MARKEL FINANCIAL HOLDINGS LIMITED

1986 ANNUAL REPORT

CORPORATE PROFILE

MARKEL
FINANCIAL
HOLDINGS
LIMITED

Markel Financial Holdings Limited is a financial services holding company whose objective is to achieve a high rate of return on invested capital. Currently the company owns three subsidiaries – Markel Insurance Company of Canada, Sphere Reinsurance Company of Canada and Morden & Helwig Group Inc.

Markel Insurance is one of the largest trucking insurance companies in Canada and has provided the Canadian trucking industry with the longest continuous market for this very specialized class of insurance. For 1986, gross premium volume was $51.6 million and the company had 62 employees.

Sphere Reinsurance, acquired on September 2, 1986, is one of only two Canadian owned reinsurance companies writing property, auto and casualty risks. Gross premiums totalled $17.5 million for the 1986 year and there were 7 employees.

Morden & Helwig, acquired on October 27, 1986, is Canada's largest independent insurance claims management company, engaged in providing claims adjusting, appraisal and loss management services to a wide variety of insurance companies and self-insured organizations. For the year gross revenues totalled $30.9 million, and the company had 570 employees located in 135 branches across Canada.

MARKEL FINANCIAL HOLDINGS LIMITED
CONSOLIDATED FINANCIAL SUMMARY ($000 except per share amount)

	for the years ended December 31									
	1986	1985	1984	1983	1982	1981	1980	1979	1978	1977
REVENUES										
Insurance premiums earned	40,885	14,049	16,616	19,621	14,443	10,676	7,633	6,250	7,604	10,424
Service revenues	6,850	–	–	–	–	–	–	–	–	–
Interest & dividend income	4,678	2,455	2,337	2,009	2,198	2,421	1,757	1,619	1,534	1,348
TOTAL REVENUES OF CONSOLIDATED COMPANIES	52,781	16,623	18,953	21,630	16,641	13,097	9,390	7,869	9,138	11,772
EARNINGS										
Earnings before realized investment gains & taxes	8,133	(1,339)	(4,879)	93	542	(538)	(2,425)	143	1,041	1,708
Realized investment gains	952	459	25	215	(66)	(276)	424	219	64	(7)
Total pre tax earnings	9,085	(880)	(4,854)	308	476	(814)	(2,001)	362	1,105	1,701
Extraordinary items	1,711	–	–	–	–	–	–	–	–	–
NET EARNINGS AFTER TAX	6,548	(910)	(4,775)	280	218	(326)	(785)	524	742	982
TOTAL ASSETS	129,845	41,477	31,401	32,325	28,739	29,351	27,714	25,341	22,927	25,039
CASH & INVESTMENTS	95,696	32,728	25,391	24,218	20,337	22,265	21,853	19,701	18,057	18,124
TOTAL DEBT	4,976	–	1,000	300	800	–	–	–	–	–
SHAREHOLDERS' EQUITY	41,275	10,379	2,287	7,062	6,782	6,565	6,891	7,715	7,389	6,801
NUMBER OF SHARES – FULLY DILUTED	7,007	5,000	616	616	616	616	616	616	616	616
RETURN ON SHAREHOLDERS' EQUITY	25.4%	–	–	4.1%	3.3%	–	–	7.0%	11.0%	17.2%
PER COMMON SHARE – FULLY DILUTED										
Net earnings	1.35	(1.89)	(7.75)	0.45	0.35	(0.53)	(1.27)	0.85	1.20	1.60
Dividends	–	–	–	–	–	–	0.0625	0.25	0.25	0.232
Shareholders' equity	5.89	2.08	3.71	11.46	11.01	10.66	11.19	12.52	12.00	11.04

QUARTERLY EARNINGS AND COMMON STOCK PRICES

	Net Earnings ($000)		Net Earnings Per Share		Share Price High/Low	
	1986	1985	1986	1985	1986	1985
1st Quarter	890	(1,324)	.21	(2.15)	7.88/6.00	4.10/4.10
2nd Quarter	1,235	(38)	.24	(.06)	10.50/7.25	3.15/3.00
3rd Quarter	2,054	285	.55	.46	12.75/10.00	5.00/4.75
4th Quarter	2,369	167	.35	.27	14.13/12.50	6.00/6.00

TO OUR SHAREHOLDERS:

MARKEL FINANCIAL HOLDINGS LIMITED

1986 was a year of significant achievement for your company. Net income after-tax (including tax loss carryforwards) amounted to $6.5 million compared to a loss of $0.9 million in 1985. The company has never earned more than $1.0 million in the past. Total assets increased to $130 million vs $41 million in 1985 while shareholders' equity increased to $41 million from $10 million in 1985. Fully diluted book value per common share increased by 183% to $5.89 from $2.08 in 1985. After-tax return on average common shareholders' equity was 25.4%. This figure includes the tax loss carryforwards in income, assumes all convertible preferreds are converted into common shares (as they most likely will be) and is based on the average common equity during the year as common equity expanded considerably because of the public issue.

The major reasons for this significant performance in 1986 were three fold:

1) A tremendous increase in Markel's trucking insurance business.
2) A common stock issue of $20 million.
3) Acquisitions.

Keith Ingoe discusses in greater detail in his report the reasons for the superb year that Markel Insurance had in 1986. While the company benefitted from the demise of a major competitor, Keith and his staff have done an outstanding job in managing the company as its business more than doubled during the year.

The business potential that Markel Insurance faced allowed us to complete a public financing of $20 million led by Wood Gundy and Dean Witter Reynolds. We sold 2 million subordinate voting shares from treasury at $10 share in July 1986. The issue was successful because we were very fortunate in having people of the calibre of Dick Falconer, Jim Hinds and Joe Brosseau from Wood Gundy and Bryan Smith and Rob Bell from Dean Witter Reynolds working on our behalf. Rick Salsberg, from Tory & Tory, together with Bob Karp, were invaluable in navigating us through the legal maze. It all culminated in a well crafted prospectus which all shareholders should review to better understand our business. We thank these gentlemen for their great effort and welcome our new shareholders. After months of work, we were extremely gratified to receive a cheque for $20 million from small and large investors across Canada. We appreciate the vote of confidence and will do our best to continue to earn it. The common stock issue was a significant milestone for Markel Financial as it placed the company on a very firm financial footing.

Why did we sell subordinate voting shares which have only one vote and retain multiple voting shares (10 votes) for ourselves? Mainly because we wanted to control Markel Financial and manage the company to provide an above average long term return to shareholders. Our multiple voting shares are not traded and can be sold in the public markets only as subordinate voting shares. Also, a takeover offer for our shares, if accepted, immediately triggers a similar offer for all the common shares outstanding. A Canadian Tire type situation, which we find very distasteful, cannot and will not happen with Markel Financial. However, we must add that it is extremely unlikely that we would sell our multiple voting shares even if an offer came in at 100% above the current market price. Thus, our multiple voting shares prevent an investor from getting an attractive one time bonanza. Our feeling though, is that for this short term pain, there could be some excellent long term gains. Berkshire Hathaway, for example, has experienced an unbelievable increase in its share price from $20 in 1965 to $3500 currently. Any takeover offer for Berkshire Hathaway, though attractive in the short run, would be hard pressed to match the long term returns that have been achieved. For Berkshire Hathaway, this is a fact. For us it is only a goal!

The public issue provided us with $18.4 million after expenses. After providing $5 million in additional capital to Markel Insurance, we had $13.5 million available for acquisitions. Fortunately, we were able to complete two acquisitions in late 1986. We purchased Sphere Reinsurance Company of Canada on September 2, 1986 and Morden & Helwig Ltd., the largest claims adjusting firm in Canada, on October 27, 1986. We purchased Sphere for $4 million cash plus a five year note of $2.8 million which is adjustable based on loss reserves development until 1990. Rui Quintal and his team have run the company for over five years. In the extremely risky business of reinsurance their experience and conservative underwriting policy will hold us in good stead in the future. We amalgamated with Morden & Helwig by paying its shareholders $2.0 million in cash and $6.9 million in Markel Financial stock. The amalgamation was supported by over 99% of the more than 200 Morden & Helwig shareholders. The company is run by a fine management team led by Ken Polley. Under Ken's leadership, Morden & Helwig has tremendous growth potential in Canada and abroad and we are excited to be shareholders. To take advantage of the growth opportunities and also to allow its employees to become shareholders again, Morden & Helwig is planning an initial public offering of subordinate voting shares and has filed the preliminary prospectus on March 16, 1987. We welcome the employees of Sphere Re and Morden & Helwig to our team and look forward to a long association.

My partner, Steven Markel, in his report discusses these acquisitions in greater detail and shows how they provide further diversification. Rui and Ken have reports on their own operations that follow.

The two acquisitions made in 1986 illustrate some of the principles that will guide us in the future.

1) We will acquire companies with good management already in place.
2) We will not acquire companies unless we believe they can achieve a 20% return on capital.
3) Each company will be run independently and be measured against the targeted return of 20% on capital invested.
4) We consider our stock as good as cash. We will not issue stock indiscriminately. When we issue stock, as we did for Morden & Helwig, we will ensure that we get as much value as we give.

When we began our association with Markel Financial in September 1985, Markel Financial was a holding company with only one subsidiary, Markel Insurance. In fact, Markel Financial was synonymous with Markel Insurance. Remarkably, in a little more than a year, Markel Financial is now operating in three different businesses. We think this creates some confusion between the holding company and Markel Insurance. With your approval, we are proposing to change the name of Markel Financial to Fairfax Financial Holdings Limited. If you are wondering where "Fairfax" came from, you may be surprised to know that it did not come from a "name" consultant or from the Board of Directors but from Brenda Adams who is Keith Ingoe's secretary. Brenda's logic for Fairfax – <u>Fair</u>, <u>f</u>riendly, <u>ac</u>quisitions – made sense to us and thus the name. Markel Insurance will always use the "Markel" name under which it has done business for more than 35 years.

Markel Financial will be soon moving to 95 Wellington Street West in Toronto. David Rooney has recently joined us as Vice-President, Finance and Chief Financial Officer for Markel Financial. David comes to us after 11 years as Chief Financial Officer of Ault Foods (a subsidiary of John Labatt) during which time Ault achieved a significant compound rate of growth in sales and earnings.

Since September 1985, we have developed a number of new investment guidelines and policies for the management of our Insurance Company portfolios. First the operating requirements of Markel Insurance and more recently Sphere Reinsurance were reviewed and all excess funds were earmarked for potential long term investment. Cash and short term deposits at Markel Insurance for example have fallen from 47% of the investment portfolio at December 31, 1984 to 14% as of December 31, 1986. Second, we have restricted the term to maturity of the bond portfolio to less than five years unless unusual opportunities exist. Finally, we have increased the proportion of investments in common shares and convertible securities. As of December 31, 1986, we had $43.8 million in common stocks and convertible securities.

For the benefit of new investors we reiterate our investment philosophy from last year's annual report — "Our investment philosophy is based on the value approach as laid out by Ben Graham and practised by his famous disciple, Warren Buffett. This means we buy stocks of financially sound companies at prices below their underlying long term values. We expect to make money over time, not in the next month or two. In fact, in the short term, stock prices could go well below our cost. In our purchases, we are always trying to first protect your capital from long term losses (as opposed to short term price fluctuations) before attempting to make money. We do not speculate with your money and thus, do not buy options, commodities, futures, gold and other short term trading instruments. Over time, our investment philosophy has served us well and we plan to stick with it."

In 1986, Markel Financial realized about $1 million from capital gains vs $0.5 million in 1985. Unrealized gains amounted to $1.0 million at December 31, 1986 vs $1.3 million in 1985. The total investment portfolio for Markel Insurance was up 10.4% which was a mediocre result. Common stocks did well for us in 1986 but convertible securities did poorly. Over time, we expect our common stock and convertible positions to contribute significantly to consolidated profits of Markel Financial. As of December 31, 1986, we had $13.2 million in Natural Resources (particularly Mines) and $3.4 million in the Banks.

Where does the stock market go from here? We don't know but if we had to guess we think there are many long term secular forces that could result in the stock market experience of the 1950's being repeated. While the Dow Jones has more than doubled in the past four years, we should point out that in the fifties and sixties this index increased five-fold from 200 in 1950 to 1000 in 1965. We think there will be ups and downs in the market, as there always have been, but we think there is a good possibility of the Dow Jones rising significantly in the next five years. We continue to find good long term values that meet our criteria.

We have one change among our Directors this year. Jack Herbert will be resigning from the Board to pursue other interests while Ken Polley will be joining the Board. We thank Jack for his support and contribution during the year. Also, on your behalf, we would like to thank the Board and the Management and Employees of our subsidiaries for their significant contributions in 1986. Without their help, 1986 would not have been as successful as it was.

April 5, 1987

V. P. Watsa

V. Prem Watsa
Chairman of the Board

OPERATING REVIEW

MARKEL FINANCIAL HOLDINGS LIMITED

1986 was an eventful year for your company. The corporate operating results were the best in our history. Revenues grew over 200% to \$53.7 million as compared to \$17.1 million in 1985. Net income was \$6.5 million as compared to a loss in 1985 of \$910,000. On a per share basis, fully diluted, net income was \$1.35 as compared to a loss in 1985 of \$1.89. The 1986 results were benefited by the recovery of deferred income taxes in the amount of \$1.7 million or \$0.34 per share, fully diluted.

The company's growth in 1986 was the result of very favourable industry conditions as well as the acquisition of Sphere Reinsurance company of Canada and Morden & Helwig Ltd. Each of these companies provides the holding company with a unique specialty in the insurance industry. In the case of Sphere Re, the specialty is in reinsurance and with Morden & Helwig the specialty is claims management services. Together with Markel Insurance, the holding company now has the diversification as well as the specialization necessary to meet our future goals.

The consolidated financial statements and results of Markel Financial contained in this annual report include the results of Sphere Re from the September 2, 1986 date of its acquisition and the results of Morden & Helwig from October 27, 1986. The annual and five year data on these companies is provided to offer a complete and meaningful discussion of these operations.

In last year's annual report we defined two important financial goals of the corporation. The first was to achieve a return on equity of 20%. During 1986 we exceeded this goal by earning a return on equity of 25.4%. We were able to achieve these results as each operating company earned excellent returns. For Markel Insurance the return on equity was 43.9%, for Sphere Re 11.4% and for Morden & Helwig 40.5%.

Our second financial goal was to maintain a high level of financial security. The goal was achieved both as a result of the company's profit as well as the successful share issue which together have increased shareholders' equity to \$41.3 million. Each of our operating subsidiaries has sufficient capital to support its operation and the holding company has additional funds to enable it to take advantage of any opportunities which may arise.

For our insurance company operations, sound underwriting and adequate claims reserving are also important elements in maintaining financial security. In each of these areas we have devoted much energy to insure our success. To assist us in evaluating our outstanding loss reserves we have retained outside actuarial consultants. The report of The Wyatt Company confirming the adequacy of our loss reserves is included in this annual report. Actuarial projections are based on assumptions about the future and involve a degree of uncertainty. We believe, as do our consultants, that we have adequately provided for our outstanding losses, and that the projections are based on reasonable assumptions.

There is currently a proposal before the Ontario government recommending the implementation of a form of privately administered "no fault" automobile insurance for personal injury based upon first party, rather than third party, liability. The proposal has been referred to a commission of inquiry for study, and a report is expected by November 1, 1987. This report is expected to form the basis of further consultation with the industry and with other interested parties.

Due to uncertainty with respect to these proposals and their likelihood and timing, we are unable to estimate the impact of such proposals on our future operation. Implementation of a comprehensive "no fault" regime in Ontario could reduce the amount of our insurance and adjusting business in the motor vehicle segment in the province. However, the importance to the company of motor vehicle coverage and claims handling in Ontario has diminished in recent years as we have diversified our lines of business and geographic emphasis, and this trend is expected to continue. Currently 24% of our total revenues, comprising 38% of total insurance premiums and 15% of claims management revenues, are attributable to motor vehicles in Ontario and include out-of-province coverage on Ontario based vehicles. We believe that if this current recommendation is effected, our insurance operation may experience an overall reduction of premium revenue which would be offset by lower claims costs expected to result from a first party no fault system. Claims management revenues would be reduced but this impact could be partially offset by attrition amongst smaller, less diversified independent claims adjusters.

In last year's report we promised to look for opportunities to expand in the insurance industry, but to do so in specialized segments of the market. We believe the acquisitions of Sphere Re and Morden & Helwig are excellent fits to our corporate goal. As a service business, Morden & Helwig should not be adversely affected by changes in the insurance underwriting cycles.

While our operating companies all participate in different areas of the insurance industry and provide the holding company with both diversification and specialization, each operating company is run independently. Each is a separate, self-sufficient organization responsible for its own operation and profitability. While the operating companies do business with each other, the amounts are modest and in all cases based on arms-length business relationships.

The insurance marketplace continued the trend established in 1985 of firm prices and limited availability of coverage. This marketplace enabled our insurance company operations to enjoy very successful years. While the insurance industry is now in its recovery, we can see early signs of increased competition. We expect that the market place will continue to be tight throughout this year and that as we approach 1988 downward pressure on insurance prices may well return. Should this occur, we are committed to maintaining our sound underwriting standards and will refuse to participate in any future price war. With the diversification completed in 1986, we believe we will be able to achieve our profit goals in any market environment.

As we look toward 1987 we expect continued growth in each of our operations and we will continue to look for further opportunities to expand our business profitably.

April 5, 1987

SAMarkel

Steven A. Markel
President and Vice-Chairman

OPERATING REVIEW

MARKEL INSURANCE COMPANY OF CANADA

FINANCIAL SUMMARY ($000) For the years ended December 31

	1986	1985	1984	1983	1982
Gross premiums written	**51,615**	23,415	21,064	24,326	26,732
Net premiums earned	**34,633**	14,049	16,616	19,620	14,443
Net incurred losses	**24,614**	13,533	17,588	14,598	11,101
Net commission & operating expenses	**7,363**	4,147	5,646	6,958	4,801
COMBINED RATIO	**92.4%**	125.8%	139.7%	109.9%	110.2%
Underwriting income (loss)	**2,656**	(3,631)	(6,619)	(1,934)	(1,384)
Investment income	**4,297**	2,850	2,150	2,104	1,744
Earnings (loss) after tax	**5,612**	(781)	(4,468)	178	123
Total assets	**70,584**	38,472	29,875	32,048	26,226
Shareholders' equity	**18,082**	7,471	3,252	6,720	6,542
RETURN ON EQUITY	**43.9%**	—	—	2.7%	2.4%

Markel Insurance Company of Canada is principally engaged in providing property and casualty insurance and related services to the trucking industry. It specializes in insuring small to medium Canadian long-haul common carrier fleets against property damage and public liability. In addition, the company writes a small portfolio of cargo insurance and umbrella/excess liability insurance.

During 1986, the market remained firm throughout most of the year due to the withdrawal of several large property and casualty insurers from the market and the insolvency of one specialty truck insurer. This created a very positive market environment which enabled the company to sell adequate premiums, implement strong underwriting and loss prevention controls and to write more business. The result of this was that gross written premiums increased to $51.6 million from $23.3 million in 1985 and the earned premiums increased to $34.6 million from $14 million. Premiums from long-haul trucking policies accounted for 97% of gross written premiums. The balance is made up from cargo and umbrella/excess business.

The average number of power units increased to 7,724 from 3,748 of the previous year. Ontario accounts for 57% of premium income, with another 29% from Quebec. The Maritime Provinces provide about 10% and the balance is from Western Canada.

Throughout this period of exceptional growth, the company maintained adequate pricing, sound underwriting and loss control practices. These features, combined with efficient claims handling routines, held the incurred losses in check. The loss ratio shows a significant improvement to 71.9% compared to 96% in 1985.

A Claims Reserve Analysis Committee was established in 1986 and meets quarterly to ensure that both our claims incurred but not reported and case reserves are adequate to meet future claims payment requirements. This activity is supported by semi-annual audits of case files to ensure that our reserving methods are producing adequate reserves.

During the year, Markel strengthened the staff complement. Seventeen new positions were created, bringing the total to sixty-two. This enabled the company to improve service to a more acceptable level by year end. In addition, it was necessary to expand the offices in both Toronto and Montreal to meet our accommodation needs. In spite of these increased costs, the operating expense ratio was reduced to 13.4% from 18.7% in 1985. It is also interesting to note that our total acquisition and underwriting expense ratio of 21.3% is much lower than the industry average of approximately 33%. This is due to the specialty nature of our business.

The Combined Ratio for the year was 92.4% which translates into an underwriting profit of $2.7 million. This is an excellent turn-around from the 125.8% combined ratio and $3.6 million underwriting loss of 1985.

The infusion of $5 million of capital in July, combined with the substantial increase in business during the year, built the investment portfolio to $59.5 million. This, in turn, generated a record investment income of $4.3 million which compares quite favourably with the $2.9 million in 1985.

Before tax earnings amounted to $7 million – a significant improvement over the $781,000 loss in the prior year. Shareholders' equity is now in excess of $18 million, which is more than adequate to support the premium growth and position us well for the future.

We anticipate that the market will maintain a firmness throughout most of 1987. However, competition is increasing as a number of companies who withdrew within the last few years are returning to the marketplace due to improved industry results. In addition, there are indications that there will be some new entries from the United States.

In spite of the increasing activity, we intend to maintain our sound underwriting, loss prevention and pricing integrity. Through continuing our concentration on the development of the less price-sensitive, small to medium-sized account and the implementation of a revitalized marketing plan which includes diversification into other specialty product lines, we expect to be able to meet our income objectives for 1987.

We also intend to focus a good deal of attention on further improvements in customer service through upgrading of our automation facilities and taking the time to establish sound working relationships with our policyholders and brokers.

Overall, we are extremely proud of our accomplishments in 1986, as we either met or exceeded the results for which we planned. An excellent effort was made by our staff under somewhat difficult conditions at times to achieve this level of success. The Management and Directors of the company recognized this feat by way of an employee bonus. As a result, employee morale is at a high level. In addition, Markel appreciates the support it received from its policyholders and brokers.

We recognize that we will face many new challenges in 1987, including the possible intervention of the Ontario Government in automobile insurance. However, we are confident that we have planned our activities well to manage these challenges and that these plans will be successfully executed.

April 5, 1987

Keith E. Ingoe
President and Chief Executive Officer
Markel Insurance Company of Canada

OPERATING REVIEW

MORDEN & HELWIG GROUP INC.

FINANCIAL SUMMARY ($000) For the years ended December 31

	1986	1985	1984	1983	1982
Revenues	*30,939*	*27,398*	*23,331*	*23,119*	*30,918*
Earnings before extraordinary items	1,423	1,304	660	74	57
Earnings after tax	2,155	1,764	740	74	57
Total assets	14,501	14,121	12,475	12,178	13,922
Shareholders' equity	6,219	4,429	2,684	1,986	1,905
RETURN ON EQUITY	40.5%	49.6%	31.7%	3.8%	2.0%

Morden & Helwig Group Inc. is an independent insurance claims management company, which, through its subsidiaries, is engaged in providing claims adjusting, appraisal and loss management services. The company is Canada's largest independent insurance claims management company with 135 branch offices in all provinces of Canada and in the Yukon Territory, providing services to a wide variety of insurance companies and self-insured organizations. Morden & Helwig's core business of claims adjusting generates approximately two-thirds of its revenues, with the remainder being derived mainly from appraisal and loss management services. The company has a total of 570 employees, of which 300 are licensed claims adjusters or accredited appraisers.

In 1986 total revenues increased by 12.9% to $30.9 million, due primarily to the consolidation of a full twelve months operations of subsidiary Centapp Services compared to consolidation of only four months in 1985. While the total number of claims managed in 1986 declined from 1985, mainly due to excellent weather conditions across Canada, claims of a more complex nature were handled.

An increase in sales and marketing expenses in 1986 reflects growing emphasis on sales to national accounts, including self-insured organizations. Higher legal, audit and management expenses as a result of the amalgamation of Morden & Helwig with a Markel Financial Holdings subsidiary were offset in part by a reduction in interest expenses.

Earnings before extraordinary items of $1.4 million increased by 9.1% over 1985, and a refund of surplus contributions to the company's pension plan and a settlement of litigation brought final profit for the year to $2.2 million, an increase of 22.2% over 1985.

There is currently a proposal before the Ontario government recommending the implementation of a form of privately administered "no fault" automobile insurance for personal injury compensation based upon first party, rather than third party, liability. This proposal may ultimately have a negative impact on our revenues, however, the importance to Morden & Helwig of motor vehicle claims in Ontario has diminished in recent years as the company has diversified its lines of business and geographic emphasis, and this trend is expected to continue. The company estimates that approximately 15% of its revenues for 1986 were attributable to adjusting services in connection with motor vehicle claims in Ontario.

Morden & Helwig's strategy for internal growth in Canada has three aspects. The first aspect is to capitalize on the demand for full claims management services resulting from the trend toward self-insurance by corporations, governments and government agencies, and of the trend toward large insurance contracts being underwritten by groups of insurance companies. As an increasing number of businesses and government organizations choose to self-insure, the demand for full claims management services is likely to increase. The second aspect is to promote specialization among our adjusters in our traditional business, thereby encouraging enhanced use by insurance company clients of these highly specialized personnel and services. The third aspect is to broaden our range of loss management services to clients.

The company also plans to increase market share in Canada by further acquisitions of existing independent claims management firms. Many of these companies, which are often family-controlled, have strong local or regional market position but are less sophisticated in their approach to claims adjusting and are less automated in claims handling. By selective acquisition of such companies, Morden & Helwig believes that it can gain experienced personnel and increase its local or regional presence. The company is also exploring expansion through acquisition of independent claims management companies in the United States and the United Kingdom. To prepare for our expansion Morden & Helwig expects to raise $15 million in an initial public offering to position the company to take advantage of expansion opportunities as they arise.

We appreciate the outstanding contribution of all of our employees to our record 1986 results. We are in a period of change with a positive outlook, and we are anticipating it with enthusiasm.

April 5, 1987

Kenneth R. Polley, A.I.I.C.
President and Chief Executive Officer
Morden & Helwig Group Inc.

SPHERE REINSURANCE COMPANY OF CANADA

OPERATING REVIEW

FINANCIAL SUMMARY ($000)

For the years ended December 31

	1986	1985	1984	1983	1982
Gross premiums written	17,506	15,352	14,229	13,400	14,197
Net premiums earned	16,359	12,162	9,751	8,427	6,202
Net incurred losses	12,693	10,000	7,547	5,966	5,713
Net commission & operating expenses	5,308	4,101	3,430	3,083	2,163
COMBINED RATIO	110.0%	115.9%	112.6%	107.4%	127.0%
Underwriting loss	1,642	1,939	1,226	622	1,674
Investment income	2,855	2,164	2,005	1,700	1,499
Earnings (loss) after tax	807	262	779	1,078	(175)
Total assets	31,352	24,636	21,035	18,572	16,877
Shareholders' equity	7,487	6,680	6,419	5,640	4,562
RETURN ON EQUITY	11.4%	4.0%	12.9%	21.1%	—

Sphere Reinsurance is one of only two Canadian owned reinsurance writers. The company is registered under the Canadian Insurance Act and is licensed to write all classes of insurance other than life. Property risks represent the largest part of Sphere's premium volume while auto and casualty risks make up the remainder. Proportional treaties account for the majority of premiums.

In 1986 net premiums earned rose 35% to $16.4 million. This substantial increase resulted primarily from the following:

- much needed rate increases introduced by the industry during the past eighteen months now being felt at the reinsurance level;
- shortage of reinsurance capacity which led to substantial rate increases in the excess of loss sector,
- an increase in our net retention to 100% in 1986 from 89% in 1985.

While the loss ratio improved to 78% in 1986 from 82% in 1985 our claims experience was adversely impacted by some major events. In 1986 large claims arose from a major fire in the Alexis Nihon complex in Montreal and a severe hailstorm also in Montreal. Prior years claims developments were particularly aggravated by a loss in a potash mine in western Canada and our participation in two cancelled casualty treaties. The premium increases and an improved loss experience other than the above listed cases lowered the combined ratio to 110% in 1986 from 116% in 1985, which resulted in a reduction of the underwriting loss to $1.6 million. Our claim reserves have been certified by an independent actuary and at December 31, 1986 totalled $13.6 million compared to $8.9 million at the end of 1985.

Overall investment income improved in 1986. Net interest and dividend income rose to $2.4 million as a result of an increase in the size of the portfolio, partly offset by reduced interest rates and dividend yields. Capital gains realized increased to $489,000 from $84,000 in 1985.

As a result of the improved underwriting performance and better investment results net earnings for the year were $807,000, up 208% from $262,000 in 1985.

In 1987 the company is looking for continued improvement in underwriting results and higher volumes as a result of much better pricing already established in the marketplace.

We would like to take this opportunity to extend our thanks to our employees and brokers for their continuing support.

April 5, 1987

L. Rui Quintal
President and Chief Executive Officer
Sphere Reinsurance Company of Canada

GOALS AND STRATEGIES

Markel Financial Holdings is a financial services holding company whose objective is to achieve a high rate of return on invested capital and thus to provide an above average long term return to shareholders. The company's goals are to maintain a return on equity of 20%, increase earnings and asset values, and maintain a high level of financial security. Markel Financial's strategy is to realize growth in our existing specialty insurance operations and look for acquisitions in the financial services industry that will meet our return criteria and provide further diversification. To avoid dilution of shareholder equity common shares will only be issued to the advantage of all shareholders.

We have established goals and strategies for our Markel Insurance subsidiary as set out below, and will, over the next few months, develop specific goals and strategies for Morden & Helwig and Sphere Reinsurance to ensure achievement of our corporate goal of maintaining a 20% return on equity.

Markel Insurance Company - Goals and Strategies

Goals and strategies have been established in several critical areas including Financial, Underwriting, Reinsurance, Claims and Investment.

Financial

- Achieve a return on equity of 20%. We believe a 20% return on shareholders' equity over time is a level of profitability which will enable us to maintain reasonable growth and fairly reward shareholders' investment.
- Maintain a high level of financial security. While insurance buyers often overlook this critical aspect of the insurance product, we believe in the long run it will prove its value.

Underwriting

- Maintain a combined operating ratio no worse than 100%. When we achieve a combined ratio of 100% our underwriting operations break even and investment income flows to the bottom line. To achieve this we have set more detailed objectives in pricing, underwriting selection and the adequacy of loss reserves.

Reinsurance

- Markel Insurance's primary reinsurance goal is to maintain sound reinsurance with financially solid reinsurers. In order to achieve this goal we must continue to apply sound underwriting and pricing standards to our business to assure our reinsurers a reasonable profit.

Claims

- Investigate, negotiate and settle all claims quickly and fairly.
- Establish adequate loss reserves on all open claims. By closely monitoring claims activity and settlements we can better determine the adequacy of our loss reserves and better project future costs enabling us to more accurately price our product. Additionally, we have established a Loss Reserve Evaluation Committee to review and monitor our loss development on a quarterly basis.

Investment

- Our primary investment goal is to generate sufficient investment income to ensure achievement of the company's goal of a 20% after tax return on shareholders' equity. We attempt to obtain the best long term return on our assets, within the regulations of the Department of Insurance, by investing in common stocks and convertible securities to achieve long term capital gains, and unless special opportunities exist, we plan on limiting the term of our fixed income investments to less than 5 years.

MARKEL
FINANCIAL
HOLDINGS
LIMITED

CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED
DECEMBER 31, 1986

MARKEL FINANCIAL HOLDINGS LIMITED

CONSOLIDATED BALANCE SHEET

ASSETS	1986 ($000's)	1985 ($000's)
CASH, ACCOUNTS RECEIVABLE AND PREPAID EXPENSES		
Cash, term deposits and short-term investments	24,389	8,821
Accounts receivable *(note 7)*	16,748	6,036
Claims adjustments in process	4,383	–
Deferred policy acquisition costs	3,936	834
Accrued interest	1,011	624
Prepaid expenses	550	63
	51,017	16,378
INVESTMENTS *(note 4)*		
Bonds – at amortized cost (market value – $30,635; 1985 – $20,140)	29,893	19,153
Preferred stocks – at cost (market value – $14,150; 1985 – $1,295)	14,657	1,260
Common stocks – at cost (market value – $27,499; 1985 – $3,454)	26,694	3,084
Other investments	63	–
	71,307	23,497
FIXED ASSETS *(note 5)*	1,983	175
TRUST FUNDS	432	–
GOODWILL	5,106	–
DEFERRED INCOME TAXES	–	1,427
	129,845	41,477

as at December 31, 1986

LIABILITIES	1986	1985
	($000's)	($000's)
ACCOUNTS PAYABLE		
Payable to reinsurers *(note 6)*	5,815	2,617
Premium deposits	4,739	1,343
Bank loans *(note 7)*	2,176	—
Accounts payable and accrued liabilities	6,468	967
Deposits from unlicensed reinsurers	5,561	2,378
Income taxes payable	1,173	—
	25,932	7,305
PROVISION FOR CLAIMS	40,236	16,839
UNEARNED PREMIUMS	17,121	6,954
FUNDS HELD IN TRUST	432	—
NOTE PAYABLE *(note 13(a))*	2,800	—
MORTGAGE PAYABLE	200	—
DEFERRED INCOME TAXES	1,322	—
MINORITY INTEREST	527	—
	88,570	31,098

SHAREHOLDERS' EQUITY

CAPITAL STOCK *(note 3)*	38,858	13,138
RETAINED EARNINGS (DEFICIT)	2,417	(2,759)
	41,275	10,379
	129,845	41,477

Signed on Behalf of the Board:

V. P. Watson

Director

S. A. Markel

Director

CONSOLIDATED STATEMENT OF OPERATIONS

MARKEL FINANCIAL HOLDINGS LIMITED

For the year ended December 31, 1986	1986	1985
	($000's)	($000's)
OPERATING INCOME		
Premiums earned	40,885	14,049
Claims adjustment fees	6,850	–
Other income	368	119
	48,103	14,168
INVESTMENT INCOME		
Interest and dividends	4,678	2,455
Realized gains on disposal of investments	952	459
	5,630	2,914
	53,733	17,082
EXPENSES		
Losses on claims incurred	28,193	13,533
Operating and investment expenses	12,144	2,906
Agents' commissions	3,281	2,112
Reinsurance commissions	1,030	(589)
	44,648	17,962
NET EARNINGS (LOSS) BEFORE INCOME TAXES	9,085	(880)
PROVISION FOR INCOME TAXES *(note 11)*	4,184	30
NET EARNINGS (LOSS) BEFORE EXTRAORDINARY ITEM AND MINORITY INTEREST	4,901	(910)
EXTRAORDINARY ITEM – RECOVERY OF DEFERRED INCOME TAXES	1,711	–
MINORITY INTEREST	(64)	–
NET EARNINGS (LOSS) FOR THE YEAR	6,548	(910)
EARNINGS (LOSS) PER SHARE BEFORE EXTRAORDINARY ITEM –		
Basic	$1.95	$(1.89)
Fully diluted	$1.01	$(1.89)
EARNINGS (LOSS) PER SHARE AFTER EXTRAORDINARY ITEM –		
Basic	$2.78	$(1.89)
Fully diluted	$1.35	$(1.89)

CONSOLIDATED STATEMENT OF RETAINED EARNINGS (DEFICIT)

For the year ended December 31, 1986	1986	1985
	($000's)	($000's)
(DEFICIT) – BEGINNING OF YEAR	(2,759)	(1,546)
Earnings (loss) for the year	6,548	(910)
Dividends on preferred shares	(1,044)	(256)
Share issuance costs *(note 3(c))*	(328)	(47)
RETAINED EARNINGS (DEFICIT) – END OF YEAR	2,417	(2,759)

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

MARKEL FINANCIAL HOLDINGS LIMITED

For the year ended December 31, 1986	1986 ($000's)	1985 ($000's)
OPERATING ACTIVITIES		
Net earnings (loss) for the year before extraordinary item and minority interest	4,901	(910)
Items not affecting cash –		
Depreciation and amortization of fixed assets	108	197
Amortization of goodwill	116	–
Deferred income taxes	2,749	30
Realized gains on disposal of investments	(952)	(459)
	6,922	(1,142)
Increase (decrease) in provision for claims	23,397	(2,116)
Increase in unearned premiums	10,167	3,208
Decrease in cash funds resulting from changes in other operating working capital items other than cash resources	(8,378)	(2,377)
CASH RESOURCES PROVIDED BY (USED IN) OPERATING ACTIVITIES	32,108	(2,427)
INVESTING ACTIVITIES		
Bonds – purchases	(5,529)	(10,830)
– proceeds on sale	5,735	3,434
Preferred stocks – purchases	(9,020)	(1,260)
– proceeds on sale	389	153
Common stocks – purchases	(22,923)	(3,439)
– proceeds on sale	3,551	1,956
Purchase of fixed assets	(89)	(5)
Proceeds on disposal of fixed assets	3	5
Acquisition of subsidiary companies	(15,806)	–
	(43,689)	(9,986)
FINANCING ACTIVITIES		
Issuance of capital stock *(note 3(c))*	25,721	9,305
Dividends on preferred shares	(1,044)	(256)
Share issuance costs *(note 3(c))*	(328)	(47)
Issue of promissory note	2,800	–
	27,149	9,002
INCREASE (DECREASE) IN CASH RESOURCES	15,568	(3,411)
CASH RESOURCES – BEGINNING OF YEAR	8,821	12,232
CASH RESOURCES – END OF YEAR	24,389	8,821

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARKEL FINANCIAL HOLDINGS LIMITED

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The operations of the company and its subsidiaries relate principally to the insuring, reinsuring and loss adjusting of property and casualty risks on commercial lines. The significant accounting policies followed by the company are as follows:

Principles of consolidation

The consolidated financial statements include the accounts of the subsidiaries Markel Insurance Company of Canada, Markel Service Canada Limited, Sphere Reinsurance Company of Canada and Morden & Helwig Limited. All significant intercompany balances and transactions have been eliminated. The acquisitions of Sphere Reinsurance Company of Canada and Morden & Helwig Limited have been accounted for using the purchase method whereby the assets and liabilities of the acquired companies are recorded at their fair value at the date of acquisition, and the results of operations of the acquired companies are included from the date of acquisition. Minority interest on the balance sheet represents the interest of the minority shareholders in the net assets of the company's subsidiaries.

Premiums

Premiums are taken into income evenly throughout the terms of the related policies. As premium deposits secure the payment of premiums and are refundable, they are not taken into income unless default in payment of premiums occurs.

Claims adjustment

The company records its inventory of claims adjustments in process at their estimated value at year-end, and management has determined the claims adjustments in process at year-end through a complete physical count of related files. Claims adjustment fees arising therefrom are accounted for on an estimated percentage-of-completion basis.

Deferred policy acquisition costs

The costs incurred in acquiring premiums are deferred, to the extent that they are considered recoverable, and then amortized over the same period as the related premiums are taken into income.

Investments

Bonds are carried at amortized cost providing for the amortization of the discount or premium over the term of the investment to the maturity date. Preferred and common stocks are carried at cost.

Investment income

Interest is recorded as income as it accrues. The discount or premium on a bond or debenture is amortized on a straight-line basis to maturity. Dividends are recorded as income on the record date. Gains and losses realized on the disposal of investments are taken into income on the date of disposal.

Claims

Claim provisions are established by the "case basis" method as claims are reported. The provisions are subsequently adjusted as additional information on the estimated amount of a claim becomes known during the course of its settlement. A provision is also made for claims incurred but not reported based on the volume of business currently in force and the historical experience on such late reported claims.

Translation of foreign currencies

Assets acquired and liabilities incurred in foreign currencies are translated into Canadian dollars at December 31 exchange rates. Income and expenses are translated at the exchange rates in effect at the date incurred. Realized and unrealized gains and losses on foreign exchange are recognized in the statement of operations.

Fixed assets

Fixed assets are recorded at their original cost less accumulated depreciation and amortization. Lease inducements received, less direct moving costs, have been applied against leasehold improvements and are amortized over the full term of the related lease.

Depreciation and amortization are recorded to depreciate the fixed assets over their estimated useful lives on the following annual bases:

Buildings – 5% declining balance
Furniture and fixtures – 20% declining balance
Leasehold improvements – straight-line over the term of the lease
Automobiles – 30% declining balance

Goodwill

Goodwill is recorded at cost and amortized on a straight-line basis over 10 years.

Income taxes

Income taxes are recorded using the tax allocation method.

2. CHANGE IN ACCOUNTING POLICY

The company has changed its policy of accounting for preferred and common stocks from market value to cost.

The effect of this change has been to decrease the assets and shareholders' equity of the company as at December 31, 1985 by $303.

3. CAPITAL STOCK

(a) Authorized capital

The authorized share capital of the company consists of an unlimited number of preferred shares issuable in series, 2,348,000 Series I preferred shares, 2,874,000 Series II preferred shares, an unlimited number of multiple voting shares and an unlimited number of subordinate voting shares.

The preferred shares will rank prior to the multiple voting shares and the subordinate voting shares with respect to the payment of dividends and to the return of capital in the event of the liquidation, dissolution or winding-up of the company.

The holders of the Series I preferred shares and multiple voting shares will be entitled to ten votes per share and the holders of the Series II preferred shares and subordinate voting shares will be entitled to one vote per share. Under certain circumstances, such as a significant reduction in the number of Series I preferred shares and multiple voting shares held by the controlling shareholders of the company, the number of votes attached to Series I preferred shares and the multiple voting shares will automatically and permanently be reduced to one vote per share.

The holders of the Series I and Series II preferred shares are entitled, in priority to dividends payable on the multiple voting or subordinate voting shares, to receive cumulative cash dividends payable quarterly at an annual rate of $0.363375 per share.

The Series I preferred shares are redeemable at the option of the company at a price per share of $3.23 plus accrued and unpaid dividends to the date of payment, at any time after September 26, 1990.

(b) Share capital reorganization

i) At meetings of shareholders held on June 26, 1986, approval of the shareholders was obtained for amendments to the articles of the company to amend the terms of the Series I preferred shares, create a class of multiple voting shares, reclassify the common shares as subordinate voting shares, and create a new class of Series II preferred shares.

ii) Holders of 526,000 of the issued and outstanding Series I preferred shares agreed on June 3, 1986 to convert, after the implementation of the share capital reorganization described in i) above, their Series I preferred shares into Series II preferred shares contemporaneously with the closing of the issue of subordinate voting shares described in note 3(c) below.

iii) All holders of the 1,503,000 issued and outstanding common share warrants agreed on June 3, 1986 to exchange, after the implementation of the share capital reorganization described in i) above, their warrants for subordinate voting shares contemporaneously with the closing of the issue of subordinate voting shares described in note 3(c) below, without payment of cash consideration for a value representing the difference between the price of the subordinate voting shares offered under note 3(c) below and the warrant exercise price of $3.80.

(c) Share issue

On July 28, 1986, the company issued 2,000,000 subordinate voting shares at an issue price of $10 per share. Net cash proceeds, after deducting expenses of issue and the share capital re-organization of $1,628 described in note 3(b) above, were used by the company to increase the capital and surplus of Markel Insurance Company of Canada by $5,000 and to finance the acquisitions referred to in note 13, with the remainder being available for general corporate purposes.

(d) Issued capital

	1986		1985	
	Number	($000's)	Number	($000's)
Series I preferred shares	2,348,000	7,584	2,874,000	9,283
Series II preferred shares	526,000	1,699	–	–
Subordinate voting shares	4,132,528	29,575	–	–
Common shares	–	–	622,926	3,855
Common share warrants	–	–	1,503,000	–
		38,858		13,138

i) Series I and Series II preferred shares

During the year 526,000 Series I preferred shares were converted to Series II preferred shares (note 3(b)ii) above).

ii) Surbordinate voting shares

During the year 622,926 subordinate voting shares were issued upon conversion of 622,926 common shares. Furthermore, 931,860 subordinate voting shares were issued in exchange for 1,503,000 warrants (note 3(b)iii) above).

A further 2,000,000 subordinate voting shares were issued for cash at a price of $10 per share (note 3(c) above) and 577,742 subordinate voting shares were issued in partial consideration for the acquisitions described in note 13.

4. INVESTMENTS

Investments with a carrying value of approximately $2,198 were on deposit with regulatory authorities at December 31, 1986.

NOTES – continued

5. FIXED ASSETS

Fixed assets are as follows:

	1986	1985
	($000's)	($000's)
Land	409	–
Buildings	748	–
Furniture and fixtures	4,360	602
Leasehold improvements	228	–
Automobiles	62	–
	5,807	602
Less: Accumulated depreciation and amortization	3,824	427
	1,983	175

6. PAYABLE TO REINSURERS

Payable to reinsurers is shown net of reinsurance recoverable of $1,548 in 1986 and $615 in 1985.

7. BANK LOANS

A general assignment of book debts and a first fixed and floating charge demand debenture for $10,000 over all the assets of a subsidiary are pledged as security for the bank loans. Subsequent to the year-end, the subsidiary's bankers agreed to release the $10,000 demand debenture over all the assets of the subsidiary.

8. OPERATING LEASES

Aggregate future commitments at December 31, 1986 under operating leases relating to premises, automobiles and equipment for various terms up to 5 years are as follows:

	($000's)
1987	2,025
1988	1,574
1989	911
1990	251
1991	56
	4,817

9. REINSURANCE

The company follows the policy of underwriting and reinsuring contracts of insurance which, in the main, limit the liability of the company to a maximum amount on any one loss of between $225 and $300 (1985 – $200). The company's reinsurance is generally placed on an excess of loss basis in several layers. Prior to 1985, a part of this coverage was subject to an annual aggregate deductible which amounted to $1,277 in 1985. This reinsurance does not, however, relieve the company of its primary obligation to the policyholders. In addition, the reinsurance cost is subject to adjustment based upon the ultimate loss experience incurred. As at December 31, 1986, provision for claims reflects recoveries from reinsurers of $13,769 (1985 – $8,749). During the year, the company ceded $12,788 (1985 – $5,668) of premium income and $6,784 (1985 – $757) of claims incurred.

10. RELATED PARTY TRANSACTIONS

(a) Markel Corporation

Markel Corporation is a shareholder of Markel Financial Holdings Limited and Steven A. Markel, Executive Vice-President and Treasurer of Markel Corporation, is Vice-Chairman and President of Markel Financial Holdings Limited.

The company holds an investment of 94,400 issued common shares of Markel Corporation at a cost of $1,310.

Markel Corporation has charged the company for computer development, management and administration fees as follows:

	($000's)
1986	693
1985	96

(b) Related company

The company reinsures a portion of risks with a related company. During the year the net premiums ceded amounted to $2,495 (1985 – $421) and the net losses recovered amounted to $1,676 (1985 – $489).

Included within deposits from unlicensed reinsurers is an amount due to the related company of $1,159 (1985 – $1,007). The amount payable to reinsurers is offset by an amount due from the related company of $106 (1985 – $11).

(c) Investment counsel

On July 2, 1985, Hamblin Watsa Investment Counsel Ltd. was retained as the investment counsellor for the Markel group. For the year ended December 31, 1986 the investment counsel fee paid or payable to Hamblin Watsa amounted to $162 (1985 – for the period July 2 to December 31 – $41).

Mr. V. Prem Watsa is Chairman of the Board of Markel Financial Holdings Limited, and is a director of Markel Insurance Company of Canada. Mr. Watsa is a director, officer and shareholder of Hamblin Watsa Investment Counsel Limited, and he is a shareholder of The Sixty Two Investment Company Limited, the controlling shareholder of the Series I class of preferred shares of Markel Financial Holdings Limited.

11. INCOME TAX POSITION

(a) The company has available unearned premium reserves and claims provisions of approximately $1,780 (1985 – $5,382) which have not been claimed for income tax purposes. The tax benefits of these reserves amount to approximately $890 (1985 – $2,916) and have not been reflected in these financial statements.

In addition, the company and its subsidiaries have losses for income tax purposes, the benefits of which have not been recorded in the accounts, which may be carried forward to reduce taxable income in future years and which expire as follows:

	($000's)
1987	59
1990	91
1991	75
1992	206
1993	1,539
	1,970

(b) The provision for income taxes is analyzed as follows:

	Current	Deferred	Total
	($000's)	($000's)	($000's)
1986:			
Federal	1,013	1,941	2,954
Provincial	422	808	1,230
	1,435	2,749	4,184
1985:			
Federal	–	21	21
Provincial	–	9	9
	–	30	30

(c) The provision for income taxes recorded in the consolidated statement of operations differs from the statutory marginal rate as certain sources of income are exempt from tax or are taxed at other than the marginal rate. Reconciliations of the statutory marginal tax rate and the effective tax rate are summarized below:

	1986	1985
	%	%
Provision for (recovery of) taxes at Canadian statutory marginal income tax rate	52.0	(50.0)
Amortization of bond discount	0.2	4.4
Non-taxable capital gains	(6.0)	(13.4)
Non-taxable investment income	(5.0)	(2.8)
Unearned premium reserve for financial statement purposes in excess of that recorded for tax purposes	–	56.2
Share issuance costs	(18.6)	–
Net operating losses carried forward	16.5	11.7
Other – net	6.9	(2.7)
Provision for income taxes at effective rate	46.0%	3.4%

NOTES – continued

12. SOLVENCY POSITION

The company's insurance and reinsurance subsidiaries are incorporated under the Canadian and British Insurance Companies Act (the "Act") and are subject to certain requirements and restrictions contained in the Act.

At December 31, 1986, these subsidiaries have a combined surplus under the solvency requirements of section 103 of the Act of $16,940 (1985 – $2,491).

These subsidiaries are presently limited in their ability to pay dividends at December 31, 1986 under provisions of the above Act, as a result of the impact of prior years' results.

13. ACQUISITIONS

(a) On September 2, 1986, the company acquired Sphere Reinsurance Company of Canada "Sphere Re", a company incorporated and registered under the Canadian and British Insurance Companies Act.

The company acquired 1,150,000 of the 1,150,450 issued and outstanding common shares of Sphere Re for a consideration of $6,800, consisting of $4,000 in cash and a 9 3/4% $2,800 promissory note due September 3, 1991. The principal sum of the promissory note is adjustable under certain circumstances.

At September 2, 1986, the total assets and total liabilities of Sphere Re at the fair values assigned were as follows:

	($000's)
Total assets	29,302
Total liabilities	22,502
	6,800

(b) On September 27, 1986, the company entered into an agreement to amalgamate a newly incorporated subsidiary company with Morden & Helwig Limited "Morden & Helwig", a Canadian firm of independent insurance adjusters. The amalgamation obtained the approval of ninety-nine percent of the shareholders of Morden & Helwig on October 27, 1986. Upon approval of the agreement, shareholders received $2,011 in cash and $6,921 in the form of subordinate voting shares of the company as consideration for their shares.

At October 27, 1986, the total assets and total liabilities of Morden & Helwig at the fair values assigned were as follows:

	($000's)
Total assets	13,270
Total liabilities	7,567
	5,703
Purchase price	9,006
Goodwill	3,303

The goodwill arising from the acquisition will be amortized over a period of 10 years.

(c) The table below summarizes on a pro-forma basis consolidated results of operations as if Morden & Helwig Limited and Sphere Re had been acquired as of January 1, 1986, and the issue of subordinate voting shares and the share capital reorganization described in notes 3(b) and (c) above had occurred on January 1, 1986:

	Year ended December 31, 1986 ($000's)
Total revenue	89,544
Net earnings before extraordinary item	5,974
Extraordinary items	2,443
Net earnings after extraordinary items and minority interest	8,417
Net earnings per share – fully diluted basis (before extraordinary item)	$0.85
Net earnings per share – fully diluted basis (after extraordinary item and minority interest)	$1.20
Shares outstanding – fully diluted	7,006,528

14. CONTINGENCIES

A subsidiary of the company is the defendant in several damage suits and has been named as third party in other suits. The uninsured exposure to the company is not considered to be material.

15. COMPARATIVE FIGURES

Certain of the 1985 comparative figures have been re-stated to conform to the presentation adopted for 1986.

REPORT OF THE PROPERTY CASUALTY VALUATION ACTUARY

We have made the valuation of claim liabilities of Markel Financial Holdings Limited for its consolidated balance sheet at 31 December 1986 and its consolidated statement of operations for the year then ended. In our opinion,

(i) the valuation for Markel Financial Holdings Limited conforms to the Recommendations for Property Casualty Insurance Company Financial Reporting of the Canadian Institute of Actuaries,

(ii) the amount of Claim Liabilities makes proper provision for the future payments under the Company's policies,

(iii) a proper charge on account of those liabilities has been made in the Income Statement.

Toronto, Canada
March 11, 1987

THE WYATT COMPANY
ACTUARIES & CONSULTANTS

AUDITORS' REPORT TO THE SHAREHOLDERS

March 11, 1987

We have examined the consolidated balance sheet of Markel Financial Holdings Limited as at December 31, 1986 and the consolidated statements of operations, retained earnings (deficit) and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied, after giving retroactive effect to the change in accounting policy as explained in note 2 to the financial statements, on a basis consistent with that of the preceding year.

COOPERS & LYBRAND
CHARTERED ACCOUNTANTS

MARKEL FINANCIAL HOLDINGS LIMITED

Directors of the Company

‡George Christoff,
Account Executive, Dean Witter Reynolds (Canada) Inc.

Jack Herbert
Chairman, Moto Internationale

†*Robbert Hartog
President, Robhar Investments Limited

‡†Keith E. Ingoe
President & Chief Executive Officer, Markel Insurance Company of Canada

*Wilfred Kaneb
Chairman, Olco Petroleum Inc.

Anthony F. Markel
Executive Vice-President, Markel Corporation (U.S.)

‡†*Steven A. Markel
President and Vice-Chairman

‡James R. Martin
Investment Vice-President, Confederation Life Insurance Co.

Robert W. McDowell
Partner, Fasken & Calvin

†*V. Prem Watsa
Chairman of the Board

*Audit Committee Member
†Executive Committee Member
‡Investment Committee Member

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David E. Rooney
Vice-President, Finance & Chief Financial Officer

Transfer Agent and Registrar

The Royal Trust Company
Montreal Toronto Vancouver

Share Listings

Toronto Stock Exchange
Montreal Stock Exchange
Exchange Symbol MFH

General Counsel

Fasken & Calvin
Toronto, Canada

Auditors

Coopers & Lybrand
Toronto, Canada

Operating Management

Keith E. Ingoe	President & Chief Executive Officer	MARKEL INSURANCE COMPANY OF CANADA 500 University Avenue Toronto, Ontario
Kenneth R. Polley	President & Chief Executive Officer	MORDEN & HELWIG GROUP INC. 155 University Avenue Toronto, Ontario
L. Rui Quintal	President & Chief Executive Officer	SPHERE REINSURANCE COMPANY OF CANADA 25 Adelaide Street East Toronto, Ontario

Rapport annuel

On peut se procurer l'édition française de ce rapport en écrivant à la Société.

Printed in Canada