions to IFRS 9. This standard is effective for annual periods beginning on or after January 1, 2018 (potential to defer to align with IFRS 17) and is to be adopted retrospectively. Further details on the Exchange’s application of IFRS 9 are noted below.

IFRS Insurance Contracts (IFRS 4)

On September 12, 2016, the IASB published an amendment to IFRS 4 Insurance Contracts. This addresses the concerns of insurance companies about the different effective dates of IFRS 9 Financial Instruments, and the forthcoming new insurance contracts standard. The amendment to IFRS 4 provides two different solutions for insurance companies: the “deferral approach” which is a temporary exemption from IFRS 9 for entities that meet specific requirements (applied at the reporting entity level); and the “overlay approach”. The standard is effective for annual periods beginning on or after January 1, 2021. Management believes it meets the criteria to defer IFRS 9 and is currently assessing the impact of this standards on the Exchange.

IFRS 17 Insurance Contracts (IFRS 17)

On May 18, 2017, the IASB published the standard IFRS 17 Insurance Contracts which replaces the provisions of IFRS 4. The standard has an objective to ensure that an entity provides relevant information that faithfully represents those contracts and gives a basis for users of the financial statements to assess the effect that insurance contracts have on the financial position, income statement and cash flow statements. The standard establishes the principles for recognition, measurement, presentation and disclosure and defines a general model and a variable fee approach applicable to all insurance contracts and reinsurance contracts to measure the insurance contract liabilities and a specific model for contracts of one year or less. The standard is effective for annual periods beginning on or after January 1, 2021 and is to be adopted retrospectively. Management is assessing the impact of this standard on the Exchange.

3 Investments

The Exchange’s investments are governed by a Statement of Investment Policies and Goals as approved by the Advisory Board and managed under contract with an external investment manager. The Exchange’s investments are carried at fair market value and the statement of net and comprehensive income and changes in equity reports both realized and unrealized gains and losses on investments. The Exchange’s investments consist of treasury bills, bonds and equity investments.

Investments are as follows:

	2017	2016
	\$	\$
Bonds		
Corporate	5,352,069	3,198,719
Provincial government	3,804,841	2,649,194
Federal government	4,361,186	2,720,423
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	13,518,096	8,568,336
T-Bills	3,335,691	4,628,707
Equities	3,975,052	2,696,145
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	20,828,839	15,893,188
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The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

4 Contributed capital

Prior to the commencement of operations on July 1, 2014, the Association contributed \$5,000,000 to the Exchange which has been recorded as contributed capital. The Association contributed an additional \$4,000,000 in 2017 (2016 - \$0).

5 Provision for claims and related costs

The change in the Professional liability provision for claims and related costs is summarized as follows:

	2017 \$	2016 \$
Provision for claims and related costs, Professional liability – beginning of year	7,659,000	3,379,000
Increase due to claims experience	4,957,000	4,280,000
Provision for claims and related costs, Professional liability – end of year	<u>12,616,000</u>	<u>7,659,000</u>
Case reserve	4,337,000	1,984,000
Provision for adverse deviation	1,832,000	1,179,000
Provision for incurred but unreported claims	<u>6,447,000</u>	<u>4,496,000</u>
Provision for claims and related costs – Professional liability	<u>12,616,000</u>	<u>7,659,000</u>

The change in the Trust safety provision for claims and related costs is summarized as follows:

	2017 \$	2016 \$
Provision for claims and related costs, Trust safety – beginning of year	378,000	200,000
Increase due to claims experience	339,000	178,000
Provision for claims and related costs, Trust safety – end of year	<u>717,000</u>	<u>378,000</u>
Provision for adverse deviation	107,000	56,000
Provision for incurred but unreported claims	<u>610,000</u>	<u>322,000</u>
Provision for claims and related costs – Trust safety	<u>717,000</u>	<u>378,000</u>

Included in the Provision for claims and related costs in the statement of net and comprehensive income and changes in equity is the increase due to claims experience of \$4,957,000 for Professional liability (2016 - \$4,280,000) and \$339,000 for Trust Safety (2016 - \$178,000).

The discount rate applied by the actuary at December 31, 2017 is 1.65% (2016 - 1.80%), which is based on the expected market yield of the Exchange's investment portfolio. The undiscounted provision balance at December 31, 2017 is \$11,522,000 for Professional liability (2016 - \$6,996,000) and \$664,000 for Trust Safety (2016 - \$340,000).

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

Actuarial analysis

The process of determining actuarial liabilities necessarily involves the risk that actual results may vary from assumed results. The risk varies in proportion to the length of period covered by each assumption and the potential volatility of the actual results.

The provision for incurred but not reported claims has been estimated for the year using actuarial methods and is based on expected claims development patterns and expected losses.

Sensitivity analysis

The sensitivity analysis below is based on a change in assumption while holding all other conditions constant. In practice, this is unlikely to occur, and changes in some of the assumptions may be correlated. The table below provides the impact on net income of the most significant assumption changes.

Assumption	Income impact 2017 \$	Income impact 2016 \$
10% increase in incurred but not reported claims	(900,000)	(570,000)
10% decrease in incurred but not reported claims	900,000	570,000
1% increase in discount rate impact on claims provision	518,000	361,000
1% decrease in discount rate impact on claims provision	(556,000)	(323,000)
1% increase in interest rate impact on bond values	(987,000)	(637,000)
1% decrease in interest rate impact on bond values	987,000	637,000

6 Related party transactions

During the year the Exchange paid the Association \$308,000 (2016 - \$200,000) for management fees. The Association provides and performs certain management, claims management and administrative duties and services to the Exchange as outlined within a Management Agreement. The Association paid the Exchange \$5,420,000 (2016 - \$4,100,000) for insurance premiums of which \$2,710,000 was recorded as income during the year with the balance of \$2,710,000 recorded as unearned premiums.

The Exchange is governed by the Advisory Board whose members include lawyers drawn from law firms across the province. These law firms may at times be engaged by the Exchange in the normal course of business. During the year expenses of \$58,198 were incurred with these law firms (2016 - \$33,747). The Advisory Board members are not involved in retaining these firms.

All related party transactions occurred in the normal course of operations and have been measured at the agreed to exchange amount, which is the amount of consideration established and agreed to by the related parties.

7 Financial instruments

The Exchange recognizes financial instruments at fair value upon initial recognition, plus transaction costs in the case of financial instruments measured at amortized cost. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Exchange has transferred substantially all risks and rewards of ownership. Financial liabilities are derecognized when the obligation is discharged, cancelled, or has expired.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

The Exchange's investments are classified as held for trading or designated at fair value through profit or loss (FVTPL) at inception. A financial asset or financial liability is classified as held for trading if it is acquired or incurred principally for the purpose of selling or repurchasing in the short term; or if, on initial recognition, it is part of a portfolio of identifiable financial investments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking.

Gains and losses arising from changes in the fair value of FVTPL financial instruments are presented in the statement of net and comprehensive income and changes in equity as unrealized (loss) gain on fair market value of investments in the year in which they arise.

All other financial assets and liabilities are measured at amortized cost. Under this method, financial assets and liabilities reflect the amount required to be received or paid, discounted, when appropriate, at the contract's effective interest rate.

Fair value hierarchy

A fair value hierarchy is presented below that distinguishes the significance and objectivity of the inputs used in determining the fair value measurements of financial instruments. The hierarchy contains the following levels based on the nature of the pricing inputs:

Level 1 – Inputs that reflect unadjusted quoted prices in active markets for identical assets or liabilities that are publicly available at the measurement date.

Level 2 – Inputs other than quoted prices that are observable for the assets or liabilities either directly or indirectly, including inputs in markets that are not considered to be active.

Level 3 – Inputs that are largely unobservable. Fair value requires significant management estimate and judgment.

The following table illustrates the fair value classification of the Exchange's financial instruments within the fair value hierarchy.

As at December 31, 2017:

	Estimated fair value (2017)			Estimated fair value (2016)		
	Level 1	Level 2	Total	Level 1	Level 2	Total
	\$	\$	\$	\$	\$	\$
T-Bills	3,335,691	-	3,335,691	4,628,707	-	4,628,707
Bonds	13,518,096	-	13,518,096	8,568,336	-	8,568,336
Equities	-	3,975,052	3,975,052	-	2,696,145	2,696,145
Total Investments	16,853,787	3,975,052	20,828,839	13,197,043	2,696,145	15,893,188

Equities classified as Level 2 are invested in pooled funds, the underlying assets of which are traded in active markets. The pooled funds are valued based on the net asset value per share of the pooled fund.

The Exchange did not have any transfers between levels and there were no level 3 investments as at December 31, 2017 and December 31, 2016.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

8 Reinsurance

The Association and the Exchange have entered into stop loss reinsurance and excess insurance contracts as described in Note 1.

As of December 31, 2017, there were no claims above the Exchange's Professional Liability and Trust Safety coverage of \$1,000,000 and \$3,000,000 respectively and no claims above these levels considered to be incurred but not reported as determined by the appointed actuary (2016 - \$nil). As such, no assets for reinsurance or excess insurance contracts have been recognized in the statement of financial position.

9 Insurance and financial risk management

In the normal course of business, the Exchange enters into contracts that transfer insurance risk or financial risk or both. The Exchange monitors and manages these risks through internal risk reports which analyze exposures by degree and magnitude of risk.

Insurance risk

The insurance risk under any one insurance contract is the possibility that the insured event occurs and the uncertainty of the amount of the resulting claim. By the very nature of an insurance contract, this risk is random and therefore unpredictable. The key risk related to insurance is that the actual claims payment amounts or timing are different from expectations.

The Exchange manages insurance risk rating within an overall risk management framework that includes a focus on rating, use of reinsurance and surplus management. Reinsurance is purchased to mitigate the effect of potential loss to the Exchange from individual large events. Reinsurance policies are written with reinsurers who meet the Exchange's standards for financial strength. Reinsurers and reinsurer security is monitored on a continuous basis.

Financial risk

The Exchange is exposed to a range of financial risks. The key financial risk is that in the long term its investment proceeds are not sufficient to fund the obligations arising from its insurance contracts. The most important components of this financial risk are market risk, credit risk and liquidity risk.

Market risk

Market risk is the risk that the fair value of financial instruments will fluctuate due to changes in market prices. The Exchange separates market risk into three categories: foreign exchange risk, price risk, and interest rate risk.

Foreign exchange risk

Foreign exchange risk arises from the possibility that changes in the price of foreign currencies will result in losses. The Exchange holds assets and liabilities, including cash and investments, in Canadian dollars.

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

Price risk

General economic conditions affect the market value of equity investments and currency exchange rates impact the market value of the investments denominated in currencies other than the Canadian dollar. The risk is mitigated by engaging an investment manager for the long term portfolio investments and by investing other funds in short term fixed rate products with high credit ratings. The Exchange's investment policy specifies limits to the exposure to equities.

A 10% increase in the market value of equities would result in an increase in net and comprehensive income for the year ended December 31, 2017 of \$397,505 (2016 - \$269,615). A 10% decrease in the market value of equities would result in a decrease in net and comprehensive income for the year ended December 31, 2017 of \$397,505 (2016 - \$269,615).

Interest rate risk

Interest rate risk is the risk of financial loss arising from changes in interest rates. Fluctuations in interest rates will impact the market value of the fixed income portion of the investment portfolio. The Exchange is exposed to interest rate risk if the cash flows from investments are not matched to the liabilities they support. The Exchange manages the interest rate risk on fixed income bonds by engaging an investment manager who operates subject to investment parameters designed to mitigate this risk.

An interest rate sensitivity analysis is provided in Note 5.

Credit risk

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. The Exchange's financial assets exposed to credit risk consist of cash and cash equivalents, investments in bonds and accrued interest receivable. The maximum exposure of the Exchange to credit risk is the carrying amount of these financial instruments as presented in the statement of financial position.

The Exchange manages credit risk by maintaining bank accounts with reputable financial institutions, only investing in securities that are highly rated and traded in active markets and by placing limits on its exposure to a single counterparty.

The credit quality of the Exchange's investment in bonds is described in the following table:

Securities:	2017	2016
	\$	\$
Bonds – AAA rating	5,461,541	3,991,111
Bonds – AA rating	3,829,446	1,210,681
Bonds – A rating	2,513,137	2,467,961
Bonds – BBB rating	1,713,972	898,583
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	13,518,096	8,568,336
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The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

Liquidity risk

Liquidity risk is the risk the Exchange will be unable to meet its obligations when they fall due, or that it may be required to settle its obligations on terms that are disadvantageous. The Exchange engages an investment manager to administer the investments it plans to hold for a long period of time. These investments are subject to liquidity risk if the Exchange is required to sell at a time the market for these investments is unfavourable or the investments are illiquid.

The maturity dates and interest rate ranges are as follows:

	2017		2016	
	Interest rate range	Market Value \$	Interest rate Range	Market value \$
Maturity dates (from balance sheet date)				
Within five years	1.968-2.621%	2,738,911	1.59-2.621%	1,753,503
Greater than five years but less than ten years	1.00-3.94%	9,165,233	1.50-3.94%	4,682,914
Greater than ten years	3.45%	<u>1,613,952</u>	1.00-3.45%	<u>2,131,919</u>
		<u>13,518,096</u>		<u>8,568,336</u>

The following tables present a comparison of the estimated maturities of the assets and liabilities of the Exchange as at December 31, 2017:

<i>Terms to maturity of assets</i>	Less than 1 year	From 1 to 5 years	Over 5 years	No specific maturity	Total
Cash and cash equivalents	4,086,884	-	-	-	4,086,884
Investments	3,335,691	2,738,911	10,779,185	3,975,052	20,828,839
Accrued interest receivable	56,982	-	-	-	56,982
Prepaid expenses	145,350	-	-	-	145,350
Deferred premium tax	108,400	-	-	-	108,400
Total	7,733,307	2,738,911	10,779,185	3,975,052	25,226,455

<i>Terms to maturity of liabilities and equity</i>	Less than 1 year	From 1 to 5 years	Over 5 years	No specific maturity	Total
Accounts payable and accrued liabilities	298,348	-	-	-	298,348
Unearned premiums	2,710,000	-	-	-	2,710,000
Claims liabilities - Professional liability	1,749,000	7,169,000	3,698,000	-	12,616,000
Claims liabilities - Trust safety	22,000	389,000	306,000	-	717,000
Equity	-	-	-	8,885,107	8,885,107
Total	4,779,348	7,558,000	4,004,000	8,885,107	25,226,455

The Alberta Lawyers Insurance Exchange

Notes to the Financial Statements

For the year ended December 31, 2017

10 Premium deficiency

The premium deficiency represents the difference between the projected costs of the program from January 1, 2018 to June 30, 2018 and unearned premiums recorded at December 31, 2017 as determined by the actuary. The premium deficiency does not include offsetting investment income that will accrue to the Exchange from January 1, 2018 to June 30, 2018. The premium deficiency at December 31, 2017 was NIL (2016 - \$85,513).

11 Equity management

As at December 31, 2017 the Exchange's equity was \$8,885,107 (2016 - \$5,668,431). The Exchange's objectives for managing the equity are for the prudent operation of the reciprocal and to provide relatively stable premium costs for insured lawyers over time.

Under the requirements of Section 99 and 100 of the *Act*, the Exchange must maintain, as a reserve fund, a sum of cash or approved securities equal to at least 50% of the subscribers' annual premiums. In addition, the Exchange is required to maintain in a guarantee fund a sum of cash or approved securities of at least \$50,000 plus the sum of all liabilities excluding unearned premiums. As per section 101 if, at any time, the reserve fund or the guarantee fund is less than the required amount, the parties to the Subscribers Agreement as outlined in Note 1 are required to make up the deficiency.

The total reserve and guarantee funds required are as follows:

	2017	2016
	\$	\$
Reserve fund		
Premiums written	5,420,000	4,100,000
Less: Amount paid to licensed reinsurers	(276,700)	(207,525)
Subtotal	<u>5,143,300</u>	<u>3,892,475</u>
	50%	50%
Reserve fund required reserve	<u>2,571,650</u>	<u>1,946,238</u>
Guarantee fund required reserve	<u>13,681,348</u>	<u>8,407,601</u>
Cash and marketable securities required	<u>16,252,998</u>	<u>10,353,839</u>
Cash and marketable securities maintained	<u>24,915,723</u>	<u>15,930,430</u>
Cash and marketable securities maintained in excess of required amounts	<u><u>8,662,725</u></u>	<u><u>5,576,591</u></u>

The Superintendent of Insurance also expects reciprocals to meet a Minimum Capital Test (MCT) ratio of capital available to capital required of at least 210%. As of December 31, 2017, the Exchange's MCT was 247% (2016 - 250%).