

financial statements: Liberty Mutual Group

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Combined Statutory Balance Sheets

December 31,	2001	2000
(dollars in thousands)		
Admitted Assets		
Investments:		
Fixed maturities	\$17,274,074	\$18,255,773
Common and preferred stocks	2,092,870	2,383,875
Investments in affiliates	2,227,142	2,868,367
Cash and short-term investments	1,570,847	1,264,935
Company occupied properties	218,635	230,403
Other investments	521,177	698,845
Cash and invested assets	23,904,745	25,702,198
Premiums receivable, net	2,878,621	2,802,282
Deferred tax asset, net	612,598	-
Reinsurance recoverable	353,646	358,532
Funds held by affiliates and other reinsurers	556,747	473,772
Other admitted assets	1,069,053	926,786
Total admitted assets	\$29,375,410	\$30,263,570
Liabilities and Surplus		
Liabilities:		
Losses unpaid	\$14,079,478	\$13,513,462
Loss adjustment expenses unpaid	2,753,214	2,864,576
Unearned premiums	3,487,623	3,129,686
Deposits and other liabilities	1,200,379	2,643,553
Funds held under reinsurance contracts	1,480,901	593,842
State taxes and assessments	449,976	95,495
Federal income taxes accrued	99,432	241,556
Dividends declared to policyholders	44,187	34,397
Total liabilities	23,595,190	23,116,567
Surplus:		
Surplus notes	1,141,019	1,140,855
Special and other surplus funds	1,127,384	321,500
Contributed capital	15,000	149,662
Unassigned surplus	3,496,817	5,534,986
Total surplus	5,780,220	7,147,003
Total liabilities and surplus	\$29,375,410	\$30,263,570

Combined Statutory Statements of Income

Years ended December 31,	2001	2000
(dollars in thousands)		
Premiums earned	\$ 8,760,262	\$ 8,450,375
Losses	7,459,379	6,323,149
Loss adjustment expenses	1,379,664	1,301,327
Underwriting and other expenses	1,952,312	1,852,062
Premium and other taxes and assessments	425,845	302,878
Total underwriting expenses	11,217,200	9,779,416
Underwriting loss before dividends	(2,456,938)	(1,329,041)
Dividends declared to policyholders	88,568	101,004
Underwriting loss	(2,545,506)	(1,430,045)
Net investment income	1,232,835	1,274,804
Realized investment gains, net	295,997	336,549
Other income, net	659,280	263,467
(Loss) income before income taxes	(357,394)	444,775
Federal and foreign income tax (benefit) expense	(68,671)	41,681
Net (loss) income	\$ (288,723)	\$ 403,094

See accompanying notes to combined statutory financial statements.

Combined Statements of Changes in Statutory Surplus

Years ended December 31,	2001	2000
(dollars in thousands)		
Statutory surplus, beginning of year	\$7,147,003	\$7,045,853
Add (deduct):		
Net (loss) income	(288,723)	403,094
Unrealized capital gains (losses):		
From unconsolidated subsidiaries	(479,401)	(16,186)
From non-affiliated securities	(541,757)	(264,383)
Cumulative codification adjustment	(181,000)	-
Other surplus changes, net	124,098	(21,375)
Statutory surplus, end of year	<u>\$5,780,220</u>	<u>\$7,147,003</u>

Combined Statutory Statements of Cash Flow

Years ended December 31,	2001	2000
(dollars in thousands)		
Cash provided:		
From operations:		
Premiums collected	\$9,069,843	\$8,493,039
Investment income and other income, net	1,235,253	1,240,004
Loss and loss adjustment expenses	8,500,641	8,193,785
Underwriting and other expenses, net	2,303,657	2,089,389
Net cash used by operations	<u>(499,202)</u>	<u>(550,131)</u>
From investments sold or matured:		
Fixed maturities	8,282,624	3,526,665
Common and preferred stocks	689,950	886,047
Other investments	144,179	122,250
Cash provided by investments	<u>9,116,753</u>	<u>4,534,962</u>
Securities lending collateral received, net	-	185,088
Debt financing, net	183,314	126,016
Other, net	-	220,369
Total other cash provided	<u>183,314</u>	<u>531,473</u>
Total cash provided	<u>8,800,865</u>	<u>4,516,304</u>
Cash applied:		
Cost of investments purchased:		
Fixed maturities	7,155,972	3,181,092
Common and preferred stocks	606,533	452,587
Investments in affiliates, net	59,278	227,273
Other investments	174,778	237,057
Cash applied to investments	<u>7,996,561</u>	<u>4,098,009</u>
Deposit liability	82,198	195,088
Securities lending collateral returned, net	375,848	-
Other, net	40,346	-
Total other cash applied	<u>498,392</u>	<u>195,088</u>
Total cash applied	<u>8,494,953</u>	<u>4,293,097</u>
Increase in cash and short-term investments	305,912	223,207
Cash and short-term investments, beginning of year	1,264,935	1,041,728
Cash and short-term investments, end of year	<u>\$1,570,847</u>	<u>\$1,264,935</u>

See accompanying notes to combined statutory financial statements.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying combined statutory financial statements of Liberty Mutual Insurance Company ("Liberty Mutual"), Liberty Mutual Fire Insurance Company ("Liberty Fire"), Montgomery Mutual Insurance Company ("Montgomery"), Merchants and Business Men's Mutual Insurance Company ("M&B") and Employers Insurance Company of Wausau ("EICOW"), formerly Employers Insurance of Wausau A Mutual Company ("EIOW"), collectively referred to as the "Companies", include, on a combined basis, the accounts of their U.S. property and casualty insurance subsidiaries.

The Companies provide most types of property-casualty insurance, fidelity and surety bonds and insurance-related services for individuals, businesses, government units and associations.

In 2001, Liberty Mutual reorganized into a stock insurance company as part of an overall conversion to a mutual holding company structure. Liberty Mutual formed as its ultimate parent Liberty Mutual Holding Company Inc., a Massachusetts mutual holding company ("LMHC"). Additionally, as part of its reorganization, Liberty Mutual formed (i) LMHC Massachusetts Holdings, Inc., a Massachusetts stock holding company ("LMHC MA") which is a direct, wholly-owned subsidiary of LMHC and (ii) Liberty Mutual Group, Inc., a Massachusetts stock holding company ("LMGI"), which is a direct, wholly-owned subsidiary of LMHC MA and the direct parent of Liberty Mutual. In 2001, EIOW reorganized into a stock insurance company named Employers Insurance Company of Wausau as part of an overall conversion to a mutual holding company structure. EICOW formed as its direct parent Employers Insurance of Wausau Mutual Holding Company, a Wisconsin mutual holding company ("EIOW MHC"). This was the first step in a series of transactions to be completed in 2002 designed to result in Liberty Mutual, Liberty Fire and EICOW, becoming indirect wholly-owned stock subsidiaries of LMHC, subject to satisfaction of all applicable approvals.

These financial statements exclude the accounts of LMHC, LMHC MA, LMGI and EIOW MHC.

The accompanying combined statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the insurance departments of the states in which the companies are domiciled, which vary in some respects from accounting principles generally accepted in the United States ("GAAP"). Effective January 1, 2001 the National Association of Insurance Commissioners ("NAIC") revised the Accounting Practices and Procedures Manual in a process referred to as "codification". Accordingly, insurance companies are required to prepare their statutory basis financial statements in accordance with codification, subject to any deviations prescribed or permitted by the domiciliary state insurance departments. Principal variations from GAAP include:

Investments: Investments in bonds and mandatory redeemable preferred stocks are reported at amortized cost or market value based on their NAIC rating; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, trading or available-for-sale. Held-to-maturity fixed investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized

gains and losses reported in operations for those designated as trading and as a separate component of surplus for those designated as available-for-sale.

Undistributed results of limited partnerships are reflected in unrealized gains on a statutory basis while GAAP utilizes the equity method unless the investor's interest is so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Investments in excess of three to five percent are considered more than minor.

Subsidiaries: Controlling interests in subsidiaries other than domestic property and casualty insurance subsidiaries are not consolidated or combined, and the equity in earnings of unconsolidated subsidiaries is recorded in surplus as net unrealized capital gains or losses, with insurance subsidiaries' equity adjusted to a U.S. statutory basis. For domestic property and casualty subsidiaries acquired during the year, the full year's results of operations are included in the combined statements of income.

Purchase Accounting: The excess of purchase price over the fair value of net assets acquired, or historical statutory surplus in the case of domestic insurance companies ("statutory purchase accounting"), is considered goodwill and is capitalized and amortized on a straight-line basis over periods of up to ten years, subject to certain statutory limitations. Statutory accounting limits the amount of goodwill that can be carried as an admitted asset to ten percent of surplus for the most recently filed statutory financial statements adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets ("limitation basis surplus"). Goodwill in excess of the limitation is non-admitted. Goodwill is amortized over a period not to exceed ten years and is reflected as a component of unrealized capital gains or losses for unconsolidated subsidiaries and other surplus changes for combined companies. Under GAAP, goodwill is determined as the excess of purchase price over the fair value of net assets acquired and for acquisitions prior to July 1, 2001 is amortized through earnings over a period not to exceed 40 years. For acquisitions after July 1, 2001 and for all goodwill as of January 1, 2002, GAAP no longer requires periodic amortization of goodwill.

Deferred Policy Acquisition Costs: The costs of acquiring and renewing business are expensed when incurred. Under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective period of the related insurance policies. Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and amortized with deferred policy acquisition costs, as required under GAAP.

Non-admitted Assets: Certain assets designated as "non-admitted," principally premiums receivable greater than ninety days old (net of any valuation allowance established for amounts deemed uncollectible and charged to earnings), furniture and equipment, deferred tax assets and goodwill in excess of statutory limitations, other intangible assets, and as of January 1, 2001, any other assets not specifically identified as an admitted asset within statutory accounting guidance, are excluded from the accompanying balance sheets. Changes in such non-admitted assets are charged or credited directly to surplus. Additionally, codification requires valuation allowances to be recorded by a

Notes to Combined Statutory Financial Statements

(dollars in thousands)

charge to operations if asset impairment is probable and can be reasonably estimated. Such allowances are included in the cumulative effect of the implementation of codification and result in an offsetting reduction in non-admitted assets. Under GAAP, such assets are included in the balance sheet, net of any valuation allowance required.

Policyholder Dividends: Policyholder dividends are recognized when declared rather than over the term of the related policies under GAAP.

Employee Benefits: For purposes of calculating the Companies' pension and postretirement benefit obligations, only vested participants and current retirees are included in the valuation. Under GAAP, active participants not currently eligible are also included.

Reinsurance: Reserves for losses and loss adjustment expenses and unearned premiums ceded to reinsurers have been reported as reductions of the related reserves, rather than as assets as would be required under GAAP.

Gains from retroactive reinsurance contracts are reported as a segregated surplus account ("special surplus funds") and are not reported as unassigned surplus until the Companies have recovered amounts in excess of the consideration paid. Reserves transferred are recorded as a contra liability in "other liabilities". Under GAAP, such gains are deferred and recognized in income using the interest method over the period the underlying reinsured claims are paid.

A liability for reinsurance balances (net of any allowance for amounts deemed uncollectible and charged directly to earnings) has been provided for unsecured reinsurance balances due from reinsurers not authorized to transact business in the respective states of domicile ("unauthorized reinsurance"). This liability is not required under GAAP.

Deferred Income Taxes: Effective January 1, 2001, deferred tax assets are limited to (1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year; plus (2) the lesser of the remaining gross deferred tax assets expected to be realized within one year of the balance sheet date or 10% of limitation basis surplus; plus (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The remaining deferred tax assets are non-admitted. Deferred taxes do not include amounts for state taxes. Prior to January 1, 2001, deferred federal income taxes were not provided for differences between financial statement amounts and tax bases of assets and liabilities. Changes in deferred tax assets and liabilities are recognized as a separate component of changes in surplus. Under GAAP, state taxes are included in the computation of deferred taxes, a deferred tax asset is recorded for the amount of gross deferred tax assets expected to be realized in future years, and a valuation allowance is established for deferred tax assets not realizable.

Surplus Notes: Surplus notes represent subordinated debt instruments classified as a component of surplus for statutory accounting purposes. Associated surplus note issuance costs are deferred, non-admitted and amortized using the interest method over the period to maturity. The difference between proceeds received and the face value of the surplus notes is amortized using the interest method

over the period to maturity. Interest expense on surplus notes is reported as a component of net investment income. Under GAAP, surplus notes are reported as debt and the associated interest is reported as interest expense.

Guaranty Funds and Other Assessments: Effective January 1, 2001, a liability for guaranty funds and other assessments is accrued after an insolvency has occurred, regardless of whether the assessment is based on premiums written before or after the insolvency, and offsetting premium tax credits and policyholder surcharges are recognized. Loss based assessments are assumed probable when the subject losses are incurred. Prior to January 1, 2001, guaranty fund and other assessments were accrued when the Companies received notice that an assessment was payable. Under GAAP, assessments are typically accrued to match the underlying basis of assessment.

Statements of Cash Flow: Cash and short-term investments include investments with maturities of one year or less at the time of purchase. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less.

On a GAAP basis, consolidated policyholders' surplus was \$5,885,000 and \$7,888,000 at December 31, 2001 and 2000, respectively, and net loss for the year ended December 31, 2001 was \$1,946,000 and net income for the year ended December 31, 2000 was \$161,000.

Upon adoption of codification, effective January 1, 2001, the cumulative effect of the change in accounting was a decrease in surplus of \$181,000. The components of the cumulative codification adjustment were as follows:

Guaranty funds and other assessments	\$(294,075)
Net deferred tax asset	574,174
Postemployment benefits and compensated absences	(98,561)
Non-admitted goodwill	(78,277)
Allowance for doubtful accounts	(195,273)
Other	(298,744)
Subtotal	(390,756)
Offsetting changes in non-admitted assets	209,756
Total	<u>\$(181,000)</u>

The preparation of financial statements requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known that could impact the amounts reported and disclosed herein.

(b) Investment Securities

Investment securities are carried according to valuations promulgated by the NAIC. Fixed maturity securities are generally carried at cost and adjusted where appropriate for amortization of premium or discount, including anticipated prepayments; unaffiliated common stocks are carried at market value; preferred stocks are carried at cost or market in accordance with the NAIC; investments in

Notes to Combined Statutory Financial Statements

(dollars in thousands)

affiliated common stock of insurers and noninsurers are generally carried on the statutory equity basis and GAAP equity basis, respectively; short-term investments are carried at cost; and company-occupied properties are carried at depreciated cost. Investments in venture capital limited partnerships are carried on the equity method. In 2000, the investment in Liberty Financial Companies, Inc. (LFC) was carried at its publicly traded market value, net of a 30% valuation discount determined by the NAIC.

Prepayment assumptions for single class mortgage-backed/asset-backed securities and multi-class securities are obtained from internal estimates. These assumptions are consistent with the current interest rate and economic environment. The retrospective adjustment method is used to value all single class mortgage-backed/asset-backed securities and multi-class securities.

Realized gains and losses on sales of investments are recognized in net income using the specific identification method. Changes in unrealized gains and losses on stocks, certain fixed maturities, and other investments are recorded in surplus. Investment securities are regularly reviewed for impairment based upon criteria that include the extent to which cost exceeds market value, the duration of the market decline and specific issuer financial condition. Unrealized losses that are other-than-temporary are recognized in earnings. Any derivatives not qualifying as hedges are marked to market through income and are included in other assets or liabilities.

(c) Fair Values of Financial Instruments

The Companies have used the following methods and assumptions in estimating fair value disclosures of financial instruments:

Investment securities: Fair values for fixed maturity securities are based on quoted market prices, when available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or values obtained from independent pricing services. The fair values for equity securities are based on quoted market prices.

Cash and short-term investments: The carrying amounts reported in the balance sheets for these instruments approximate their fair values.

Derivatives: The carrying amounts reported in the balance sheets for these instruments approximate their fair values.

(d) Securities Lending

Securities lending activities consist of lending certain U.S. government and corporate bonds to approved counterparties. All lending transactions are collateralized by securities, accrued interest and cash with a total market value equal to or in excess of at least 102% of the market value of the loaned securities. Short-term investments and cash collateral received are recorded as assets, with a corresponding liability recorded for the return obligation.

(e) Recognition of Premium Revenues

Premiums are recognized as income on a pro-rata basis over the terms of the policies or as loss experience dictates in the case of retrospectively rated policies. Unearned premiums represent the unexpired portion of premiums written. Premium adjustments resulting from retrospective rating of experience-rated policies and unbilled audit premiums are estimated and accrued, along with the related taxes, assessments and expenses associated with acquiring, billing and collecting the premiums. When the anticipated losses, loss adjustment expenses, commissions, other acquisition costs and maintenance costs exceed the recorded unearned premium reserve and future installment premiums on existing policies, a premium deficiency reserve is established.

(f) Reinsurance

Transactions with reinsurers which do not transfer risk or which transfer risk but are retroactive are included in other admitted assets or deposits and other liabilities.

(g) Losses and Loss Adjustment Expenses Unpaid

The Companies provide reserves for unpaid insurance losses and loss adjustment expenses covering events that occurred in 2001 and prior years. These reserves reflect estimates of the total cost of claims reported but not yet paid and the cost of claims not yet reported, as well as the estimated expenses necessary to settle the claims. Reserve estimates are based on past loss experience modified for current claim trends, as well as prevailing social, economic and legal conditions. Final claim payments, however, may ultimately differ from the established reserves, since these payments may not occur for several years. Reserve estimates are continually reviewed and updated, and any resulting adjustments are reflected in current operating results.

The Companies do not discount reserves other than tabular discounting on the long-term indemnity portion of certain workers compensation claims and the long-term disability portion of group accident and health claims as permitted by insurance regulations in certain states. Reserves are reduced for estimated amounts of salvage and subrogation, deductibles recoverable from policyholders and amounts recoverable under reinsurance contracts.

(h) Foreign Exchange

The Companies convert foreign currencies to U.S. dollars in accordance with Statement of Statutory Accounting Principles No. 23, "Foreign Currency Transactions and Translations" whereby items of income and expense are translated at the average exchange rate for the period while balance sheet items are translated using the spot rate as of the balance sheet date.

(i) Reclassifications

Certain reclassifications to the 2000 combined statutory financial statements have been made to conform to the 2001 presentations.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

(2) Investments

(a) Fixed Maturities

The statement and fair values of fixed maturity securities at December 31, 2001 and 2000, are as follows:

	Statement Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2001				
U.S. Treasury securities	\$ 639,211	\$ 26,707	\$ (4,776)	\$ 661,142
Mortgage and asset-backed securities of government and corporate agencies	6,737,332	176,543	(42,908)	6,870,967
State and municipal	1,579,366	91,921	(1,964)	1,669,323
Corporate and other	8,318,165	271,234	(37,769)	8,551,630
Total fixed maturities	<u>\$17,274,074</u>	<u>\$566,405</u>	<u>\$(87,417)</u>	<u>\$17,753,062</u>
December 31, 2000				
U.S. Treasury securities	\$ 945,144	\$ 31,160	\$ (262)	\$ 976,042
Mortgage and asset-backed securities of government and corporate agencies	6,946,575	166,810	(59,505)	7,053,880
State and municipal	2,125,140	123,205	(1,485)	2,246,860
Corporate and other	8,238,914	146,418	(115,886)	8,269,446
Total fixed maturities	<u>\$ 18,255,773</u>	<u>\$ 467,593</u>	<u>\$(177,138)</u>	<u>\$ 18,546,228</u>

The statement and fair values of fixed maturity securities at December 31, 2001, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because some securities may be called or prepaid.

	Statement Value	Fair Value
Due to mature:		
One year or less	\$ 490,902	\$ 497,430
Over one year		
through five years	3,015,121	3,128,547
Over five years		
through ten years	4,999,376	5,136,039
Over ten years	2,031,343	2,120,079
Mortgage and asset-backed securities	6,737,332	6,870,967
Total fixed maturities	<u>\$17,274,074</u>	<u>\$17,753,062</u>

(b) Common and Preferred Stocks and Other Investments

The cost of common and preferred stocks and other investments at December 31, 2001 and 2000, was as follows:

	2001	2000
Common stocks	\$ 784,409	\$ 799,513
Preferred stocks	225,383	136,550
Other investments	510,101	485,756
	<u>\$1,519,893</u>	<u>\$1,421,819</u>

(c) Derivatives

At December 31, 2001 and 2000, the Companies were party to derivative contracts in the form of equity swap contracts. The purpose of the equity swap contracts is to exchange rates of return of a specified set of common stocks for rates of return consistent with the broad equity markets as represented by Standard & Poor's Index of 500 common stocks. The Companies agree with counterparties to exchange, at quarterly intervals, the net performance differential of the Standard & Poor's Index of 500 common stocks and a portfolio of the Companies' common stocks. A single net payment is made by one counterparty at each due date. The Companies are exposed to potential credit loss with respect to only the net differential payments in the event of nonperformance by the counterparties.

At December 31, 2001 and 2000, the equity swaps had combined notional amounts of \$361,879 and \$383,285, respectively and fair values of \$13,516 and (\$51,980), respectively.

(d) Investments in Affiliates

Investments in affiliates consist primarily of the Companies' investments in unconsolidated insurance, international and financial services subsidiaries. The Companies' equity in the net assets of unconsolidated subsidiaries is summarized as follows at December 31, 2001 and 2000:

	2001	2000
Equity in net assets of unconsolidated subsidiaries	\$ 2,220,320	\$ 1,635,263
Market value of Liberty Financial Companies, Inc.	-	1,053,104
Loans to unconsolidated subsidiaries	6,822	180,000
Companies' investment in affiliates	<u>\$ 2,227,142</u>	<u>\$ 2,868,367</u>
Total assets	\$ 14,095,002	\$10,593,804
Total liabilities	(11,862,260)	(8,947,801)
Interests of other shareholders	(12,422)	(10,740)
Companies' equity in net assets	<u>\$ 2,220,320</u>	<u>\$ 1,635,263</u>
Equity in net assets of unconsolidated subsidiaries is distributed as follows at December 31, 2001 and 2000:		
	2001	2000
International subsidiaries	\$831,302	\$1,126,739
Liberty Financial Companies, Inc.	909,953	-
Liberty Life Assurance Company of Boston	131,031	140,589
Other subsidiaries	348,034	367,935
Companies' equity in net assets	<u>\$2,220,320</u>	<u>\$1,635,263</u>

Notes to Combined Statutory Financial Statements

(dollars in thousands)

In 2000, the Companies changed the valuation methodology for LFC to the market value approach. The change in methodology increased the carrying value of LFC by approximately \$456,000 at December 31, 2000. On October 31, 2001, LFC sold its annuity and bank marketing business for \$1.7 billion in cash and on November 1, 2001, LFC sold its asset management business for \$900,000 in cash and the buyer assumed approximately \$110,000 in revolving debt. LFC recorded a gain on the sale, net of tax of \$140,000 and the Companies recognized an unrealized gain of \$98,000. Following the sales of LFC's operating subsidiaries, the Companies' acquired 100% ownership of LFC. As of December 31, 2001, the Companies' investment in LFC is valued on the statutory equity basis.

The remaining unamortized goodwill and other intangible asset balances included as a component of the Companies' investments in affiliates at December 31, 2001 and 2000, were \$360,562 and \$333,438, respectively. The remaining unamortized goodwill and other intangible asset balances associated with combined insurance subsidiaries reported in other assets at December 31, 2001 and 2000, were \$40,220 and \$42,338, respectively.

Liberty Mutual purchased a 99.99% interest in Royal & Sun Alliance, S.A. Compañía Española de Seguros y Reaseguros (re-named Liberty Insurance Group, Compañía de Seguros y Reaseguros, S.A.) in Spain on November 26, 2001. Liberty Insurance Group, Compañía de Seguros y Reaseguros, S.A. is licensed in Spain and sells property, casualty and life insurance. The transaction was accounted for as a statutory purchase and the cost was \$191,937. Goodwill amortization relating to the purchase was \$6,935 for the year ended December 31, 2001. Unamortized goodwill as of December 31, 2001 was \$131,772.

In addition, the Companies' unconsolidated subsidiaries acquired various companies in 2001 and 2000 for aggregate consideration of \$111,462 and \$16,925, respectively.

(e) Realized Investment Gains (Losses)

Realized investment gains (losses) were as follows in 2001 and 2000:

	2001	2000
Fixed maturities:		
Gross gains	\$248,432	\$ 31,185
Gross losses	(85,633)	(48,839)
Common and preferred stocks:		
Gross gains	266,571	168,947
Gross losses	(110,622)	(63,871)
Other investments:		
Gross gains	21,992	259,933
Gross losses	(44,743)	(10,806)
	<u>\$295,997</u>	<u>\$336,549</u>

Proceeds from sales of fixed maturity investments during 2001 and 2000, were \$6,007,281 and \$2,578,060, respectively.

Gross losses included other-than-temporary impairment write-downs of \$80,786 in 2001.

(f) Net Investment Income

Net investment income for the years ended December 31, 2001 and 2000, consisted of:

	2001	2000
Fixed maturities	\$1,286,098	\$1,331,269
Common and preferred stocks	38,090	40,794
Short-term investments	26,749	39,006
Other	82,409	68,872
Gross investment income	1,433,346	1,479,941
Investment and interest expense	(200,511)	(205,137)
Net investment income	<u>\$1,232,835</u>	<u>\$1,274,804</u>

(g) Statutory Deposits

At December 31, 2001 and 2000, fixed maturity securities carried at \$4,564,853 and \$4,671,043, respectively, were on deposit with regulatory authorities as required by law.

(h) Securities Loaned

At December 31, 2001 and 2000, the market values of fixed maturity securities loaned were approximately \$153,515 and \$697,434, respectively. Cash and short-term investments received as collateral in connection therewith at December 31, 2001 and 2000, were approximately \$121,893 and \$498,666, respectively, while non-cash collateral received in connection therewith was approximately \$34,692 and \$212,717, respectively.

(3) Losses and Loss Adjustment Expenses Unpaid

The Companies establish loss and loss adjustment expense reserves, which are estimates of future payments of reported and unreported claims for losses and the related future expenses. The process of establishing loss reserves is subject to uncertainties that are normal, recurring and inherent in the property and casualty insurance business. The process requires reliance upon estimates based on available data that reflects past experience, current trends and other information, and the exercise of informed judgment.

As information develops that varies from past experience, provides additional data or, in some cases, augments data that previously was not considered sufficient for use in determining reserves, changes in the Companies' estimate of ultimate liabilities may be required. The effects of these changes are reflected in current operating results.

Activity in the insurance loss and loss adjustment expense reserves of the Companies is summarized as follows:

	2001	2000
Balance as of January 1	\$16,378,038	\$16,928,795
Incurred attributable to:		
Current year	7,657,053	7,256,863
Prior years	1,181,990	367,613
Total incurred	8,839,043	7,624,476
Paid attributable to:		
Current year	3,517,835	3,302,112
Prior years	4,849,162	4,863,901
Total paid	8,366,997	8,166,013
Net adjustment due to foreign exchange	(17,392)	(9,220)
Balance as of December 31	<u>\$16,832,692</u>	<u>\$16,378,038</u>

In 2001 and 2000, incurred attributable to prior years was due to reserve increases primarily in commercial lines, including asbestos and environmental.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

In 2000, incurred attributable to prior years was favorably impacted by reinsurance transactions with a wholly owned subsidiary as more fully disclosed in Note 5.

The Companies do not discount unpaid insurance losses and loss adjustment expenses other than tabular discounting on the long-term indemnity portion of workers compensation claims and group accident and health claims as permitted by insurance regulations in certain states.

The tabular discounting on these workers compensation claims is based upon Unit Statistical Plan tables as approved by the respective states and generally approximates 4.0%. Unpaid losses at December 31, 2001 and 2000 include liabilities of \$3,619,664 and \$2,782,925 at discounted values of \$2,302,836 and \$1,719,278, respectively.

The tabular discounting on group accident and health claims is based on the 1987 Commissioners Group Disability Table (CGDT) at annual discount rates varying from 5.00% to 5.75% (6.0% in 2000). Unpaid losses at December 31, 2001 and 2000 include liabilities of \$674,854 and \$611,108 carried at discounted values of \$466,996 and \$425,951, respectively.

Loss and loss adjustment expense reserves are recorded net of anticipated salvage and subrogation of \$428,393 and \$410,498 as of December 31, 2001 and 2000, respectively.

For certain commercial lines of insurance, the Companies offer experience-rated insurance contracts whereby the ultimate premium is dependent upon the level of ultimate losses and loss adjustment expenses incurred. At December 31, 2001 and 2000, the Companies held \$4,228,743 and \$4,067,094, respectively, of loss and loss adjustment expense reserves related to experience-rated contracts. Premiums receivable included accrued retrospective premiums and accrued unbilled audit premiums of \$710,278 and \$623,209 at December 31, 2001 and 2000, respectively, and \$78,313 and \$76,581, respectively, have been designated non-admitted and charged to surplus.

As of December 31, 2001, the amount of reserve credit recorded for high deductibles on unpaid losses was \$1,451,967 and the amount billed and recoverable was \$257,163.

(4) Asbestos and Environmental Reserves

The Companies have exposure to asbestos and environmental claims arising from the sale of general liability insurance. The Companies estimate the full impact of the asbestos and environmental exposures by establishing case basis reserves on all known losses and computing incurred but not reported losses based on previous experience and known changes in the legal and regulatory environment.

The process of establishing reserves for asbestos and environmental claims is subject to significant uncertainties including long reporting delays and uncertainty as to the number and identity of insureds alleging exposure. The legal issues concerning the interpretation of various insurance policy provisions and whether these asbestos and environmental losses are, or were ever, intended to be covered are complex. Courts have reached different and sometimes inconsistent conclusions as to when an alleged loss occurred, whether general liability insurance policies provided coverage, and if so, which policies would apply, whether there is an insured obligation to defend, how policy limits are determined, how policy exclusions are applied and interpreted and whether clean-up costs are covered as insured property damage.

Additionally, the Companies have historically maintained excess of loss reinsurance protection against large or unusual casualty losses. In specific instances, and at their discretion based on an analysis of the claims at issue, the Companies record reinsurance recoveries for those known claims which are clearly subject to reinsurance. However, the extent of future potential recoveries under reinsurance agreements cannot be fully determined at this time.

As more fully discussed in Note 5, upon deaffiliation from the Nationwide Group, EICOW entered into a reinsurance contract whereby, among other coverages, all asbestos and environmental exposures on policies with effective dates prior to January 1, 1986 were fully reinsured by Nationwide Indemnity Company. This reinsurance contract represents the majority of ceded asbestos and environmental reserves.

Reserve changes on individual asbestos and environmental matters reflect consideration of any newly acquired relevant information that may have an impact on reserve development. Given the complexities and significant uncertainties associated with estimating asbestos and environmental exposures, no assurances can be made as to the future potential impact of such claims upon the Companies. As additional information develops that would dictate a reserve change, the Companies' estimates of losses and loss adjustment expenses associated with asbestos and environmental claims are adjusted accordingly.

The following tables summarize activity for the Companies' asbestos and environmental losses and loss adjustment expense reserves, a component of the Companies' total reserves summarized in Note 3, for the years ended December 31, 2001 and 2000:

	2001	2000
Gross Asbestos:		
January 1 reserves:	\$ 1,371,347	\$ 1,238,326
Incurred activity	408,725	340,249
Paid activity	195,162	207,228
Ending reserves	<u>\$ 1,584,910</u>	<u>\$ 1,371,347</u>
Net Asbestos:		
January 1 reserves:	\$ 754,645	\$ 678,749
Incurred activity	162,825	218,053
Paid activity	109,110	142,157
Ending reserves	<u>\$ 808,360</u>	<u>\$ 754,645</u>
Gross Environmental:		
January 1 reserves:	\$ 852,246	\$ 1,084,827
Incurred activity	73,917	(115,265)
Paid activity	153,211	117,316
Ending reserves	<u>\$ 772,952</u>	<u>\$ 852,246</u>
Net Environmental:		
January 1 reserves:	\$ 460,570	\$ 679,621
Incurred activity	92,777	(132,229)
Paid activity	114,960	86,822
Ending reserves	<u>\$ 438,387</u>	<u>\$ 460,570</u>

(5) Reinsurance

In the ordinary course of business, the Companies assume reinsurance and also cede reinsurance to other insurers to reduce overall risk, including exposure to large losses and catastrophic events. The Companies are also members of various involuntary pools and associations and serve as servicing carriers for residual market organizations.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

Premiums earned and losses and loss adjustment expenses incurred from reinsurance assumed for the years ended December 31, 2001 and 2000, were as follows:

	2001	2000
Premiums earned (residual markets)	\$ 98,207	\$ 79,211
Premiums earned (all other)	579,967	503,997
Incurred losses and loss adjustment expenses	905,724	703,015

Premiums earned and losses and loss adjustment expenses incurred have been reduced for reinsurance ceded for the years ended December 31, 2001 and 2000, as follows:

	2001	2000
Premiums earned (residual markets)	\$ 345,158	\$ 248,868
Premiums earned (all other)	1,378,101	1,371,370
Incurred losses and loss adjustment expenses	2,661,789	1,748,945

Unearned premiums and unpaid losses and loss adjustment expenses have been reduced for reinsurance ceded as follows:

	2001	2000
Unpaid losses and loss adjustment expenses (residual markets)	\$1,816,260	\$1,880,805
Unpaid losses and loss adjustment expenses (all other)	5,115,906	4,132,127
Unearned premiums (residual markets)	130,351	84,475
Unearned premiums (all other)	441,092	211,215

The Companies remain contingently liable in the event reinsurers are unable to meet the obligations for paid and unpaid loss recoverables and unearned premiums ceded under reinsurance agreements.

Effective November 1, 2001, Liberty Mutual acquired the renewal rights to the independent agency business of OneBeacon, excluding New York, New Jersey and New England. The business includes small commercial and personal lines and total premiums are estimated to be approximately \$1,000,000. Under the terms of the agreement, Liberty Mutual will retain one third of the underwriting results in the first year, two thirds in the second year and one hundred percent thereafter. The transaction excludes insurance liabilities incurred prior to the effective date. Under the terms of the transaction, Liberty Mutual assumed the related infrastructure, employees and underwriting responsibility for the business.

In 2001 and 2000, the Companies entered into retroactive reinsurance treaties with unaffiliated entities. The Companies transferred loss and loss adjustment expense reserves of \$1,603,000 and \$460,000, respectively and recognized a gain through other income of \$800,000 and

\$319,000, respectively. Included in the other income figures are accrued contingent profit sharing commissions of \$162,500 and \$0 for 2001 and 2000, respectively.

Liberty Mutual entered into a reinsurance agreement effective January 1, 1998 with Liberty Life Assurance Company of Boston ("Liberty Life"), an indirect, unconsolidated subsidiary of the Companies, whereby Liberty Life ceded 100% of long and short-term disability business on a funds withheld basis. Liberty Mutual assumed premiums earned of \$253,480 and \$261,528 in 2001 and 2000, respectively; and loss and loss adjustment expense reserves of \$625,604 and \$545,148 as of December 31, 2001 and 2000, respectively. The transaction resulted in a net loss of \$2,062 and \$18,091 in 2001 and 2000, respectively.

The Companies have reinsurance recoverables from Nationwide Indemnity Company in the amount of \$1,099,175 as of December 31, 2001. The reinsurance recoverables are guaranteed by Nationwide Mutual Insurance Company. Additionally, the Companies have significant reinsurance recoverable concentration with National Indemnity Company (a Berkshire Hathaway, Inc. subsidiary) and North American Specialty Insurance Company (a subsidiary of Swiss Reinsurance Company) totaling \$489,334 and \$509,508, respectively, as of December 31, 2001, net of offsetting contractual liabilities.

The Companies entered into commutation agreements in 2000 with unaffiliated reinsurers. Loss and loss expense reserves of \$143,974, were returned along with cash of \$97,100. The transaction resulted in a net statutory loss of \$30,468.

Liberty Mutual entered into an intercompany reinsurance agreement with a wholly owned unconsolidated subsidiary in 2000 whereby Liberty Mutual ceded \$195,983 of loss and loss adjustment expense reserves in exchange for premium of \$147,591. The transaction resulted in net statutory income of \$31,454, with no impact upon statutory surplus. The Companies received regulatory approval to use prospective reinsurance accounting for 2000. In 2001, the treaty was commuted in conjunction with the implementation of codification.

In 1997 San Diego Insurance Company ("San Diego") entered into an assumed indemnity reinsurance agreement recorded under the deposit method in accordance with statutory accounting. At inception, approximately \$1,215,000 of securities and other assets were transferred to San Diego and recorded as a deposit liability. Interest is credited on the contractual deposit balance at a rate of 7% annually. The outstanding deposit liability was \$316,827 and \$399,000 at December 31, 2001 and 2000, respectively. The Companies have recorded the maximum liability under the contract.

(6) Short-Term Borrowings

The Companies maintain a \$600,000 revolving loan agreement maturing on December 31, 2003, with Liberty Mutual Capital Corporation (Boston), a wholly owned unconsolidated subsidiary. At December 31, 2001 and 2000, there were balances outstanding of \$283,113 and \$111,239, respectively. Interest is based on the average daily outstanding borrowings at a variable interest rate (5.00% and 6.91% at December 31, 2001 and 2000, respectively). Interest expense incurred related to this agreement was \$10,205 and \$10,041 in 2001 and 2000, respectively.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

Liberty Mutual has aggregate pound sterling denominated demand notes payable to its subsidiary, Liberty Re Limited, totaling \$333,188 and \$341,984 (U.S. dollar equivalent at December 31, 2001 and December 31, 2000, respectively), and a demand note payable to its subsidiary Liberty Re (Bermuda) Limited, in the amount of \$34,359 and \$24,359 as of December 31, 2001 and 2000, respectively. Interest on these notes is payable semi-annually on the first day of April and October, computed at LIBOR plus .15%.

(7) Surplus Notes

Surplus notes represent subordinated debt instruments classified as a component of surplus for statutory accounting purposes. At December 31, 2001 and 2000, Liberty Mutual had the following surplus notes outstanding:

	2001	2000
8.20%, \$250,000 Notes due May 4, 2007	\$ 249,706	\$ 249,651
8.50%, \$150,000 Notes due May 15, 2025	149,759	149,749
7.88%, \$250,000 Notes due October 15, 2026	249,654	249,640
7.70%, \$500,000 Notes due October 15, 2097	491,900	491,815
	<u>\$1,141,019</u>	<u>\$1,140,855</u>

Payments for interest on and principal of the notes are expressly subordinate to all policyholder claims and other obligations of Liberty Mutual. Accordingly, interest and principal payments are contingent upon prior approval of the Commissioner of Insurance of the Commonwealth of Massachusetts. Interest paid was \$91,422 for the years ended December 31, 2001 and 2000.

The components of deferred tax assets (liabilities) are as follows:

	December 31, 2001	January 1, 2001	Change
Gross deferred tax assets	\$1,886,335	\$1,885,270	\$ 1,065
Gross deferred tax liabilities	(597,465)	(744,070)	146,605
Net deferred tax assets	1,288,870	1,141,200	147,670
Deferred tax assets non-admitted	(676,272)	(567,026)	(109,246)
Deferred tax assets admitted	<u>\$ 612,598</u>	<u>\$ 574,174</u>	<u>\$ 38,424</u>

The Companies' net deferred tax asset is principally due to net operating loss carryforwards, loss and loss adjustment expense reserve discounting, and unearned premium discounting offset by unrealized gains on securities.

(9) Benefit Plans

(a) Pension Plans and Postretirement Benefits

The Companies sponsor noncontributory defined benefit pension plans ("the Plans") covering substantially all U.S. and Canadian employees. The benefits and eligibility are based on age, years of service and the employee's compensation, as more fully defined in the Plans.

Assets of the Plans consist primarily of investments in life insurance company separate accounts and a collective investment trust fund, which invests primarily in fixed income and Standard & Poor's Index of 500 equity

(8) Federal and Foreign Income Taxes

The Companies file consolidated federal income tax returns with their respective eligible subsidiary companies. Liberty Fire, Montgomery, M&B, and EICOW each file separate federal income tax returns. Pursuant to intercompany federal income tax allocation agreements, net operating losses and tax credits generated by certain subsidiaries and used to reduce the consolidated tax liability are reimbursed based on separate-return calculations. Intercompany tax balances are settled quarterly. Provision is made, where applicable, for taxes on foreign branch operations.

Total federal and foreign income taxes paid (recovered) were (\$22,541) and \$16,497 in 2001 and 2000, respectively. The amount of federal income taxes incurred and available for recoupment in the event of future net losses is \$8,255 for the current year and \$13,105 for the first preceding year. EICOW has net operating losses available for carryforward of approximately \$294 million, expiring in 2002 through 2018. LMHC and Subsidiaries have net operating losses available for carryforward of approximately \$844 million, expiring in 2020 and 2021.

Federal income taxes incurred for financial statement purposes are provided based upon the manner in which income and deductions are reported for tax purposes. The Companies' income tax expense differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes in 2001, principally due to revisions to estimates and the creation of net operating loss carryforwards; and in 2000, principally due to the effects of tax-exempt interest, dividends-received deductions and revisions to estimates.

securities. At December 31, 2001 and 2000, assets of the Plans totaling \$2,000,255 and \$2,301,358, respectively, were held in separate accounts of Liberty Life Assurance Company of Boston ("Liberty Life").

The Companies also provide certain health care and life insurance benefits ("postretirement") for retired employees. Substantially all employees may become eligible for these benefits if they reach retirement age and have ten years of service working for the Companies. Alternatively, retirees may elect certain prepaid health care benefit plans. Life insurance benefits are based upon a participant's final compensation subject to the plan maximum.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

A summary of assets, obligations and assumptions of the Plans and postretirement benefits are as follows at December 31, 2001 and 2000:

	Pension		Postretirement	
	2001	2000	2001	2000
Change in benefit obligation				
Benefit obligation at beginning of year	\$1,700,837	\$1,535,834	\$ 288,548	\$ 276,755
Eligibility costs	74,860	64,466	10,836	7,351
Interest cost	124,425	117,995	20,362	20,338
Amendments	60,842	25,580	(6,500)	(931)
Actuarial loss	136,246	66,245	23,134	5,340
Other	28,824	-	7,539	2,994
Benefits paid	(89,042)	(109,283)	(25,990)	(23,299)
Benefit obligation at end of year	\$2,036,992	\$1,700,837	\$ 317,929	\$ 288,548
Change in plan assets				
Fair value of plan assets				
at beginning of the year	\$2,434,278	\$2,544,049	\$ 24,800	\$ 25,026
Actual return on plan assets	(194,958)	4,230	(791)	1,674
Other	29,524	(1,919)	-	-
Employer contribution	-	-	24,159	21,399
Benefits paid	(85,620)	(106,266)	(25,990)	(23,299)
Administrative expense	(8,879)	(5,816)	-	-
Fair value of plan assets at end of the year	\$2,174,345	\$2,434,278	\$ 22,178	\$ 24,800
Reconciliation of prepaid/(accrued)				
Funded status of the plan	\$ 137,353	\$ 733,441	\$(295,751)	\$(261,558)
Unrecognized net (gain)/loss	411,557	(652,892)	30,782	5,144
Unrecognized prior service cost	49,681	-	(6,539)	(504)
Unrecognized net transition (asset)/obligation	(666,284)	(104,442)	112,925	124,124
Net amount recognized	\$ (67,693)	\$ (23,893)	\$(158,583)	\$(132,794)
Components of net periodic benefit cost for fiscal year				
Eligibility costs	74,860	64,466	10,836	\$ 7,351
Interest cost	124,425	117,995	20,362	20,338
Special termination benefit charges	-	-	-	803
Expected return on plan assets	(187,603)	(142,047)	(1,984)	(2,065)
Amortization of unrecognized:				
Net (gain)/loss	(325)	(24,843)	21	1
Prior service cost	-	1,720	(465)	(31)
Net transition (asset)/obligation	1,370	(3,922)	11,279	11,304
Net periodic pension cost	\$ 12,727	\$ 13,369	\$ 40,049	\$ 37,701
Weighted-average assumptions				
Discount rate	7.00%	7.25%	7.00%	7.25%
Expected return on plan assets	9.00%	9.00%	7.15%	7.15%
Rate of compensation increase	5.20%	5.60%	-	-

The amount of the benefit obligation for non-vested employees was \$39,904 and \$28,444 at December 31, 2001 and 2000, respectively. The accumulated postretirement benefit obligation for non-vested employees was \$107,984 and \$91,318 at December 31, 2001 and 2000, respectively.

The health care cost trend rates were 6.75% in 2001 and 7.75% in 2000 respectively, graded to 5.00% in 2003. Health care cost trend rate assumptions have a material impact on the postretirement benefit obligation. An assumed change in health care cost trend rates by a one percentage point increase or decrease in each year would impact the postretirement benefit obligation as of December 31, 2001, by an increase of \$29,642 or a decrease of \$27,077 and the estimated eligibility cost and interest cost components of the net periodic postretirement benefit cost for 2001 by an increase of \$1,982 or a decrease of \$1,857.

(b) Thrift-Incentive Plan

The Companies sponsor defined contribution savings plans for employees who meet certain eligibility requirements. During 2001 and 2000, employees were permitted to contribute a percentage of their annual compensation on a combined before-tax and after-tax basis, subject to certain limitations imposed by the Tax Reform Act of 1986. The Companies made matching contributions of \$57,000 and \$54,000 in 2001 and 2000, respectively.

(c) Other Compensation Plans

The Companies provide various performance based compensation plans to employees meeting the participation requirements of the respective plans. Related compensation is determined in accordance with plan formulas.

Notes to Combined Statutory Financial Statements

(dollars in thousands)

(10) Commitments and Contingent Liabilities

The Companies periodically purchase annuity contracts from various life insurance companies to settle claims. When a contract is purchased, the corresponding loss reserve is eliminated. The primary liability for future claim payments resides with the life insurance company, but in certain instances, the Companies remain contingently liable in the event the life insurer is unable to meet its obligation. These annuities were primarily purchased from Liberty Life. At December 31, 2001 and 2000, the contingent liabilities amounted to \$668,423 and \$591,586, respectively, and represent the statutory reserves of the annuities as reported by the issuing companies.

On October 3, 2001, the Companies received notification of the insolvency of the Reliance Insurance Group. It is expected the insolvency will result in a gross guaranty fund assessment against the Companies of approximately \$104,000 which was charged to operations in 2001 and was offset by future premium tax credits and policy surcharges of \$44,000.

At December 31, 2001, the Companies had commitments to purchase various mortgage backed securities settling in 2002, at a cost of \$725,716 with a fair market value of \$720,867.

At December 31, 2001, the Companies had unfunded capital commitments to private equity partnerships of \$609,500.

The Companies lease certain office facilities and equipment from others under operating leases expiring in various years through 2009. Rental expense amounted to \$149,700 and \$131,968 for the years ended December 31, 2001 and 2000, respectively. Future minimum rental payments under non-cancelable leases with terms in excess of one year are estimated to be, \$180,393 for 2002, \$160,278 for 2003, \$132,960 for 2004, \$95,712 for 2005, and \$100,134 for 2006 and thereafter. It is expected that as leases expire they will be replaced.

In 2001, the Companies entered into a sale-leaseback agreement with an unrelated party for certain equipment, under a thirteen month lease period with monthly renewal options to a maximum of sixty months. The Companies sold non-admitted assets with a book value of \$88,090 and received cash in the amount of \$125,502. The transaction resulted in a deferred gain of \$37,412 and an increase to unassigned surplus of \$88,090.

During 2001, the Companies sold premiums receivable over 90 days past due totaling \$74,831, net of valuation allowance, to LMGI for proceeds of \$63,961, representing the estimated fair market value of the related asset. The transaction was completed without recourse. The Companies realized an increase in surplus equal to the proceeds received and recorded a loss on the sale in the amount of \$10,870. Concurrent with the transaction, LMGI entered into a premiums receivable swap financial arrangement with a third party, whereby LMGI received \$75,000 in cash for the discounted non-admitted premiums receivable.

Liberty Mutual guarantees the obligations of Liberty Life on insurance policies and contracts issued.

The Companies guarantee the performance of certain affiliates' obligations under various credit facilities. The total facilities had outstanding balances of \$349,249 and \$335,592 (\$600,000 total revolving credit facility and \$300,000 backup line of credit facility) as of December 31, 2001 and 2000, respectively.

Various lawsuits against the Companies have arisen in the normal course of business. Contingent liabilities arising from litigation, income taxes and other matters are not considered material in relation to the financial position of the Companies.

(11) Unusual or Infrequent Items

The Companies have material exposure to losses arising from the terrorist attacks of September 11, 2001. The exposure arises from property, workers compensation, surety and reinsurance contracts written by member companies of the Liberty Mutual Group. Although uncertainty about the final loss amount still exists, the losses are reasonably estimable and such estimate has been recorded. The Companies believe that their reinsurers are financially sound and that reinsurance collectibility is not a significant issue or concern. The Liberty Mutual Group, including international subsidiaries, recognized a pretax loss, net of reinsurance, of approximately \$500,000, with \$167,000 being recognized directly by the Companies.

Report of Management

The Boards of Directors
Liberty Mutual Insurance Company
Liberty Mutual Fire Insurance Company
Employers Insurance Company of Wausau

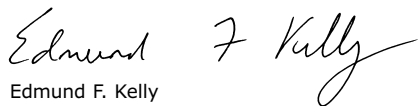
The accompanying combined statutory financial statements and related information contained in this annual report are the responsibility of management and have been prepared in conformity with accounting practices prescribed or permitted by insurance regulatory authorities. These combined statutory financial statements include amounts that are based on management's estimates and judgments, particularly our reserves for losses and loss adjustment expenses. We believe that these combined statutory financial statements present fairly the Companies' financial position and results of operations and that other information contained in the annual report is consistent with the combined statutory financial statements.

We maintain and rely on a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded and transactions are properly authorized and recorded. We continually monitor these internal accounting controls, modifying and improving them as business conditions and operations change. Our internal audit department also independently reviews and evaluates these controls. We believe our systems of internal accounting controls provide reasonable assurance that errors or irregularities that would be material to the combined statutory financial statements are prevented or detected in the normal course of business.

Our independent auditors, Ernst & Young LLP, have audited the combined statutory financial statements and

expressed their opinion on the fairness of these combined statutory financial statements. Their audit provides an independent, objective review of our combined statutory financial statements. They review our internal controls and procedures, perform tests of accounting records and conduct other auditing procedures as they consider necessary to comply with auditing standards generally accepted in the United States.

The Audit Committee of the Board of Directors, comprised solely of outside directors, oversees management's discharge of its financial reporting responsibilities. The Audit Committee meets periodically with management, our internal auditors and representatives from Ernst & Young LLP to discuss auditing, financial reporting and internal control matters. Both our internal audit department and Ernst & Young LLP have access to the Audit Committee without management's presence.



Edmund F. Kelly
Chairman, President and Chief Executive Officer



J. Paul Condrin, III
Senior Vice President and Chief Financial Officer

Report of Independent Auditors

The Boards of Directors
Liberty Mutual Insurance Company
Liberty Mutual Fire Insurance Company
Employers Insurance Company of Wausau

We have audited the accompanying combined statutory balance sheets of Liberty Mutual Insurance Companies (the Companies) as of December 31, 2001 and 2000, and the related combined statutory statements of income, changes in statutory surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Companies' management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described in Note 1 to the financial statements, the Companies present their financial statements in conformity with accounting practices prescribed or permitted by the insurance departments of the states in which the individual companies are domiciled, which practices differ from accounting principles generally accepted in the United States. The variances between such practices and

accounting principles generally accepted in the United States also are described in Note 1.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States, the combined financial position of Liberty Mutual Insurance Companies at December 31, 2001 and 2000, or the combined results of their operations or their cash flows for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Liberty Mutual Insurance Companies at December 31, 2001 and 2000, and the combined results of their operations and their cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the insurance departments of the states in which the individual companies are domiciled.

As discussed in Note 1 to the financial statements, in 2001 the Companies changed various accounting policies to be in accordance with the revised NAIC Accounting Practices and Procedures Manual, as adopted by the insurance departments of the states in which the individual companies are domiciled.

Boston, Massachusetts
February 15, 2002

