**Management's Discussion & Analysis of**
**Financial Condition and Results of Operations**

# Quarter Ended June 30, 2006

*Management's Discussion & Analysis of Financial Condition and Results of Operations*

The following discussion highlights significant factors influencing results of operations and changes in financial position of Liberty Mutual Holding Company Inc., the parent corporation of the Liberty Mutual Group of companies (the "Company" or "LMG"), for the three and six months ended June 30, 2006 and 2005. This Management's Discussion & Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with the Company's 2005 Annual Report, Second Quarter 2006 Consolidated Financial Statements (unaudited), Second Quarter 2006 Financial Supplement and First Quarter MD&A, located on the Company's Investor Relations web site at www.libertymutual.com/investors. The Company's discussions related to net income are presented on an after-tax GAAP basis. All other discussions are presented on a pre-tax GAAP basis, unless otherwise noted.

## Index


| | Page |
|---|---|
| Cautionary Statement Regarding Forward-Looking Statements | 3 |
| Executive Summary | 4 |
| Consolidated Results of Operations | 7 |
| Review of Financial Results by Business Unit | |
| Personal Market | 14 |
| Commercial Markets | 17 |
| Agency Markets | 21 |
| International | 25 |
| Corporate and Other | 29 |
| Investments | 32 |
| Liquidity and Capital Resources | 38 |
| Critical Accounting Policies | 41 |
| About the Company | 46 |

**Cautionary Statement Regarding Forward-Looking Statements**

This report contains forward-looking statements that are intended to enhance the reader's ability to assess the Company's future financial and business performance. Forward-looking statements include, but are not limited to, statements that represent the Company's beliefs concerning future operations, strategies, financial results or other developments, and contain words and phrases such as "may," "expects," "should," "believes," "anticipates," "estimates," "intends" or similar expressions. Because these forward-looking statements are based on estimates and assumptions that are subject to significant business, economic and competitive uncertainties, many of which are beyond the Company's control or are subject to change, actual results could be materially different.

In particular, the sufficiency of the Company's reserves for (i) asbestos, (ii) environmental, and (iii) toxic tort (i.e., claims that arise primarily from exposure to chemical or other hazardous substances, including welding rod and silica related claims ((i), (ii), and (iii) together "A&E"), as well as its results of operations, financial condition and liquidity, to the extent impacted by the sufficiency of the Company's A&E reserves, are subject to a number of potential adverse developments including adverse developments involving A&E claims and the related level and outcome of litigation, the willingness of parties, including the Company, to settle disputes, the interpretation of aggregate policy coverage limits, the Company's ability to recover reinsurance for A&E and other claims, the legal, economic, regulatory, and legislative environments, and their impact on the future development of A&E claims, and the impact of bankruptcies of various asbestos producers and related peripheral businesses.

Some of the other factors that could cause actual results to differ include, but are not limited to, the following: the Company's inability to obtain price increases due to competition or otherwise; the performance of the Company's investment portfolios, which could be adversely impacted by unanticipated developments in U.S. and global financial markets, interest rates and rates of inflation; weakening U.S. and global economic conditions; insufficiency of, or changes in, loss reserves; the occurrence of catastrophic events, both natural and man-made, including terrorist acts, with a severity or frequency exceeding the Company's expectations; exposure to, and adverse developments involving, environmental claims and related litigation; the impact of claims related to exposure to potentially harmful products or substances, including, but not limited to, lead paint, silica and other potentially harmful substances; adverse changes in loss cost trends, including inflationary pressures in medical costs and auto and home repair costs; developments relating to coverage and liability for mold claims; the effects of corporate bankruptcies on surety bond claims; adverse developments in the cost, availability and/or ability to collect reinsurance; the ability of the Company's subsidiaries to pay dividends to the Company; adverse results or other consequences from legal proceedings; the impact of regulatory investigations or reforms, including governmental actions regarding the compensation of brokers and agents and the purchase and sale of nontraditional products and related disclosures; unusual loss activity resulting from adverse weather conditions, including storms, hurricanes, hail, snowfall and winter conditions; repatriation of foreign earnings; judicial expansion of policy coverage and the impact of new theories of liability; the impact of legislative actions, including Federal and state legislation related to asbestos liability reform; larger than expected assessments for guaranty funds and mandatory pooling arrangements; a downgrade in the Company's claims-paying and financial strength ratings; the loss or significant restriction on the Company's ability to use credit scoring in the pricing and underwriting of Personal Lines policies; and amendments and changes to the risk-based capital requirements. The Company's forward-looking statements speak only as of the date of this report or as of the date they are made and should be regarded solely as the Company's current plans, estimates and beliefs. For a detailed discussion of these and other cautionary statements, visit the Company's Investor Relations web site at www.libertymutual.com/investors. The Company undertakes no obligation to update these forward-looking statements.

**EXECUTIVE SUMMARY**

*The following highlights do not address all of the matters covered in the other sections of Management's Discussion & Analysis of Financial Condition and Results of Operations or contain all of the information that may be important to the investing public. This summary should be read in conjunction with the other sections of Management's Discussion & Analysis of Financial Condition and Results of Operations and the Company's unaudited financial statements.*

**Three Months Ended June 30, 2006 - Consolidated Results of Operations**

- Revenues for the three months ended June 30, 2006 were $6.050 billion, an increase of $760 million or 14.4% over the same period in 2005.
- Pre-tax income for the three months ended June 30, 2006 was $483 million, a decrease of $147 million or 23.3% from the same period in 2005. Results in the period include realized capital gains of $44 million, a decrease of $141 from the same period in 2005.
- Net income for the three months ended June 30, 2006 was $323 million, a decrease of $177 million or 35.4% from the same period in 2005.
- Cash flow from operations for the three months ended June 30, 2006 was $1.012 billion, an increase of $123 million or 13.8% over the same period in 2005.
- The combined ratio before catastrophes[1], net incurred losses attributable to prior years[2] and discount accretion for the three months ended June 30, 2006 was 94.5%, a decrease of 0.6 points from the same period in 2005. Including the impact of catastrophes, net incurred losses attributable to prior years and discount accretion, the Company's combined ratio increased 1.9 points over 2005 to 101.0% in 2006.

**Six Months Ended June 30, 2006 - Consolidated Results of Operations**

- Revenues for the six months ended June 30, 2006 were $11.498 billion, an increase of $1.237 billion or 12.1% over the same period in 2005.
- Pre-tax income for the six months ended June 30, 2006 was $887 million, a decrease of $148 million or 14.3% from the same period in 2005. Results in the period include realized capital gains of $69 million, a decrease of $137 million from the same period in 2005.
- Net income for the six months ended June 30, 2006 was $615 million, a decrease of $281 million or 31.4% from the same period in 2005.
- Cash flow from operations for the six months ended June 30, 2006 was $1.624 billion[3], a decrease of $123 million or 7.0% from the same period in 2005.
- The combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion for the six months ended June 30, 2006 was 95.3%, a decrease of 0.7 points from the same period in 2005. Including the impact of catastrophes, net incurred losses attributable to prior years and discount accretion, the Company's combined ratio increased 1.4 points over 2005 to 100.5% in 2006.

---

[1] Catastrophes include all current and prior year catastrophe losses related to the Company's insurance lines and exclude losses related to the Company's reinsurance assumed lines (assumed voluntary reinsurance and reinsurance assumed through Lloyd's Syndicate 4472) except for losses related to the events of September 11, 2001, hurricanes Charley, Frances, Ivan and Jeanne ("2004 hurricanes") and hurricanes Katrina, Rita and Wilma ("2005 hurricanes"). Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums. After-tax amounts are presented net of a 35% marginal tax rate. All tables within this document conform to this presentation.

[2] Net incurred losses attributable to prior years is defined as incurred losses attributable to prior years (excluding prior year losses related to natural catastrophes and the events of September 11, 2001) including both earned premium attributable to prior years and amortization of retroactive reinsurance gains and excluding discount accretion.

[3] Cash flow from operations for the first quarter of 2006 was restated to reflect a reclassification of $114 million from financing to operations.

**Financial Condition as of June 30, 2006**

- Total assets were $81.839 billion as of June 30, 2006, an increase of $3.015 billion or 3.8% over December 31, 2005.
- Policyholders' equity was $8.729 billion as of June 30, 2006, a decrease of $129 million or 1.5% from December 31, 2005.
- Statutory surplus as regards policyholders for the combined operations of Liberty Mutual Insurance Company ("LMIC") and its U.S. affiliates was $10.157 billion, an increase of $288 million or 2.9% over December 31, 2005.
- The consolidated debt-to-capital ratio including accumulated other comprehensive income ("AOCI") as of June 30, 2006 was 23.5%, an increase of 0.1 points over December 31, 2005. Excluding AOCI, the consolidated debt-to-capital ratio was 22.8%, a decrease of 1.4 points from December 31, 2005.

**Other 2006 2nd Quarter Highlights**

***Rating Actions***

- On May 2, 2006, Moody's Investors Service confirmed its A2 insurer financial strength rating on LMIC and its related property and casualty companies, Baa2 rating on LMIC's surplus notes and Baa3 rating on Liberty Mutual's senior unsecured notes. The outlook for all of these ratings was revised to stable from negative.
- On May 9, 2006, Standard & Poor's Ratings Services affirmed its BBB counterparty credit and senior debt ratings on Liberty Mutual Group, Inc ("LMGI") and affirmed its A counterparty credit and financial strength ratings on LMIC and its related insurance company subsidiaries. The outlook for these ratings is stable.

***Acquisitions***

- On June 16 2006, Liberty Mutual signed an agreement with Sert Holding A.S. to acquire a majority interest in Seker Sigorta A.S., a mid-sized property and casualty insurer located in Turkey. The transaction is subject to regulatory approval and is expected to close in the fourth quarter of 2006.

## Other

### *Legal and Regulatory Matters*

- In May and July of 2006, the Company was named in three separate civil actions filed by the Attorneys General for the States of Connecticut, New York and Illinois. These suits arise from the ongoing investigation of sales practices within the insurance industry. The complaints contain allegations concerning three distinct matters: contingent commissions; reinsurance brokering; and improper quotations. The New York complaint alleges claims for fraudulent business practices, anti-competitive behavior, common law fraud, unjust enrichment and inducement of breach of fiduciary duty. In its lawsuit, New York seeks: disgorgement of the alleged illegal profits; restitution to injured policyholders; and damages, including punitive and treble damages. The Connecticut complaint alleges claims for breach of the Connecticut antitrust act and unfair trade practices and seeks remedies similar to those sought by New York. The Illinois complaint alleges the Company committed unfair and deceptive acts in violation of the Illinois Consumer Fraud Act and seeks restitution remedies similar to those sought by New York. In August 2005, the Company was named in the Insurance Brokerage Antitrust Litigation filed in the U.S. District Court of New Jersey. That suit seeks monetary and injunctive relief. The Company believes that it has substantial defenses to these pending suits and intends to defend each of the actions vigorously.

  Since 2004, the Company has also received subpoenas and requests for information from other insurance and governmental enforcement authorities as part of the on-going investigation of the insurance industry. As the sixth largest property and casualty insurer in the United States based on 2005 direct written premium, the Company expects that it may receive additional subpoenas or requests for information and could be named in additional civil suits as the industry investigations continue.

### *Sale of Securities*

- On July 13, 2006, the Company recognized a gain of approximately $235 million on the sale of a restricted equity holding, which will be included in third quarter 2006 results.

## CONSOLIDATED RESULTS OF OPERATIONS

The Company has identified consolidated pre-tax operating income ("PTOI") and net written premium as non-GAAP financial measures. PTOI is defined by the Company as net income excluding net realized gains (losses), Federal and foreign income taxes, extraordinary items, discontinued operations and cumulative effects of changes in accounting principles. PTOI is considered by the Company to be an appropriate indicator of underwriting and operating results and is consistent with the way the Company internally evaluates performance, except that limited partnership results recognized on the equity method are not included in internal PTOI. Net realized investment gains (losses) are significantly impacted by both discretionary and economic factors and are not necessarily indicative of operating results. Federal and foreign income taxes are significantly impacted by permanent differences and valuation allowances. References to "direct written premium" represent the amount of premium recorded for policies issued during a fiscal period excluding assumed reinsurance and ignoring the effects of ceded reinsurance. References to "net written premium" represent the amount of premium recorded for policies issued during a fiscal period including audits, retrospectively rated premium related to loss sensitive policies, and assumed premium, less ceded premium. Assumed and ceded reinsurance premiums include premium adjustments for reinstatement of coverage when a loss has used some portion of the reinsurance provided, generally under catastrophe treaties ("reinstatement premium"). In addition, the majority of workers compensation premium is adjusted to the "booked as billed" method through the Corporate & Other segment. "Premium earned," which is the portion of premium that applies to the expired part of the policy period, is a GAAP measure. The Company believes that net written premium is a performance measure useful to investors as it generally reflects current trends in the Company's sale of property and casualty insurance products.

The Company's discussions related to net income are presented on an after-tax GAAP basis. All other discussions are presented on a pre-tax GAAP basis, unless otherwise noted.

Effective January 1, 2006, the Company changed its methodology for allocation of corporate expenses and investment income. The effects of the change are immaterial to the results of the Strategic Business Units ("SBUs"). Prior period results have not been restated.

### *(1) Overview – Consolidated*

Consolidated net written premium by significant line of business was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Private passenger automobile | $1,453 | $1,434 | 1.3% | $2,770 | $2,713 | 2.1% |
| Workers compensation | 1,013 | 862 | 17.5 | 2,453 | 2,104 | 16.6 |
| Homeowners | 465 | 417 | 11.5 | 817 | 743 | 10.0 |
| Commercial multiple peril / Fire | 384 | 364 | 5.5 | 776 | 701 | 10.7 |
| LIU[1] reinsurance | 303 | 198 | 53.0 | 687 | 469 | 46.5 |
| Commercial automobile | 272 | 273 | (0.4) | 557 | 562 | (0.9) |
| International local businesses[2] | 270 | 231 | 16.9 | 555 | 484 | 14.7 |
| General liability | 235 | 174 | 35.1 | 431 | 362 | 19.1 |
| LIU[1] first party[3] | 151 | 52 | 190.4 | 276 | 126 | 119.0 |
| LIU[1] third party[3] | 122 | 113 | 8.0 | 232 | 207 | 12.1 |
| Group disability | 100 | 88 | 13.6 | 198 | 173 | 14.5 |
| Surety | 61 | 52 | 17.3 | 118 | 99 | 19.2 |
| Assumed voluntary reinsurance | 27 | 21 | 28.6 | 46 | 48 | (4.2) |
| Other | 488 | 143 | NM | 738 | 288 | 156.3 |
| Total net written premium | $5,344 | $4,422 | 20.9% | $10,654 | $9,079 | 17.3% |

1 Liberty International Underwriters (LIU).
2 Local international businesses, selling small commercial and other personal lines products locally; excluding private passenger automobile.
3 In the first quarter of 2006, LIU reclassified its inland marine specialty business to LIU first party from LIU third party.
NM = Not Meaningful (represents increases or decreases greater than 200%, or changes from a net gain to a net loss, or vice versa).

Consolidated net written premium by strategic business unit was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Personal Market | $1,404 | $1,363 | 3.0% | $2,599 | $2,524 | 3.0% |
| Commercial Markets[1] | 929 | 812 | 14.4 | 2,123 | 1,869 | 13.6 |
| Agency Markets [1] | 1,462 | 1,351 | 8.2 | 3,047 | 2,838 | 7.4 |
| International | 1,217 | 923 | 31.9 | 2,491 | 1,934 | 28.8 |
| Corporate and Other[2] | 332 | (27) | NM | 394 | (86) | NM |
| Total net written premium | $5,344 | $4,422 | 20.9% | $10,654 | $9,079 | 17.3% |

1 Effective July 2, 2005, the results of Wausau and Surety (formerly included Commercial Markets) are included in Agency Markets due to an organizational change. Prior periods have been restated to reflect this change.
2 Includes Individual Life operations.
NM = Not Meaningful

Net written premium for the three and six months ended June 30, 2006 was $5.344 billion and $10.654 billion, respectively, an increase of $922 million and $1.575 billion over the same periods in 2005. Significant changes by major line of business include:

- Private passenger automobile net written premium increased $19 million and $57 million in the quarter and year-to-date, respectively. The increase in both periods is primarily due to organic growth in the Company's international local business operations in Latin America and Europe, partially offset by a decrease in Agency Markets net written premium, due to lower customer retention and a decrease in new business. Personal Market net written premium also decreased in both periods due primarily to lower average premium per policy, partially offset by a 2.4% increase in voluntary policies in force over the same period in 2005.
- Workers compensation net written premium increased $151 million and $349 million in the quarter and year-to-date, respectively. The increase in both periods reflects new business growth and improved customer retention in Commercial Markets' Business Market and National Market segments, new business growth in Wausau and Agency Markets' Regional Companies segment, and increased exposure on existing accounts at Summit. Both periods also reflect the non-renewal of a ceded reinsurance program, which increased Agency Markets' and Commercial Markets' net written premium. These increases were partially offset by modest rate decreases in most states, mandated rate decreases in Florida and a significant decline in California rates due to workers compensation reform.
- Homeowners net written premium increased $48 million and $74 million in the quarter and year-to-date, respectively, primarily due to rate increases and a 3.8% increase in policies in force in Personal Market over the same periods in 2005. The increase in policies in force reflects strong customer retention and new business growth.
- Commercial multiple peril / fire net written premium increased $20 million and $75 million in the quarter and year-to-date, respectively. The increase is primarily due to new business growth, rate increases and strong customer retention in Commercial Markets and increased customer retention in Wausau.
- LIU reinsurance increased $105 million and $218 million in the quarter and year-to-date, respectively, primarily due to rate increases in the property lines of business.
- International local businesses net written premium (excluding private passenger automobile net written premium) increased $39 million and $71 million in the quarter and year-to-date, respectively. The increase in both periods reflects organic growth in Latin America, primarily in Brazil and Venezuela.
- General liability net written premium increased $61 million and $69 million in the quarter and year-to-date, respectively, primarily due to improved customer retention and new business growth in Commercial Markets (primarily a large National Market account) and Agency Markets, partially offset by rate decreases due to a more competitive environment.

- LIU first party net written premium increased $99 million and $150 million in the quarter and year-to-date, respectively, primarily due to the establishment of an inland marine specialty program in the third quarter of 2005.
- Other net written premium increased $345 million and $450 million in the quarter and year-to-date, respectively. The increase primarily reflects growth in the immediate annuity and structured settlement lines.

More detailed explanations of the changes in net written premium by line of business are included in the related discussion of financial results for each strategic business unit.

For a fuller description of the Company's business operations, products and distribution channels, please visit the Company's Investor Relations web site at www.libertymutual.com/investors.

***Results of Operations – Consolidated***

| $ in Millions | Three Months Ended June 30, 2006 | 2005 | Change | Six Months Ended June 30, 2006 | 2005 | Change |
|---|---|---|---|---|---|---|
| Revenues | $6,050 | $5,290 | 14.4% | $11,498 | $10,261 | 12.1% |
| | | | | | | |
| PTOI before catastrophes, net incurred losses attributable to prior years and discount accretion | $741 | $609 | 21.7% | $1,295 | $1,085 | 19.4% |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | (17) | - | NM | (41) | - | NM |
| - All other | (170) | (86) | 97.7 | (245) | (123) | 99.2 |
| Net incurred losses attributable to Prior years: | | | | | | |
| - Asbestos | - | (2) | (100.0) | (1) | (2) | (50.0) |
| - All other[2] | (87) | (48) | 81.3 | (134) | (74) | 81.1 |
| Discount accretion[3] | (28) | (28) | - | (56) | (57) | (1.8) |
| Pre-tax operating income | 439 | 445 | (1.3) | 818 | 829 | (1.3) |
| Realized investment gains, net | 44 | 185 | (76.2) | 69 | 206 | (66.5) |
| Federal and foreign income tax (expense) | (160) | (127) | 26.0 | (272) | (127) | 114.2 |
| Discontinued operations, net of tax | - | (3) | (100.0) | - | (12) | (100.0) |
| Net income | $323 | $500 | (35.4%) | $615 | $896 | (31.4%) |

1 Catastrophes include all current and prior year catastrophe losses related to the Company's insurance lines and exclude losses related to the Company's reinsurance assumed lines (assumed voluntary reinsurance and reinsurance assumed through Lloyd's Syndicate 4472) except for losses related to the events of September 11, 2001, the 2004 hurricanes and the 2005 hurricanes. Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.

2 Net of earned premium attributable to prior years of $18 million and $34 million for the three and six months ended June 30, 2006, respectively, and zero and $8 million for the comparable periods of 2005. Net of amortization of deferred gains on retroactive reinsurance of $15 million and $31 million for the three and six months ended June 30, 2006, respectively, and $46 million and $58 million for the comparable periods of 2005.

3 The Company discounts the long-term indemnity portion of its workers compensation claims as permitted by insurance regulations. The discount accretion on these claims is included in underwriting results as the loss reserves for voluntary and involuntary business accrete to nominal value. Asbestos structured settlements are discounted at 4.5%.

NM = Not Meaningful

Revenues for the three and six months ended June 30, 2006 were $6.050 billion and $11.498 billion, respectively, an increase of $760 million and $1.237 billion over the same periods in 2005. The major components of revenues include net premium earned, net investment income, net realized investment gains/losses and fee and other revenues.

Net premium earned for the three and six months ended June 30, 2006 was $5.180 billion and $9.846 billion, respectively, an increase of $848 million and $1.309 billion over the same periods in 2005. The increases in both periods are primarily due to new business growth and improved customer retention across most lines of business, partially offset by rate decreases in non-property commercial lines due to a more competitive environment.

Net investment income for the three months and six months ended June 30, 2006 was $634 million and $1.194 billion, respectively, an increase of $41 million and $46 million over the same periods in 2005. The increase in net investment income in both periods reflects higher interest income due to a larger invested asset base and continued strong cash flow from operations, as well as an increase in limited partnership and limited liability company income of $23 million and $12 million in the quarter and year-to-date, respectively, related to both private equity and energy investments. Partially offsetting these increases was a decrease in dividend income resulting from the termination of an equity investment program in the second quarter of 2005 and the Company's lower overall domestic book yield. The decrease in the Company's overall domestic book yield was due in part to the increased investment in tax-exempt

securities in the second half of 2005 and continuing into 2006. The lower portfolio yield was the primary factor in constraining overall growth in investment income compared to 2005.

Net realized investment gains for the three months and six months ended June 30, 2006 were $44 million and $69 million, respectively, a decrease of $141 million and $137 million from the same periods in 2005. The decrease in both periods primarily reflects lower fixed maturity gains (primarily due to 2005 gains associated with the sale of targeted taxable securities as part of a strategic realignment that did not recur in 2006) and other market gains (primarily due to energy gains realized in 2005 that did not recur in 2006), partially offset by higher year-to-date equity gains. These results were also impacted by a $10 million and $24 million increase in impairment losses for the three months and six months ended June 30, 2006, respectively, primarily due to the Company's recognition of impairments on securities previously anticipated to be held to recovery and credit events affecting individual securities.

Fee and other revenues for the three and six months ended June 30, 2006 were $192 million and $389 million, respectively, an increase of $12 million and $19 million over the same periods in 2005. The increase in both periods is primarily due to lease income earned from a commercial office building acquired in January 2006, partially offset by lower fee revenues associated with the Company's involuntary market servicing carrier operations due to lower premium volumes.

Claims, benefits and expenses for the three and six months ended June 30, 2006 were $5.567 billion and $10.611 billion, respectively, an increase of $907 million and $1.385 billion over the same periods in 2005. The increase in both periods reflects an increase in sales and service personnel costs in Personal Market, higher catastrophe losses across the Company's SBUs, and an increase in incurred losses attributable to prior years[1], partially offset by lower variable incentive compensation expenses. Catastrophe losses increased $163 million and $226 million in the quarter and year-to-date, respectively, due to higher 2006 storm activity and additional incurred losses on the 2005 hurricanes. Incurred losses attributable to prior years increased by $55 million and $84 million in the quarter and year-to-date, respectively, primarily due to additional ex-catastrophe losses incurred in liability reinsurance. The remainder of the increase reflects business growth and general cost increases.

---

[1] Incurred losses attributable to prior years is defined as net incurred losses attributable to prior years (excluding natural catastrophes and the events of September 11, 2001), excluding earned premium attributable to prior years and including discount accretion and amortization of retroactive reinsurance gains.

| CONSOLIDATED | Three Months Ended June 30, 2006 | 2005 | Change (Points) | Six Months Ended June 30, 2006 | 2005 | Change (Points) |
|---|---|---|---|---|---|---|
| **Combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion** | | | | | | |
| Claims and claim adjustment expense ratio | 67.0% | 67.3% | (0.3) | 68.0% | 68.4% | (0.4) |
| Underwriting expense ratio | 27.2 | 27.9 | (0.7) | 27.0 | 27.6 | (0.6) |
| Dividend ratio | 0.3 | (0.1) | 0.4 | 0.3 | - | 0.3 |
| Subtotal | 94.5 | 95.1 | (0.6) | 95.3 | 96.0 | (0.7) |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | 0.4 | - | 0.4 | 0.5 | - | 0.5 |
| - All other | 3.6 | 2.1 | 1.5 | 2.7 | 1.5 | 1.2 |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other | 1.9 | 1.2 | 0.7 | 1.4 | 0.9 | 0.5 |
| Discount accretion | 0.6 | 0.7 | (0.1) | 0.6 | 0.7 | (0.1) |
| Total combined ratio[2] | 101.0% | 99.1% | 1.9 | 100.5% | 99.1% | 1.4 |

1 The Company does not typically identify catastrophe losses from assumed voluntary reinsurance and Lloyd's Syndicate 4472 in the tables above given the expected volatility associated with property-reinsurance coverage. However, due to the significant impact that the 2004 hurricanes, 2005 hurricanes and the events of September 11, 2001 had on the Company's results, these losses have been classified as catastrophes. Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.

2 The combined claim and expense ratio, expressed as a percentage, is a measure of underwriting profitability. This measure should only be used in conjunction with, and not in lieu of, underwriting income and may not be comparable to other performance measures used by the Company's competitors. The combined claim and expense ratio is computed as the sum of the following property and casualty ratios: the ratio of claims and claim adjustment expense to earned premium; the ratio to earned premium of insurance operating costs plus amortization of deferred policy acquisition costs less fee income (primarily related to the Company's involuntary market servicing carrier operations) and less installment charges; and the ratio of policyholder dividends to earned premium. Provisions for uncollectible premium and reinsurance are not included in the combined ratio.

NM = Not Meaningful

The consolidated combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion for the three and six months ended June 30, 2006 was 94.5% and 95.3%, respectively, a decrease of 0.6 and 0.7 points from the comparable periods in 2005. The decrease in both periods was due to a decrease in the underwriting expense and claims and claim adjustment expense ratios, partially offset by an increase in the dividend ratio. The decrease in the underwriting expense ratio in both periods was primarily due to lower variable incentive compensation expense and an increase in the percentage mix of International's inland marine specialty program business, which has a lower expense ratio than the Company's other lines of business. Partially offsetting these decreases in the expense ratio was an increase in sales and service personnel costs in Personal Market and a reduction in the expense reimbursement received from the Company's servicing carrier operations due to lower premium volumes. Similarly, the claims and claim adjustment expense ratio decreased in both periods, primarily due to favorable current accident year surety results and lower claims frequency trends (excluding catastrophes) in Commercial Markets' and Personal Market's auto and homeowners lines of business, partially offset by the aforementioned increase in the percentage mix of International's inland marine specialty program business, which has a higher claims and claim adjustment expense ratio than the Company's other lines of business. The decrease in the claims and claim adjustment ratio was also due in part to the re-estimation of assumed involuntary pool underwriting results. In addition, the improvement in the claims and claim adjustment ratio was partially offset by a higher loss ratio at Summit Holdings Southeast Inc. and affiliates ("Summit") due to the effects of state mandated rate decreases in Florida and higher property (excluding catastrophes) losses in Agency Markets. These decreases in both periods were partially offset by an increase in the

dividend ratio due to the re-evaluation of the estimate for dividend reserves in 2005 that did not recur in 2006.

Including the impact of catastrophes, net incurred losses attributable to prior years and discount accretion, the total combined ratio was 101.0% for the quarter and 100.5% year-to-date, an increase of 1.9 and 1.4 points, respectively, over the same periods in 2005. Catastrophe losses increased 1.9 and 1.7 points in the quarter and year-to-date, respectively, due to higher 2006 storm activity and additional incurred losses on the 2005 hurricanes. Net incurred losses attributable to prior years increased 0.7 and 0.5 points, respectively, due primarily to additional incurred losses in liability reinsurance.

PTOI for the three and six months ended June 30, 2006 was $439 million and $818 million, respectively, a decrease of $6 million and $11 million from the same periods in 2005.

Federal and foreign income tax expense for the three and six months ended June 30, 2006 was $160 million and $272 million, respectively, an increase of $33 million and $145 million over the same periods in 2005. The Company's effective tax rates for the three and six months ended June 30, 2006 were 33% and 31% respectively, compared to 20% and 12% for the same periods for 2005. The Company determines its estimated annual effective tax rate in accordance with APB Opinion No. 28. This rate is revised at the end of each successive interim period to reflect the Company's best current estimate of its annual effective tax rate. Any change in the estimated annual effective tax rate is reflected in the interim period results in which the change occurs. The increase in the Company's 2006 effective tax rate is primarily due to the reduction of the domestic valuation allowance to zero in 2005. The Company's effective tax rate differs from the Federal statutory rate of 35% principally due to tax-preferenced investment income, goodwill, and foreign taxes.

Net income for the three and six months ended June 30, 2006 was $323 million and $615 million, respectively, a decrease of $177 million and $281 million from the same periods in 2005. Results from discontinued operations in 2005 reflect a loss on the disposal of certain pension business in Spain, which was a part of the acquisition of Genesis Seguros Generales, S.A. and its subsidiary Seguros Genesis S.A. (collectively, "Genesis").

## PERSONAL MARKET

### *(1) Overview – Personal Market*

Personal Market net written premium by line of business was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Private passenger automobile | $974 | $983 | (0.9%) | $1,839 | $1,848 | (0.5%) |
| Homeowners and other | 430 | 380 | 13.2 | 760 | 676 | 12.4 |
| Total net written premium | $1,404 | $1,363 | 3.0% | $2,599 | $2,524 | 3.0% |

Net written premium for the three and six months ended June 30, 2006 was $1.404 billion and $2.599 billion, respectively, an increase of $41 million and $75 million from the same periods in 2005. The increase in both periods is a result of rate increases in the homeowners line of business and an increase in policies in force due to strong customer retention and homeowners new business growth.

Private passenger automobile net written premium for the three and six months ended June 30, 2006 was $974 million and $1.839 billion, respectively, a decrease of $9 million from the same periods in 2005. The decrease in both periods is a result of lower average written premium per policy, which reflects rate decreases, a shift in state mix, a reduction in involuntary market policies and a general improvement in the quality of the risks underwritten. Partially offsetting this decrease was a 2.4% increase in voluntary policies in force over the same period in 2005 due to strong customer retention.

Homeowners and other net written premium for the three and six months ended June 30, 2006 was $430 million and $760 million, respectively, an increase of $50 million and $84 million over the same periods in 2005. The increase is due to rate increases and a 3.8% increase in policies in force over the same period in 2005 driven by strong customer retention and new business growth.

### (2) *Results of Operations – Personal Market*

| $ in Millions | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | Change | 2006 | 2005 | Change |
| Revenues | $1,394 | $1,354 | 3.0% | $2,756 | $2,695 | 2.3% |
| | | | | | | |
| PTOI before catastrophes, net incurred losses attributable to prior years and discount accretion | $228 | $214 | 6.5% | $404 | $403 | 0.2% |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | (2) | - | NM | (13) | - | NM |
| - All other | (79) | (34) | 132.4 | (127) | (61) | 108.2 |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other[2] | - | - | - | - | 7 | (100.0) |
| Discount accretion | - | - | - | - | - | - |
| Pre-tax operating income | 147 | 180 | (18.3) | 264 | 349 | (24.4) |
| Realized investment gains, net | - | - | - | - | - | - |
| Federal and foreign income tax (expense) | (50) | (63) | (20.6) | (91) | (122) | (25.4) |
| Discontinued operations, net of tax | - | - | - | - | - | - |
| Net income | $97 | $117 | (17.1%) | $173 | $227 | (23.8%) |

1 Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.
2 Net of earned premium attributable to prior years of zero for the three and six months ended June 30, 2006, respectively, and $1 million and ($4) million for the comparable periods of 2005.
NM = Not Meaningful

Revenues for the three and six months ended June 30, 2006 were $1.394 billion and $2.756 billion, respectively, an increase of $40 million and $61 million over the same periods in 2005. The major components of revenues include net premium earned and net investment income.

Net premium earned for the three and six months ended June 30, 2006 was $1.308 billion and $2.584 billion, respectively, an increase of $29 million and $48 million over the same periods in 2005. The increase in both periods is a result of rate increases in the homeowners line of business and an increase in policies in force due to strong customer retention and homeowners new business growth.

Net investment income for the three and six months ended June 30, 2006 was $73 million and $144 million, respectively, an increase of $11 million and $13 million from the same periods in 2005. The increase in both periods reflects a higher invested asset base and cash flow from operations, partially offset by lower investment yields.

Claims, benefits and expenses for the three and six months ended June 30, 2006 were $1.247 billion and $2.492 billion, respectively, an increase of $73 million and $146 million over the same periods in 2005. The increase in both periods reflects higher 2006 catastrophe losses and an increase in sales and service personnel costs, partially offset by lower claims frequency (excluding catastrophes) in the private passenger automobile and homeowners lines of business.

| PERSONAL MARKET | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | Change (Points) | 2006 | 2005 | Change (Points) |
| **Combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion** | | | | | | |
| Claims and claim adjustment expense ratio | 61.7% | 64.2% | (2.5) | 64.2% | 66.3% | (2.1) |
| Underwriting expense ratio | 25.9 | 24.3 | 1.6 | 25.3 | 23.1 | 2.2 |
| Dividend ratio | - | - | - | - | - | - |
| Subtotal | 87.6 | 88.5 | (0.9) | 89.5 | 89.4 | 0.1 |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | 0.2 | - | 0.2 | 0.5 | - | 0.5 |
| - All other | 6.0 | 2.7 | 3.3 | 4.9 | 2.4 | 2.5 |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other | - | - | - | - | (0.3) | 0.3 |
| Discount accretion | - | - | - | - | - | - |
| Total combined ratio | 93.8% | 91.2% | 2.6 | 94.9% | 91.5% | 3.4 |

1 Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.

Personal Market's combined ratio before catastrophes and net incurred losses attributable to prior years for the three and six months ended June 30, 2006 was 87.6% and 89.5%, respectively, a decrease of 0.9 points and an increase of 0.1 points versus the same periods in 2005. The decrease in the claims and claim adjustment expense ratio in both periods reflects lower claims frequency trends (excluding catastrophes) in the auto and homeowners lines of business. The increase in the expense ratio in both periods reflects an increase in acquisition expenses primarily due to an increase in sales and service personnel costs.

Including the impact of catastrophes and net incurred losses attributable to prior years, the total combined ratio for the three and six months ended June 30, 2006 was 93.8% and 94.9%, respectively, an increase of 2.6 points and 3.4 points versus the same periods in 2005, primarily due to 2006 catastrophe activity.

PTOI for the three and six months ended June 30, 2006 was $147 million and $264 million, respectively, a decrease of $33 million and $85 million from the same periods in 2005.

Federal and foreign income tax expense for the three and six months ended June 30, 2006 was $50 million and $91 million, respectively, a decrease of $13 million and $31 million from the same periods in 2005.

Net income for the three and six months ended June 30, 2006 was $97 million and $173 million, respectively, a decrease of $20 million and $54 million from the same periods in 2005.

## COMMERCIAL MARKETS

### *(1) Overview – Commercial Markets*

Commercial Markets net written premium by market segment was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Business Market | $349 | $314 | 11.1% | $886 | $796 | 11.3% |
| National Market [1] | 290 | 273 | 6.2 | 637 | 625 | 1.9 |
| Liberty Mutual Property | 74 | 69 | 7.2 | 159 | 114 | 39.5 |
| Group Market | 100 | 88 | 13.6 | 198 | 173 | 14.5 |
| Other Markets [1] | 116 | 68 | 70.6 | 243 | 161 | 50.9 |
| Total net written premium[2] | $929 | $812 | 14.4% | $2,123 | $1,869 | 13.6% |

1 Effective January 1, 2006, Liberty Mutual Alternative Markets, included within Other Markets, was reorganized to include certain energy business that was previously included within National Market. Results for all years have been restated for this reorganization.

2 Effective July 2, 2005, the results of Wausau and Surety (formerly included in Commercial Markets) are included in Agency Markets due to an organizational change. Results for all years have been restated for this reorganization.

Commercial Markets net written premium by line of business was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Workers compensation | $447 | $405 | 10.4% | $1,186 | $1,047 | 13.3% |
| Commercial automobile | 94 | 100 | (6.0) | 207 | 220 | (5.9) |
| General liability | 147 | 102 | 44.1 | 256 | 217 | 18.0 |
| Group disability / life | 100 | 88 | 13.6 | 198 | 173 | 14.5 |
| Commercial multiple peril / Fire | 70 | 58 | 20.7 | 147 | 98 | 50.0 |
| Assumed voluntary reinsurance | 27 | 21 | 28.6 | 46 | 48 | (4.2) |
| Other | 44 | 38 | 15.8 | 83 | 66 | 25.8 |
| Total net written premium | $929 | $812 | 14.4% | $2,123 | $1,869 | 13.6% |

Net written premium for the three and six months ended June 30, 2006 was $929 million and $2.123 billion, respectively, an increase of $117 million and $254 million over the same periods in 2005. New business growth and improved customer retention across the business segments was the primary driver for the premium increases in the workers compensation, general liability (primarily a large National Market account), group disability/life and commercial multiple peril/fire lines for both periods. The commercial multiple peril/fire and assumed voluntary reinsurance lines also benefited from significant rate increases compared to 2005. In addition, the non-renewal of a ceded reinsurance program in 2006 increased Other Markets involuntary workers compensation premium. These increases were partially offset by rate decreases in all non-property lines due to a more competitive environment.

***Results of Operations – Commercial Markets***

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Revenues | $1,166 | $1,062 | 9.8% | $2,270 | $2,140 | 6.1% |
| | | | | | | |
| PTOI before catastrophes, net incurred losses attributable to prior years and discount accretion | $145 | $118 | 22.9% | $245 | $223 | 9.9% |
| Catastrophes[1] | | | | | | |
| - 2005 hurricanes | (28) | - | NM | (32) | - | NM |
| - All other | (11) | (7) | 57.1 | (19) | (10) | 90.0 |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other [2] | (9) | (22) | (59.1) | (23) | (28) | (17.9) |
| Discount accretion[3] | (21) | (21) | - | (43) | (42) | 2.4 |
| Pre-tax operating income | 76 | 68 | 11.8 | 128 | 143 | (10.5) |
| Realized investment gains, net | - | - | - | - | - | - |
| Federal and foreign income tax (expense) | (27) | (24) | 12.5 | (44) | (50) | (12.0) |
| Discontinued operations, net of tax | - | - | - | - | - | - |
| Net income[4] | $49 | $44 | 11.4% | $84 | $93 | (9.7%) |

1 The Company does not typically identify catastrophe losses from assumed voluntary reinsurance in the tables above given the expected volatility associated with property-reinsurance coverage. However, due to the significant impact that the 2005 hurricanes, 2004 hurricanes and the events of September 11, 2001 had on the Company's results, these losses have been classified as catastrophes. Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.

2 Net of earned premium attributable to prior years of ($4) million and ($3) million for the three and six months June 30, 2006, respectively, and ($9) million and zero for the comparable periods in 2005. Net of amortization of deferred gains on retroactive reinsurance of $8 million and $15 million for the three and six months ended June 30, 2006, respectively, and $21 million and $26 million for the comparable periods in 2005.

3 The Company discounts the long-term indemnity portion of its workers compensation claims as permitted by insurance regulations. The discount accretion on these claims flows through underwriting results as the loss reserves accrete to nominal value. In 2006, Commercial Markets reclassified the discount accretion related to involuntary market workers compensation long-term indemnity claims from net incurred losses attributable to prior year to discount accretion. Results for 2005 reflect this reclassification.

4 In the first quarter of 2006, the Company reclassified the pre-2004 results of Commercial Markets' assumed voluntary reinsurance business to Corporate and Other. This reclassification had no impact on 2005 results.

NM = Not Meaningful.

Revenues for the three and six months ended June 30, 2006 were $1.166 billion and $2.270 billion, respectively, an increase of $104 million and $130 million over the same periods in 2005. The major components of revenues include net premium earned, net investment income and fee and other revenue.

Net premium earned for the three and six months ended June 30, 2006 was $940 million and $1.818 billion, respectively, an increase of $104 million and $139 million over the same periods in 2005. The increase in both periods reflects the earned premium recognition of new business growth and improved customer retention, partially offset by declining rate levels over the last twelve months. In addition, the non-renewal of a ceded reinsurance program in 2006 increased involuntary workers compensation earned premium by $14 million and $28 million for the three and six months ended June 30, 2006.

Net investment income for the three and six months ended June 30, 2006 was $140 million and $276 million, respectively, an increase of $3 million and $6 million over the same periods in 2005. The increases reflect a higher invested asset base and cash flow from operations, partially offset by lower investment yields.

Fee and other revenues for the three and six months ended June 30, 2006 were $86 million and $176 million, respectively, a decrease of $3 million and $15 million from the same periods in 2005. The decrease in both periods is primarily driven by lower fee revenues associated with the Company's involuntary market servicing carrier operations due to lower premium volume. As a servicing carrier, the Company receives fee income for performing certain administrative duties for all participating involuntary pool members.

Claims, benefits and expenses for the three and six months ended June 30, 2006 were $1.090 billion and $2.142 billion, respectively, an increase of $96 million and $145 million over the same periods in 2005. The increase is driven by business growth, the non-renewal of a ceded reinsurance program and higher catastrophe losses. Catastrophe losses include additional incurred losses on the 2005 hurricanes and catastrophe activity in 2006.

| | **Three Months Ended June 30,** | | | **Six Months Ended June 30,** | | |
|---|---|---|---|---|---|---|
| **COMMERCIAL MARKETS** | **2006** | **2005** | **Change (Points)** | **2006** | **2005** | **Change (Points)** |
| **Combined ratio before catastrophes and net incurred losses attributable to prior years** | | | | | | |
| Claims and claim adjustment expense ratio | 76.4% | 79.4% | (3.0) | 78.6% | 79.7% | (1.1) |
| Underwriting expense ratio | 20.7 | 19.2 | 1.5 | 20.5 | 19.0 | 1.5 |
| Dividend ratio | 0.2 | (2.0) | 2.2 | 0.2 | (1.3) | 1.5 |
| Subtotal | 97.3 | 96.6 | 0.7 | 99.3 | 97.4 | 1.9 |
| Catastrophes[1] | | | | | | |
| - 2005 hurricanes | 3.4 | - | 3.4 | 2.0 | - | 2.0 |
| - All other | 1.3 | 1.0 | 0.3 | 1.1 | 0.6 | 0.5 |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other | 1.0 | 2.9 | (1.9) | 1.4 | 1.9 | (0.5) |
| Discount accretion | 2.5 | 2.7 | (0.2) | 2.7 | 2.8 | (0.1) |
| Total combined ratio | 105.5% | 103.2% | 2.3 | 106.5% | 102.7% | 3.8 |

1. The Company does not typically identify catastrophe losses from assumed voluntary reinsurance in the tables above given the expected volatility associated with property-reinsurance coverage. However, due to the significant impact that the 2004 hurricanes, 2005 hurricanes and the events of September 11, 2001 had on the Company's results, these losses have been classified as catastrophes. Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premium.

The Commercial Markets combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion for the three and six months ended June 30, 2006 was 97.3% and 99.3%, respectively, an increase of 0.7 and 1.9 points over the same periods in 2005. The underwriting expense ratio increased by 1.5 points in both periods due to the reduction in the expense reimbursement received from the Company's servicing carrier operations and lower ceding commissions. The lower ceding commissions reflect the non-renewal of a ceded reinsurance program. The dividend ratio increased in both periods due to the re-evaluation of the estimate for dividend reserves in 2005 that did not recur in 2006. These increases in both periods were partially offset by a lower claims and claim adjustment expense ratio due to favorable loss frequency trends. In addition, the decrease in the claims and claim adjustment ratio was also due to the re-estimation of assumed involuntary pool underwriting results.

Including the impact of catastrophes, net incurred losses attributable to prior years and discount accretion, the total combined ratio for the three and six months ended June 30, 2006 was 105.5% and 106.5%, respectively, an increase of 2.3 and 3.8 points over the same periods in 2005. Catastrophe losses increased 3.7 and 2.5 points for the three and six months ended June 30, 2006, respectively, due to additional incurred losses on the 2005 hurricanes related to assumed voluntary lines as well as increased catastrophe activity during 2006.

PTOI for the three and six months ended June 30, 2006 was $76 million and $128 million, respectively, an increase of $8 million and a decrease of $15 million versus the same periods in 2005.

Federal and foreign income tax expense for the three and six months ended June 30, 2006 was $27 million and $44 million, respectively, an increase of $3 million and a decrease of $6 million versus the same periods in 2005.

Net income for the three and six months ended June 30, 2006 was $49 million and $84 million, respectively, an increase of $5 million and a decrease of $9 million versus the same periods in 2005.

## AGENCY MARKETS

### *(1) Overview – Agency Markets*

Agency Markets net written premium by market segment was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Regional Companies | $857 | $846 | 1.3% | $1,660 | $1,631 | 1.8% |
| Wausau[1, 2] | 237 | 195 | 21.5 | 645 | 568 | 13.6 |
| Summit | 280 | 250 | 12.0 | 571 | 522 | 9.4 |
| Surety[2] | 61 | 52 | 17.3 | 118 | 99 | 19.2 |
| Other | 27 | 8 | NM | 53 | 18 | 194.4 |
| Total net written premium | $1,462 | $1,351 | 8.2% | $3,047 | $2,838 | 7.4% |

1 Includes the operations of Business Solutions Group.
2 Effective July 2, 2005, the results of Wausau and Surety (formerly included Commercial Markets) are included in Agency Markets due to an organizational change. Prior periods have been restated to reflect this change.
NM = Not Meaningful

Agency Markets net written premium by line of business was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| **Commercial Lines** | | | | | | |
| Workers compensation total: | $626 | $538 | 16.4% | $1,422 | $1,256 | 13.2% |
| - Wausau | 180 | 142 | 26.8 | 510 | 441 | 15.6 |
| - Summit | 280 | 250 | 12.0 | 571 | 522 | 9.4 |
| - All other | 166 | 146 | 13.7 | 341 | 293 | 16.4 |
| Commercial multiple peril | 290 | 286 | 1.4 | 575 | 562 | 2.3 |
| Commercial automobile | 177 | 173 | 2.3 | 349 | 342 | 2.0 |
| General liability | 68 | 53 | 28.3 | 138 | 110 | 25.5 |
| Surety | 61 | 52 | 17.3 | 118 | 99 | 19.2 |
| Other | 48 | 41 | 17.1 | 95 | 81 | 17.3 |
| Subtotal | $1,270 | $1,143 | 11.1% | $2,697 | $2,450 | 10.1% |
| **Personal Lines** | | | | | | |
| Private passenger automobile | $113 | $128 | (11.7%) | $210 | $242 | (13.2%) |
| Homeowners | 70 | 72 | (2.8) | 123 | 130 | (5.4) |
| Other | 9 | 8 | 12.5 | 17 | 16 | 6.3 |
| Subtotal | $192 | $208 | (7.7%) | $350 | $388 | (9.8%) |
| Total net written premium | $1,462 | $1,351 | 8.2% | $3,047 | $2,838 | 7.4% |

Net written premium for the three and six months ended June 30, 2006 was $1.462 billion and $3.047 billion, respectively, an increase of $111 million and $209 million over the same periods in 2005. The growth in both periods reflects an increase in workers compensation premium driven by new business growth from Wausau and the Regional Companies and increased exposure on existing accounts at Summit, partially offset by modest rate decreases in most states, mandated rate decreases in Florida and a significant decline in California rates due to workers compensation reform. The remainder of the growth is primarily driven by increased customer retention, reduced reinsurance cessions in property and casualty lines and the

non-renewal of a ceded involuntary workers compensation reinsurance program in 2006, partially offset by modest rate decreases in all lines except surety. These increases were partially offset by a decrease in personal lines net written premium due to lower customer retention and a decrease in new business.

***(2) Results of Operations – Agency Markets***

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Revenues | $1,544 | $1,415 | 9.1% | $3,023 | $2,781 | 8.7% |
| | | | | | | |
| PTOI before catastrophes, incurred losses attributable to prior years and discount accretion | $170 | $143 | 18.9% | $305 | $263 | 16.0% |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | - | - | - | (3) | - | NM |
| - All other | (62) | (9) | NM | (81) | (16) | NM |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other[2] | 14 | 6 | 133.3 | 33 | 23 | 43.5 |
| Discount accretion | (4) | (5) | (20.0) | (8) | (10) | (20.0) |
| Pre-tax operating income | 118 | 135 | (12.6) | 246 | 260 | (5.4) |
| Realized investment gains, net | - | 3 | (100.0) | - | 3 | (100.0) |
| Federal and foreign income tax expense | (41) | (48) | (14.6) | (86) | (92) | (6.5) |
| Discontinued operations, net of tax | - | - | - | - | - | - |
| Net income | $77 | $90 | (14.4%) | $160 | $171 | (6.4%) |

1 Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.

2 Net of earned premium attributable to prior years of $21 million and $31 million for the three and six months ended June 30, 2006, respectively, and $7 million and $8 million for the comparable periods of 2005. Net of amortization of deferred gains on retroactive reinsurance of $2 million and $5 million for the three and six months ended June 30, 2006, respectively, and $9 million and $11 million for the comparable periods of 2005.

NM = Not Meaningful

Revenues for the three and six months ended June 30, 2006 were $1.544 billion and $3.023 billion, respectively, an increase of $129 million and $242 million over the same periods in 2005. The major components of revenues include net premium earned and net investment income.

Net premium earned for the three and six months ended June 30, 2006 was $1.408 billion and $2.757 billion, respectively, an increase of $127 million and $237 million over the same periods in 2005. The growth in both periods reflects an increase in workers compensation premium driven by new business growth from Wausau and the Regional Companies and increased exposure on existing accounts of Summit, partially offset by modest rate decreases in most states, mandated rate decreases in Florida and a significant decline in California rates due to workers compensation reform. The remainder of the growth is primarily driven by increased customer retention, reduced reinsurance cessions in property and casualty lines and the non-renewal of a ceded involuntary workers compensation reinsurance program in 2006, partially offset by modest rate decreases in all lines except surety. These increases were partially offset by a decrease in personal lines net premium earned due to lower customer retention and a decrease in new business.

Net investment income for the three and six months ended June 30, 2006 was $112 million and $220 million, respectively, an increase of $5 million and $7 million from the same periods in 2005. The increases reflect a higher invested asset base and cash flow from operations, partially offset by lower investment yields.

Claims, benefits and expenses for the three and six months ended June 30, 2006 were $1.426 billion and $2.777 billion, respectively, an increase of $149 million and $259 million over the same periods in 2005.

The increase in both periods is primarily due to business growth, general cost increases and higher catastrophe losses due to 2006 storm activity and tornadoes in the Midwest. Incurred losses attributable to prior years increased $5 million and $11 million in the quarter and year-to-date, respectively primarily due to favorable surety losses in 2005 that did not recur in 2006 and additional incurred losses in workers compensation, partially offset by a decrease in incurred losses attributable to prior years in commercial multiple peril/fire.

| | **Three Months Ended June 30,** | | | **Six Months Ended June 30,** | | |
|---|---|---|---|---|---|---|
| **AGENCY MARKETS** | **2006** | **2005** | **Change (Points)** | **2006** | **2005** | **Change (Points)** |
| **Combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion** | | | | | | |
| Claims and claim adjustment expense ratio | 65.4% | 63.8% | 1.6 | 65.3% | 64.8% | 0.5 |
| Underwriting expense ratio | 30.6 | 32.0 | (1.4) | 30.7 | 31.8 | (1.1) |
| Dividend ratio | 0.9 | 0.9 | - | 1.1 | 0.9 | 0.2 |
| Subtotal | 96.9 | 96.7 | 0.2 | 97.1 | 97.5 | (0.4) |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | - | - | - | 0.1 | - | 0.1 |
| - All other | 4.4 | 0.7 | 3.7 | 3.0 | 0.6 | 2.4 |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other | (1.0) | (0.4) | (0.6) | (1.2) | (0.9) | (0.3) |
| Discount accretion | 0.3 | 0.4 | (0.1) | 0.3 | 0.4 | (0.1) |
| Total combined ratio | 100.6% | 97.4% | 3.2 | 99.3% | 97.6% | 1.7 |

1 Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.

Agency Markets' combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion for the three and six months ended June 30, 2006 was 96.9% and 97.1%, respectively, an increase of 0.2 points and a decrease of 0.4 points versus the same periods in 2005. The increase in the claims and claim adjustment expense ratio in both periods was due to a higher loss ratio at Summit due to the effects of mandated rate decreases in Florida, higher property (excluding catastrophes) losses and a decrease in personal lines business, which has historically operated at a lower loss ratio than Agency Markets' other lines of business. Partially offsetting these increases in both periods were favorable current accident year surety results and a lower expense ratio. The decrease in the underwriting expense ratio in both periods was driven by strong premium growth and a decrease in personal lines business, which has historically operated at a higher expense ratio than Agency Markets' other lines of business.

Including the impact of catastrophes, net incurred losses attributable to prior years, and discount accretion, the total combined ratio for the three and six months ended June 30, 2006 was 100.6% and 99.3%, respectively, an increase of 3.2 and 1.7 points versus the same periods in 2005. Catastrophe losses increased 3.7 and 2.5 points in the quarter and year-to-date primarily due to 2006 storm activity and tornadoes in the Midwest. Net incurred losses attributable to prior years decreased 0.6 and 0.3 points in the quarter and year-to-date, respectively primarily due to increased earned premiums attributable to prior years at Summit and Wausau related to higher accrued audit and retrospective premiums, partially offset by a net increase in prior year incurred losses.

PTOI for the three and six months ended June 30, 2006 was $118 million and $246 million, respectively, a decrease of $17 million and $14 from the same periods in 2005.

Federal and foreign income tax expense for the three and six months ended June 30, 2006 was $41 million and $86 million, respectively, a decrease of $7 million and $6 million from the same periods in 2005.

Net income for the three and six months ended June 30, 2006 was $77 million and $160 million, respectively, a decrease of $13 million and $11 million from the same periods in 2005.

## INTERNATIONAL

### *(1) Overview – International*

International net written premium by market segment was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| International Local Businesses | $635 | $553 | 14.8% | $1,275 | $1,105 | 15.4% |
| Liberty International Underwriters | 582 | 370 | 57.3 | 1,216 | 829 | 46.7 |
| Total net written premium | $1,217 | $923 | 31.9% | $2,491 | $1,934 | 28.8% |

The Company's International operations provide insurance products and services through 1) Local Businesses, selling personal and small commercial lines products locally and 2) Liberty International Underwriters ("LIU"), which sells specialty commercial lines insurance and reinsurance products worldwide.

International's five major lines of business are as follows:

(1) Local Businesses: personal and small commercial insurance;
(2) LIU Reinsurance: includes multi-line insurance and reinsurance with an emphasis on property, treaty casualty, personal accident, aviation and reinsurance through Lloyd's Syndicate 4472;
(3) LIU First Party: includes marine, energy, engineering, aviation, property and inland marine specialty;
(4) LIU Third Party: includes casualty, excess casualty, D&O, E&O, professional liability, and other; and
(5) LIU Other: includes workers compensation, commercial auto, and residual value.

International net written premium by line of business was as follows:

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Local Businesses – private passenger auto | $365 | $322 | 13.4% | $720 | $621 | 15.9% |
| Local Businesses – all other | 270 | 231 | 16.9 | 555 | 484 | 14.7 |
| LIU Reinsurance | 303 | 198 | 53.0 | 687 | 469 | 46.5 |
| LIU First Party[1] | 151 | 52 | 190.4 | 276 | 126 | 119.0 |
| LIU Third Party[1] | 122 | 113 | 8.0 | 232 | 207 | 12.1 |
| LIU Other | 6 | 7 | (14.3) | 21 | 27 | (22.2) |
| Total net written premium | $1,217 | $923 | 31.9% | $2,491 | $1,934 | 28.8% |

1 In the first quarter of 2006, LIU reclassified its inland marine specialty business to LIU First Party from LIU Third Party.

Net written premium for the three and six months ended June 30, 2006 was $1.217 billion and $2.491 billion, respectively, an increase of $294 million and $557 million over the same periods in 2005. The increase in private passenger auto net written premium in both periods reflects organic growth in Latin America and Europe, while the increase in other local business operations reflects organic growth in Latin America, primarily Brazil and Venezuela. The increase in LIU's Reinsurance line of business in both periods was primarily due to rate increases on property business. In addition, the increase in LIU's First Party line of business in both periods was primarily due to the establishment of an inland marine specialty program in the third quarter of 2005. The increase in LIU's Third Party line of business was primarily due to a reduction in the Company's utilization of reinsurance as compared to prior periods and organic growth.

## *(2) Results of Operations – International*

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Revenues | $1,249 | $980 | 27.4% | $2,364 | $1,879 | 25.8% |
| | | | | | | |
| PTOI before catastrophes, incurred losses attributable to prior years and discount accretion | $134 | $81 | 65.4% | $248 | $159 | 56.0% |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | 12 | - | NM | 12 | - | NM |
| - All other | (18) | (30) | (40.0) | (18) | (30) | (40.0) |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other[2] | (39) | (1) | NM | (57) | (1) | NM |
| Discount accretion | - | - | - | - | - | - |
| Pre-tax operating income | 89 | 50 | 78.0 | 185 | 128 | 44.5 |
| Realized investment gains/(losses), net | 9 | (2) | NM | 24 | (1) | NM |
| Federal and foreign income tax expense | (32) | (38) | (15.8) | (66) | (64) | 3.1 |
| Discontinued operations, net of tax | - | (3) | (100.0) | - | (12) | (100.0) |
| Net income | $66 | $7 | NM | $143 | $51 | 180.4% |

1 The Company does not typically identify catastrophe losses from reinsurance assumed through Lloyd's Syndicate 4472 in the tables above given the expected volatility associated with property-reinsurance coverage. However, due to the significant impact that the 2004 hurricanes, 2005 hurricanes and the events of September 11, 2001 had on the Company's results, these losses have been classified as catastrophes. Catastrophe losses include the impact of reinstatement premiums.

2 Net of earned premium attributable to prior years of $1 million and $6 million for the three and six months ended June 30, 2006, respectively, and $2 million and $5 million for the comparable periods of 2005.

NM = Not Meaningful

Revenues for the three and six months ended June 30, 2006 were $1.249 billion and $2.364 billion, respectively, an increase of $269 million and $485 million over the same periods in 2005. The major components of revenues include net premium earned, realized investments gains and losses and net investment income.

Net premium earned for the three and six months ended June 30, 2006 was $1.124 billion and $2.123 billion, respectively, an increase of $241 million and $434 million over the same periods in 2005. The increase in both periods reflects the impact of business growth, consistent with the increase in net written premium, and the recovery of profit commission, reinstatement premium and accelerated earned premium related to ceded reinsurance contracts covering losses from Hurricane Wilma in 2005.

Net investment income for the three and six months ended June 30, 2006 was $99 million and $188 million, respectively, an increase of $9 million and $17 million over the same periods in 2005. The increase is primarily driven by a higher invested asset base, due primarily to capital contributions and operating cash flows.

Realized investment gains for the three and six months ended June 30, 2006 were $9 million and $24 million, respectively, an increase of $11 million and $25 million over the same periods in 2005. The increase in both periods primarily reflects normal portfolio turnover and the redemption of certain Government debt securities in Venezuela.

Claims, benefits and expenses for the three and six months ended June 30, 2006 were $1.151 billion and $2.155 billion, respectively, an increase of $219 million and $403 million over the same periods in 2005. Approximately $40 million and $63 million of the increase in claims expense in the quarter and year-to-date, respectively, was primarily related to additional incurred losses in LIU's Reinsurance line of business as a result of an internal actuarial review. Losses related to the 2005 and 2004 hurricanes added $40

million and $18 million, respectively in both periods. Foreign exchange gains increased $21 million and $34 million in the quarter and year-to-date, respectively, over the same periods in 2005, primarily due to the strengthening of the dollar relative to the Colombian peso and Venezuela's hyperinflationary economy in 2005. The balance of the increase in the quarter and year-to-date reflects business growth in International's other lines of business.

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **INTERNATIONAL** | **2006** | **2005** | **Change (Points)** | **2006** | **2005** | **Change (Points)** |
| **Combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion** | | | | | | |
| Claims and claim adjustment expense ratio | 68.7% | 66.6% | 2.1 | 67.5% | 66.5% | 1.0 |
| Underwriting expense ratio | 27.5 | 31.0 | (3.5) | 28.3 | 30.7 | (2.4) |
| Dividend ratio | - | - | - | - | - | - |
| Subtotal | 96.2 | 97.6 | (1.4) | 95.8 | 97.2 | (1.4) |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | (1.1) | - | (1.1) | (0.6) | - | (0.6) |
| - All other | 1.6 | 3.6 | (2.0) | 0.9 | 1.9 | (1.0) |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | - | - | - | - | - |
| - All other | 3.6 | 0.1 | 3.5 | 2.8 | - | 2.8 |
| Discount accretion | - | - | - | - | - | - |
| Total combined ratio | 100.3% | 101.3% | (1.0) | 98.9% | 99.1% | (0.2) |

1. The Company does not typically identify catastrophe losses from reinsurance assumed through Lloyd's Syndicate 4472 in the tables above given the expected volatility associated with property-reinsurance coverage. However, due to the significant impact that the 2004 hurricanes, 2005 hurricanes and the events of September 11, 2001 had on the Company's results, these losses have been classified as catastrophes. Catastrophe losses include the impact of reinstatement premiums.

International's combined ratio before catastrophes, net incurred losses attributable to prior years and discount accretion for the three and six months ended June 30, 2006 was 96.2% and 95.8%, respectively, a decrease of 1.4 points from the same periods in 2005. The change in the claims and claim adjustment expense ratio and the underwriting expense ratio in both periods is attributable to an increase in the percentage mix of inland marine specialty business as compared to prior periods, which has a lower expense ratio and a higher loss ratio than International's other lines of business. The expense ratio also benefited from the significant rate increases in LIU's Reinsurance line of business.

Including the impact of catastrophes and net incurred losses attributable to prior years, the total combined ratio for the three and six months ended June 30, 2006 was 100.3% and 98.9%, respectively, a decrease of 1.0 and 0.2 points from the same periods in 2005. The decrease in both periods reflects lower catastrophe losses due to the recovery of reinstatement premium, accelerated earned premium and profit commission related to ceded reinsurance contracts, partially offset by an increase in the Company's estimate of incurred losses for the 2004 hurricanes. The increase in both periods is also due to a 3.5 and 2.8 point increase in the quarter and year-to-date, respectively, related to additional incurred losses in LIU's Reinsurance line of business as a result of an internal actuarial review.

PTOI for the three and six months ended June 30, 2006 was $89 million and $185 million, respectively, an increase of $39 million and $57 million over the same periods in 2005.

Federal and foreign income tax expense for the three and six months ended June 30, 2006 was $32 million and $66 million, respectively, a decrease of $6 million and an increase of $2 million versus the same periods in 2005. Federal and foreign income taxes reflect volatility associated with the different tax structures within the countries where the International SBU operates.

Net income for the three and six months ended June 30, 2006 was $66 million and $143 million, respectively, an increase of $59 million and $92 million over the same periods in 2005. In 2005, the Company recorded a $12 million loss, net of tax, in discontinued operations related to the disposal of certain pension business in Spain.

## CORPORATE and OTHER

### *(1) Overview – Corporate and Other*

Corporate and Other includes the following significant items:

- Individual Life, which provides life insurance and annuities for individuals and also issues structured settlement contracts and administers separate account contracts. Individual Life is licensed and sells its products in all 50 states, the District of Columbia and Canada.

- Certain discontinued operations, composed of: asbestos, environmental, and other toxic tort exposures, and other internal discontinued operations, primarily the run-off of the California workers compensation business of Golden Eagle Insurance Corporation ("Golden Eagle"), the discontinued channels business of Prudential agency business and effective January 1, 2006, the pre-2004 Commercial assumed voluntary reinsurance business ("AVR").

- Interest expense on the Company's outstanding debt and gain or loss on extinguishment of debt.

- Internal reinsurance programs.

- Costs associated with certain long-term compensation plans and other corporate costs not allocated to the strategic business units. For presentation in this MD&A, domestic property and casualty operations' investment income was allocated based on planned ordinary investment income returns by investment category allocated to the business units. Investments are allocated as follows: fixed income equal to liabilities net of insurance assets (reinsurance, premiums receivable, etc.) and a combination of fixed income, equity and nontraditional investments supporting allocated statutory policyholders' surplus. For internal reporting purposes, the Company allocates expected long-term returns on invested assets, including realized investment gains. Under this internal reporting view, the difference between actual investment income and allocated investment income is included in Corporate and Other.

- Federal and foreign income taxes represent the difference between the consolidated income tax expense and the amounts recognized by the Personal Market, Commercial Markets, Agency Markets and International business units. Domestic operations included in the business units reflect income tax at the 35% marginal U.S. Federal tax rate and do not reflect changes in the domestic valuation allowance (included in Corporate and Other), while International reflects the actual tax expense of each country including changes in the international valuation allowance.

- Net income (loss) related to energy and non-energy related limited partnership investments.

- Substantially all realized gains (losses) from the domestic property-casualty investment portfolio.

- Fee and other revenues include revenues from the Company's wholly owned subsidiary, Liberty Energy Holdings, LLC ("Liberty Energy"), and lease and other income on investment properties. Liberty Energy generates revenue from the production and sale of oil and gas.

*(2) Results of Operations – Corporate and Other*

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| **$ in Millions** | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| Revenues | $697 | $479 | 45.5% | $1,085 | $766 | 41.6% |
| | | | | | | |
| Pre-tax operating income before catastrophes, net incurred losses attributable to prior years and discount accretion | $64 | $53 | 20.8% | $93 | $37 | 151.4% |
| Catastrophes[1]: | | | | | | |
| - 2005 hurricanes | 1 | - | NM | (5) | - | NM |
| - All other | - | (6) | NM | - | (6) | NM |
| Net incurred losses attributable to prior years: | | | | | | |
| - Asbestos | - | (2) | NM | (1) | (2) | (50.0) |
| - All other | (53) | (31) | 71.0 | (87) | (75) | 16.0 |
| Discount accretion | (3) | (2) | 50.0 | (5) | (5) | - |
| Pre-tax operating income (loss) | 9 | 12 | (25.0) | (5) | (51) | 90.2 |
| Realized investment gains, net | 35 | 184 | (81.0) | 45 | 204 | (77.9) |
| Federal and foreign income tax benefit (expense) | (10) | 46 | NM | 15 | 201 | (92.5) |
| Discontinued operations, net of tax | - | - | - | - | - | - |
| Net income | $34 | $242 | (86.0%) | $55 | $354 | (84.5%) |

1 Catastrophe losses include the impact of accelerated earned catastrophe premiums and earned reinstatement premiums.
NM = Not Meaningful

Revenues for the three and six months ended June 30, 2006 were $697 million and $1.085 billion, respectively, an increase of $218 million and $319 million over the same periods in 2005. The major components of revenues include net premium earned, net investment income, net realized investment gains and losses and fee and other revenues.

Net premium earned for the three and six months ended June 30, 2006 was $400 million and $564 million, respectively, an increase of $347 million and $451 million over the same periods in 2005. The increase is primarily the result of immediate annuity and structured settlement growth.

Net investment income for the three and six months ended June 30, 2006 was $210 million and $366 million, respectively, an increase of $13 million and $3 million over the same periods in 2005.

Realized investment gains for the three and six months ended June 30, 2006 were $35 million and $45 million, respectively, a decrease of $149 million and $159 million from the same periods in 2005. The decrease is primarily due to lower gains on fixed maturities, lower energy-related gains and an increase in impairment losses.

Fee and other revenues for the three and six months ended June 30, 2006 were $52 million and $110 million, respectively, an increase of $7 million and $24 million over the same periods in 2005. The increase in both periods is primarily due to lease income earned from a commercial office building acquired in January 2006.

Claims, benefits and expenses for the three and six months ended June 30, 2006 were $653 million and $1.045 billion, respectively, an increase of $370 million and $432 million over the same periods in 2005. The increase in both periods is primarily due to an increase in policyholder benefits related to immediate annuity and structured settlement business growth. The year-to-date increase was partially offset by a decrease of $32 million in insurance operating costs and expenses primarily related to a decrease in variable incentive compensation and other benefit costs. Also included in these results are $56 million and

$93 million of incurred losses attributable to prior years for the three and six months ended June 30, 2006, respectively, representing an increase of $21 million and $11 million over the same periods in 2005. Incurred losses attributable to prior years are primarily related to assumed voluntary reinsurance, other liability lines and workers compensation business of Golden Eagle in 2005.

Pre-tax operating income (loss) for the three and six months ended June 30, 2006 was $9 million and ($5) million, respectively, a decrease of $3 million and an increase of $46 million over the same periods in 2005.

Federal and foreign income tax (expense) benefit for the three and six months ended June 30, 2006 was ($10) million and $15 million, respectively, an expense increase of $56 million and $186 million from the comparable periods in 2005. See the Consolidated Section for a discussion of taxes.

Net income for the three and six months ended June 30, 2006 was $34 million and $55 million, respectively, a decrease of $208 million and $299 million from the same periods in 2005.

## INVESTMENTS

### *General*

The Company's investment strategy seeks long-term returns through disciplined security selection, portfolio diversity and an integrated approach to risk management. The Company selects and monitors investments to balance the goals of safety, stability, liquidity, growth and after-tax total return with its need to comply with regulatory investment requirements. A relatively safe and stable income stream is achieved by maintaining a broadly based portfolio of investment grade bonds. These holdings are supplemented by investments in additional asset types with the objective of further enhancing the portfolio's diversification and expected returns. These additional asset types include commercial mortgages and other real estate financing investments, non-investment-grade bonds and syndicated bank loans, common and preferred stock, private equity and direct investments in oil and gas ventures. Risk management is accomplished through asset liability management (including both interest rate risk and foreign currency risk), diversification, credit limits and a careful analytic review of each investment decision.

The Company's investment policy and strategy are reviewed and approved by the Investment Committee of its Board of Directors, which meets on a regular basis to review and consider investment activities, tactics and new investment classes. In addition, the Company has an experienced team of investment personnel responsible for managing and administering the investment portfolios of its domestic and foreign insurance operations.

### *Invested Assets*

The following table summarizes the Company's invested assets by asset category at June 30, 2006 and December 31, 2005:

| $ in Millions | As of June 30, 2006 | | As of December 31, 2005 | |
|---|---|---|---|---|
| **Invested Assets by Type** | **Market Value** | **% of Total** | **Market Value** | **% of Total** |
| Fixed maturities, available for sale, at fair value | $38,284 | 88.7% | $37,391 | 89.3% |
| Equity securities, available for sale, at fair value | 2,278 | 5.3 | 1,908 | 4.6 |
| Trading securities, at fair value | 22 | - | 20 | - |
| Limited partnerships and limited liability companies | 1,394 | 3.2 | 1,040 | 2.5 |
| Short-term investments | 1,109 | 2.6 | 1,430 | 3.4 |
| Other investments | 93 | 0.2 | 84 | 0.2 |
| Total invested assets | $43,180 | 100.0% | $41,873 | 100.0% |

Total invested assets as of June 30, 2006 were $43.180 billion, a $1.307 billion or 3.1% increase over December 31, 2005. The increase in invested assets was due primarily to strong cash flow from operations, deployment of existing cash and an increase in the Company's forward commitments to acquire securities, which the Company expects to fund in the third quarter of 2006, partially offset by a decline in unrealized capital gains.

Fixed maturities as of June 30, 2006 were $38.284 billion, an increase of $893 million or 2.4% over December 31, 2005. The increase reflects the aforementioned change in the amount of cash available to invest, partially offset by an increase in net unrealized losses in the portfolio due to higher market interest rates. Net unrealized gains of $429 million at December 31, 2005 declined $1.349 billion in the first half of the year to a net unrealized loss of $920 million as of June 30, 2006.

Equity securities available for sale as of June 30, 2006 were $2.278 billion, a $370 million or 19.4% increase over December 31, 2005. The increase primarily reflects $283 million in net preferred stock acquisitions. Net unrealized gains as of June 30, 2006 were $736 million, a decrease of $18 million from December 31, 2005.

Limited partnerships and limited liability companies as of June 30, 2006 were $1.394 billion, a $354 million or 34.0% increase over December 31, 2005. The increase reflects new investment activity and an increase in the allocation of funds to existing commitments. The Company's investments in private equity limited partnerships are long-term in nature and highly illiquid. The Company believes these investments offer the potential for superior long-term returns and are appropriate in the overall context of a diversified portfolio.

As of June 30, 2006, the Company had unfunded private equity, energy and commercial mortgage commitments of $959 million, $154 million and $150 million, respectively. As of June 30, 2006, fixed maturities included commitments by the Company to purchase various residential mortgage-backed securities at a cost of $144 million and a fair market value of $143 million and various corporate and municipal securities at a cost of $95 million and a fair market value of $96 million.

As of June 30, 2006, no single issuer, excluding U.S. Treasuries, agency securities and mortgage-backed securities, accounted for no more than 1% of invested assets.

The following tables summarize the Company's fixed income portfolio by security type, credit quality and maturity at June 30, 2006 and December 31, 2005:

| **$ in Millions** | **As of June 30, 2006** | | **As of December 31, 2005** | |
|---|---|---|---|---|
| **Fixed Maturities by Security Type** | **Market Value** | **% of Total** | **Market Value** | **% of Total** |
| U.S. Government and agency securities | $3,870 | 10.1% | $4,570 | 12.2% |
| Mortgage and asset-backed securities | 12,354 | 32.3 | 12,542 | 33.6 |
| U.S. state and municipal | 4,949 | 12.9 | 4,005 | 10.7 |
| Corporate and other | 15,014 | 39.2 | 14,552 | 38.9 |
| Foreign government securities | 2,097 | 5.5 | 1,722 | 4.6 |
| Total fixed maturities | $38,284 | 100.0% | $37,391 | 100.0% |

During the second quarter of 2006, the Company, after consideration of investment opportunities, its tax status, and the current and prospective business environment, increased its tactical allocation to state and municipal, and foreign government securities resulting in increases of $944 million and $375 million, respectively, partially offset by a decrease in U.S. government and agency securities of $700 million.

| $ in Millions | As of June 30, 2006 | | As of December 31, 2005 | |
|---|---|---|---|---|
| **Fixed Maturities by Credit Quality*** | **Market Value** | **% of Total** | **Market Value** | **% of Total** |
| AAA | $20,334 | 53.1% | $20,285 | 54.3% |
| AA+, AA, AA- | 4,423 | 11.6 | 3,903 | 10.4 |
| A+, A, A- | 6,515 | 17.0 | 6,786 | 18.1 |
| BBB+, BBB, BBB- | 4,187 | 10.9 | 3,824 | 10.2 |
| BB+, BB, BB- | 1,628 | 4.3 | 1,325 | 3.6 |
| B+, B, B- | 1,154 | 3.0 | 1,238 | 3.3 |
| CCC or lower | 43 | 0.1 | 30 | 0.1 |
| Total fixed maturities | $38,284 | 100.0% | $37,391 | 100.0% |

******For purposes of this disclosure, credit quality is primarily based upon Standard & Poor's ratings.*

The Company's allocation in investment grade bonds decreased slightly to 92.6% at June 30, 2006 from 93.0% at December 31, 2005.

The remaining 7.4% of the Company's investments in fixed maturity securities are non-investment grade. The decline in single B securities is largely driven by the upgrade in the ratings assigned to Venezuelan sovereign debt to double B. The increase in double B securities is also due to an increase in the Company's investment position in South American sovereign debt. The Company's holdings of below-investment grade securities consist primarily of: (1) a diversified portfolio of high yield bonds within the domestic insurance portfolios; and (2) investments in emerging market sovereign debt primarily in support of the Company's international insurance companies.

| $ in Millions | As of June 30, 2006 | | As of December 31, 2005 | |
|---|---|---|---|---|
| **Fixed Maturities by Maturity Date** | **Market Value** | **% of Total** | **Market Value** | **% of Total** |
| 1 yr or less | $1,169 | 3.1% | $1,080 | 2.9% |
| Over 1 yr through 5 yrs | 7,215 | 18.8 | 6,898 | 18.4 |
| Over 5 yrs through 10 yrs | 7,828 | 20.4 | 7,615 | 20.4 |
| Over 10 years | 9,718 | 25.4 | 9,256 | 24.8 |
| Mortgage and asset-backed securities | 12,354 | 32.3 | 12,542 | 33.5 |
| Total fixed maturities | $38,284 | 100.0% | $37,391 | 100.0% |

During 2006, after taking into consideration changes in investment opportunities and its view of the current and prospective business and economic environment, the Company made only minor adjustments to the average life of its fixed maturity portfolio.

**Net Investment Income**

The following table summarizes the Company's net investment income for the three and six months ended June 30, 2006 and 2005:

| $ in Millions | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **Net Investment Income** | **2006** | **2005** | **2006** | **2005** |
| Taxable interest income | $510 | $501 | $1,008 | $1,000 |
| Tax-exempt interest income | 46 | 12 | 87 | 20 |
| Dividends | 17 | 32 | 24 | 54 |
| Limited partnerships and limited liability companies | 87 | 64 | 129 | 117 |
| Other investment income | 2 | 4 | 5 | 7 |
| Gross investment income | 662 | 613 | 1,253 | 1,198 |
| Investment expenses | (28) | (20) | (59) | (50) |
| Net investment income | $634 | $593 | $1,194 | $1,148 |

Net investment income for the three months and six months ended June 30, 2006 was $634 million and $1.194 billion, respectively, an increase of $41 million and $46 million over the same periods in 2005. The increase in net investment income in both periods reflects higher interest income due to a larger invested asset base and continued strong cash flow from operations, as well as an increase in limited partnership and limited liability company income of $23 million and $12 million in the quarter and year-to-date, respectively, related to both private equity and energy investments. Partially offsetting these increases was a decrease in dividend income resulting from the termination of an equity investment program in the second quarter of 2005 and the Company's lower overall domestic book yield. The decrease in the Company's overall domestic book yield was due in part to the increased investment in tax-exempt securities in the second half of 2005 and continuing into 2006. The lower portfolio yield was the primary factor in constraining overall growth in investment income compared to 2005.

**Net Realized Investment Gains (Losses)**

The following tables summarize the Company's net realized investment gains (losses) at June 30, 2006 and 2005:

| $ in Millions<br>**Net Realized Investment Gains (Losses)** | Sales & Dispositions | Impairments | Change in Trading Security Unrealized | Total |
|---|---|---|---|---|
| Three Months Ended June 30, 2006: | | | | |
| Fixed maturities | $8 | ($17) | $ - | ($9) |
| Common and preferred stock | 43 | - | - | 43 |
| Other | 10 | - | - | 10 |
| Total | $61 | ($17) | $ - | $44 |
| | | | | |
| Three Months Ended June 30, 2005: | | | | |
| Fixed maturities | $68 | $ - | $ - | $68 |
| Common and preferred stock | 47 | (7) | 7 | 47 |
| Other | 70 | - | - | 70 |
| Total | $185 | ($7) | $7 | $185 |
| | | | | |
| Six Months Ended June 30, 2006: | | | | |
| Fixed maturities | $18 | ($30) | $ - | ($12) |
| Common and preferred stock | 69 | (2) | - | 67 |
| Other | 14 | - | - | 14 |
| Total | $101 | ($32) | $ - | $69 |
| | | | | |
| Six Months Ended June 30, 2005: | | | | |
| Fixed maturities | $92 | $ - | $ - | $92 |
| Common and preferred stock | 59 | (8) | (7) | 44 |
| Other | 70 | - | - | 70 |
| Total | $221 | ($8) | ($7) | $206 |

| $ in Millions | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **Components of Net Realized Investment Gains (Losses)** | **2006** | **2005** | **2006** | **2005** |
| Fixed maturities: | | | | |
| Gross realized gains | $18 | $94 | $ 46 | $138 |
| Gross realized losses | (27) | (26) | (58) | (46) |
| Equities: | | | | |
| Gross realized gains | 45 | 64 | 75 | 82 |
| Gross realized losses | (2) | (17) | (8) | (38) |
| Other: | | | | |
| Gross realized gains | 10 | 68 | 15 | 71 |
| Gross realized losses | - | 2 | (1) | (1) |
| Total net realized investment gains (losses) | $44 | $185 | $69 | $206 |

Net realized investment gains for the three months and six months ended June 30, 2006 were $44 million and $69 million, respectively, a decrease of $141 million and $137 million from the same periods in 2005. The decrease in both periods primarily reflects lower fixed maturity gains (primarily due to 2005 gains associated with the sale of targeted taxable securities as part of a strategic realignment that did not recur in 2006) and other market gains (primarily due to energy gains realized in 2005 that did not recur in 2006), partially offset by higher year-to-date equity gains. These results were also impacted by a $10 million and $24 million increase in impairment losses for the three months and six months ended June 30, 2006, respectively, primarily due to the Company's recognition of impairments on securities previously anticipated to be held to recovery and credit events affecting individual securities.

The following table shows a schedule of the Company's gross unrealized losses and fair value by security type and by the length of time these securities have continuously been in an unrealized loss position as of June 30, 2006:

| **$ in Millions** | **Less Than 12 Months** | | **Greater Than 12 Months** | |
|---|---|---|---|---|
| **Unrealized Losses & Fair Value by Security Type** | **Unrealized Losses** | **Fair Value of Investments with Unrealized Losses** | **Unrealized Losses** | **Fair Value of Investments with Unrealized Losses** |
| | | | | |
| U.S. Government and agency securities | ($94) | $2,237 | ($47) | $928 |
| Mortgage and asset-backed securities | (391) | 9,224 | (106) | 1,441 |
| U.S. state and municipal | (126) | 4,137 | (22) | 304 |
| Corporate and other | (419) | 8,580 | (120) | 1,638 |
| Foreign government securities | (39) | 1,345 | (1) | 31 |
| Equities | (34) | 396 | (9) | 49 |
| Total | ($1,103) | $25,919 | ($305) | $4,391 |

Unrealized losses increased from $509 million as of December 31, 2005 to $1.408 billion as of June 30, 2006 primarily due to the continued increase in interest rates. Approximately 88% of the unrealized losses ($1.243 billion) exist on holdings where the fair value as of June 30, 2006 was less than 10% below amortized cost. The Company monitors the difference between the amortized cost and estimated fair value of investments to ascertain whether declines in value are temporary in nature. The Company employs a systematic methodology utilizing a quantitative and qualitative process ensuring that available evidence concerning the declines in fair value below amortized cost is evaluated in a disciplined manner.

If the Company believes a decline in the value of a particular investment is temporary, the decline is recorded as an unrealized loss in shareholders' equity. If the decline is believed to be "other-than-temporary," the carrying value of the investment is written down to market and a realized loss is recorded. As a result of this review, the Company has concluded that the gross unrealized losses of fixed maturity securities as of June 30, 2006 are temporary.

The gross unrealized losses recorded on common equity securities and other investments at June 30, 2006 resulted primarily from decreases in quoted market values from the dates that certain investment securities were acquired as opposed to fundamental changes in the issuer's financial performance and near-term financial prospects. Therefore, these decreases are also viewed as being temporary in accordance with the Company's policy with respect to recognizing impairments in the investment portfolio.

## LIQUIDITY AND CAPITAL RESOURCES

***General***

The liquidity requirements of the insurance subsidiaries are met primarily by funds generated from operations, asset maturities and income received on investments. Cash provided from these sources is used primarily for claims, claim adjustment expenses and operating expenses (underwriting and corporate benefit costs). There are certain cash outflows such as catastrophes and continued settlements of asbestos reserves that are unpredictable in nature and could create increased liquidity needs. The Company believes that the insurance subsidiaries' future business liquidity needs will be met from all the above sources.

Net cash flows are generally invested in marketable securities. The Company invests its net cash flows in fixed income securities and equities while keeping a certain amount in cash and short-term investments to meet unpredictable cash obligations. For ongoing business, the Company monitors the duration of these investments, and purchases and sales are executed with the objective of having adequate cash available to satisfy its maturing liabilities. As the Company's investment strategy focuses on overall asset and liability durations, and not specific cash flows, asset sales may be required to satisfy obligations or rebalance asset portfolios. The Company's invested assets as of June 30, 2006 totaled $43.180 billion.

Short-term debt outstanding at June 30, 2006 and December 31, 2005 was as follows:

| **$ in Millions** | **As of June 30, 2006** | **As of December 31, 2005** |
|---|---|---|
| Commercial paper | $91 | $100 |
| Revolving credit facilities | 38 | 35 |
| Current maturities of long-term debt | 121 | 10 |
| Total short-term debt | $250 | $145 |

Long-term debt outstanding at June 30, 2006 and December 31, 2005 was as follows:

| **$ in Millions** | **As of June 30, 2006** | **As of December 31, 2005** |
|---|---|---|
| 8.20% Surplus notes, due 2007 | $ - | $121 |
| 6.75% Notes, due 2008 | 15 | 15 |
| 5.00% Prudential notes, due 2008 | 4 | 4 |
| 8.00% Prudential notes—series B, due 2013 | 260 | 260 |
| 5.75% Senior notes, due 2014 | 500 | 500 |
| 8.50% Surplus notes, due 2025 | 150 | 150 |
| 7.875% Surplus notes, due 2026 | 250 | 250 |
| 7.63% Notes, due 2028 | 3 | 3 |
| 7.00% Senior notes, due 2034 | 250 | 250 |
| 6.50% Senior notes, due 2035 | 500 | 500 |
| 7.697% Surplus notes, due 2097 | 500 | 500 |
| 7.10% – 7.86% Medium term notes, with various maturities | 27 | 27 |
| Subtotal | 2,459 | 2,580 |
| Unamortized discount | (25) | (25) |
| Total long-term debt excluding current maturities | $2,434 | $2,555 |

The Company issues commercial paper from LMGI. The total amount authorized for this program is $600 million and the program is backed by a $750 million five-year revolving credit agreement. To date, no funds have been borrowed under the facility.

Liberty Corporate Capital Limited entered into a new $100 million / €85 million / £65 million 364 day revolving credit agreement, which became effective July 31, 2006. The facility is available to provide working capital to the Company's Lloyd's Syndicate business. The 364 day credit agreement is guaranteed by LMIC. To date, no funds have been borrowed under the facility. Effective July 20, 2006, Liberty International Iberia S.L., S.C.S. terminated its €85 million / $100 million 364 day revolving credit agreement.

Liberty Mutual Insurance Europe Limited entered into a $20 million revolving loan agreement, which became effective June 9, 2006. The facility is available to provide working capital to the Company's international operations. The revolving loan agreement is guaranteed by LMIC. To date, no funds have been borrowed under the facility.

The Company also has a Venezuelan subsidiary, Inversora Segucar, C.A., which has entered into a revolving credit facility to provide liquidity for working capital purposes. Inversora Segucar also has short-term loans outstanding. As of June 30, 2006, total short-term loans and borrowings under the Venezuelan credit facility were approximately $38 million.

The $105 million increase in short-term debt outstanding is primarily due to $121 million of 8.2% Surplus Notes due May 4, 2007 and a $3 million increase in outstanding borrowings under the Venezuelan credit facility, partially offset by a redemption of $10 million of 5% Notes due 2008 to Prudential Financial Inc. issued in connection with the PruPac acquisition and a decrease of $9 million of commercial paper.

Consolidated interest expense for the three and six months ended June 30, 2006 was $49 million and $97 million, respectively, representing increases of $8 million and $1 million over the same periods in 2005.

***Holding Company Liquidity and Capital Resources***

The Company conducts substantially all of its operations through its wholly owned insurance and service company subsidiaries, and therefore is primarily dependent on dividends, distributions, loans or other payments of funds from these entities to meet its current and future obligations. However, the subsidiaries are separate and distinct legal entities and have no obligation to make funds available to the Company, whether in the form of loans, dividends or other distributions. As of June 30, 2006, the Company, through its downstream subsidiary LMGI, had $1.615 billion of debt outstanding.

The insurance subsidiaries' ability to pay dividends is restricted under applicable insurance law and regulations. Under the insurance laws of the domiciliary states of the insurance subsidiaries, an insurer may make an ordinary dividend payment if its surplus as regards to policyholders, following such dividend, is reasonable in relation to its outstanding liabilities and adequate to its financial needs. However, no insurer may pay an extraordinary dividend without the approval or non-disapproval of the domiciliary insurance regulatory authority. Under the insurance laws of Massachusetts, the domiciliary state of LMIC, an extraordinary dividend is defined as a dividend whose fair market value, together with other dividends made within the preceding 12 months, exceeds the greater of 10% of the insurer's surplus as regards policyholders as of the preceding December 31, or the insurer's net income for the 12-month period ending on the preceding December 31. Under the insurance laws of Wisconsin, the domiciliary state of Liberty Mutual Fire Insurance Company ("LMFIC") and Employers Insurance Company of Wausau ("EICOW"), an extraordinary dividend is defined as a dividend whose fair market value, together with other dividends paid within the preceding 12 months, exceeds the lesser of (a) 10% of the insurer's surplus as regards policyholders as of the preceding December 31, or (b) the greater of (1) the insurer's net income for the preceding calendar year, minus realized capital gains for that calendar year, or (2) the aggregate of the insurer's net income for the three preceding calendar years minus realized capital gains for those calendar years and minus dividends paid within the first two of the preceding three calendar years. Changes in the extraordinary dividend regulation of the domiciliary states of LMIC, LMFIC and EICOW could negatively affect LMGI's ability to pay principal and interest on the Notes, as could a redomestication, merger or consolidation of LMIC, LMFIC or EICOW to a different domiciliary state. Additionally, in connection with the Company's reorganization in 2001 into a mutual holding company structure, the Company entered

into Keep Well Agreements with the Massachusetts Commissioner of Insurance, LMIC and certain other affiliates which effectively limit LMIC from paying any dividends to the Company when the "total adjusted capital" of the respective insurer is below 300% of the "authorized control level," as such terms are defined in the Massachusetts risk-based capital regulations as of June 13, 2001. The Keep Well Agreements will terminate automatically upon the earlier of (i) the date that is five years from the effective date of the respective reorganization (November 28, 2006 as to LMIC and March 19, 2007 as to LMFIC), or (ii) the date upon which the Company, the respective insurer or LMHC Massachusetts Holdings Inc. becomes subject to the public reporting requirements of the Securities and Exchange Commission.

As of December 31, 2005, the authorized control level risk-based capital and 2006 dividend capacity prior to needing regulatory approval for LMIC, LMFIC and EICOW were as follows:

| **$ in Millions** | **RBC Ratio [1]** | | | **Dividend Capacity[2]** |
|---|---|---|---|---|
| **RBC Ratios and Dividend Capacity[3]** | **2005** | **2004** | **Change** | **2006** |
| LMIC | 495% | 459% | 36 points | $692 |
| LMFIC | 596% | 473% | 123 points | $5 |
| EICOW | 370% | 346% | 24 points | $86 |

[1] Authorized control level risk-based capital as defined by the NAIC.
[2] Represents maximum allowable dividend without prior regulatory approval in the state of domicile. LMIC's dividend capacity does not reflect an additional $100 million of capacity available for payment after December 26, 2006.
[3] Note: Any reallocation of surplus between insurance subsidiaries could change the dividend capacity of individual companies within the group.

LMGI also has access to funds at Liberty Corporate Services LLC (the "service companies"). The service companies, which include Helmsman Insurance Agency, Summit and Helmsman Management Services, collects fees and other revenues for claims administration and agency services rendered for affiliated and non-affiliated insurance entities. For the three and six months ended June 30, 2006, the services companies recorded $48 million and $82 million, respectively, in pre-tax income.

***Statutory Surplus***
Statutory surplus as regards policyholders for the combined operations of LMIC and its U.S. affiliates including international branches was $10.157 billion and $9.869 billion at June 30, 2006, and December 31, 2005, respectively. The increase in surplus reflects $236 million of net income, affiliated unrealized gains of $64 million, and unaffiliated unrealized losses of $7 million. The balance of the change in statutory surplus primarily reflects changes in deferred taxes, foreign exchange, and non-admitted assets.

## CRITICAL ACCOUNTING POLICIES

### Critical Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The Company's principal estimates include:

- unpaid claims and claim adjustment expense reserves, including asbestos and environmental liability reserves and recoverables on premium attributable to prior years;
- reinsurance recoverables, including bad debt provision;
- impairments to the fair value of the investment portfolio;
- variable interest entities;
- deferred acquisition costs;
- the valuation of goodwill; and
- deferred income tax valuation allowance.

While the Company believes the amounts included in the consolidated financial statements reflect best estimates and appropriate assumptions, these amounts could ultimately be materially different from the amounts currently provided for in the consolidated financial statements.

Certain reclassifications have been made to the 2005 tables to conform to the 2006 tables.

### Unpaid Claims and Claim Adjustment Expenses

Reserves for property-casualty unpaid claims and claim adjustment expenses were $38.553 billion and $38.045 billion at June 30, 2006 and December 31, 2005, respectively. The increase was primarily due to business growth less the on-going settlement of claims.

Property-casualty insurance unpaid claims and claim adjustment expenses represent the Company's best estimate of amounts necessary to settle all outstanding claims, including claims that are incurred but not reported as of the reporting date. The Company's reserve projections are based primarily on detailed analysis of the facts in each case, experience with similar cases and various historical development patterns. Consideration is given to such historical patterns as field reserving trends and claims settlement practices, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes. All of these factors can affect the estimation of reserves.

Establishing loss reserves, including loss reserves for catastrophic events that have occurred, is an estimation process. Many factors can ultimately affect the final settlement of a claim and, therefore, the necessary reserve. Changes in the law, results of litigated cases, medical costs, and cost of repair materials and labor rates can all affect ultimate claim costs. In addition, the span of time between the incidence of a loss and the payment or settlement of the claim can be a critical part of reserving determinations and will cause more variability in the ultimate claim cost. Accordingly, "short-tail" claims, such as property damage claims, tend to be easier to estimate than "long-tail" claims, such as workers compensation or general liability claims.

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

Company's estimate of ultimate liabilities may be required. The effects of these changes are reflected in current operating results.

**Asbestos and Environmental**

The Company's asbestos and environmental (A&E) reserves for unpaid claims and claim adjustment expenses net of reinsurance and including an allowance for uncollectible accounts were $1.527 billion and $1.628 billion at June 30, 2006 and December 31, 2005, respectively.

The Company's asbestos reserves as of June 30, 2006 and December 31, 2005 were as follows:

| **$ in Millions** | **As of June 30, 2006** | **As of December 31, 2005** |
|---|---|---|
| Gross reserves[1] | $1,346 | $1,421 |
| Ceded reserves[1] | 350 | 355 |
| Net reserves | 996 | 1,066 |
| Allowance for reinsurance on unpaid losses | 109 | 110 |
| **Total asbestos reserves** | **$1,105** | **$1,176** |

[1] Excludes reserves guaranteed by Nationwide Mutual Insurance Company.

All A&E claims against policies issued prior to 1986 by EICOW and its affiliates are 100% ceded to Nationwide Indemnity Company and guaranteed by Nationwide Mutual Insurance Company. In addition, the Company's 2003 acquisition of PruPac included $175 million and $118 million of gross and net asbestos reserves, respectively. Any increase in asbestos reserves related to PruPac is reinsured by Vantage Casualty Insurance Company and guaranteed by Prudential Financial Inc.

The estimation of asbestos claims and associated liabilities and the analysis of environmental claims considered prevailing applicable law and certain inconsistencies of court decisions as to coverage, plaintiffs' expanded theories of liability, and the risks inherent in major litigation and other uncertainties, the Company believes that in future periods it is possible that the outcome of the continued uncertainties regarding asbestos and environmental related claims could result in liability that differs from current reserves by an amount that could be material to the Company's future operating results and financial condition.

**Reinsurance Recoverables**

The Company reported reinsurance recoverables of $16.347 billion and $16.302 billion at June 30, 2006 and December 31, 2005, respectively, net of allowance for uncollectible accounts of $348 million and $324 million, respectively. The majority of the increase is due to continued growth in Liberty International and increased cessions to state mandated involuntary pools.

The reinsurance recoverables from Nationwide Indemnity Co. have been fully guaranteed by its parent, Nationwide Mutual Insurance Co., which has a financial strength rating of A+ from Standard & Poor's and A+ from A.M. Best. The reinsurance recoverables from state mandated involuntary pools and associations represent the Company's servicing carrier business. As a servicing carrier, the Company retains no direct underwriting risk but instead cedes 100% of the involuntary market premium and losses back to the pool. Payment of losses is shared by the pool participants in proportion to their pool participation. Credit risk with respect to this servicing carrier business is the composite of the cumulative creditworthiness of all participants in their respective pools.

As part of its reinsurance security oversight, the Company has established a Standing Reinsurance Credit Committee (SRC) that meets quarterly to monitor and review the credit quality of the existing reinsurance portfolio, discuss emerging trends in the reinsurance marketplace, and ensure that the current portfolio of reinsurance is in compliance with the committee's security standards. The SRC is directly responsible for

establishing the rating, collateral, and diversification requirements governing the Company's purchase and use of reinsurance.

Approximately 93% of the Company's reinsurance recoverable balance, net of collateral held and including voluntary and involuntary pools and associations, was placed with reinsurers rated A- or better from A.M. Best at June 30, 2006. Collateral held against outstanding gross reinsurance recoverable balances was $4.361 billion and $4.106 billion at June 30, 2006 and December 31, 2005, respectively.

The remaining 7% of the Company's net reinsurance recoverable balance is well diversified. No single reinsurer rated B++ or below by A.M. Best accounts for more than 2% of statutory surplus as regards policyholders. In addition, the average net reinsurance recoverable balance from individual reinsurers rated below A- or not rated by A.M. Best was approximately $1 million as of June 30, 2006.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured business. The Company evaluates and monitors the financial condition of its reinsurers under voluntary reinsurance arrangements to minimize its exposure to significant losses from reinsurer insolvencies. The Company reports its reinsurance recoverables net of an allowance for estimated uncollectible reinsurance recoverables. The allowance is based upon the Company's ongoing review of amounts outstanding, length of collection periods, changes in reinsurer credit standing and other relevant factors. Accordingly, the establishment of reinsurance recoverables and the related allowance for uncollectible reinsurance recoverables is also an inherently uncertain process involving estimates. Changes in these estimates could result in additional income statement charges.

The Company is party to retroactive reinsurance arrangements where a significant portion of the consideration was retained on a "funds held" basis and interest is credited on the balance at a weighted average rate of approximately 7.7% annually. These contracts resulted in deferred gains (including experience related profit accruals of $195 million as of June 30, 2006 and December 31, 2005) that are amortized into income using the effective interest method over the estimated settlement periods. At June 30, 2006 and December 31, 2005, deferred gains related to these reinsurance arrangements were $852 million and $878 million, respectively, and are included in other liabilities within the consolidated balance sheets. Interest credited to the funds held balances for the three months and six months ended June 30, 2006 was $27 million and $52 million, respectively, as compared to $37 million and $61 million, for the three months and six months ended June 30, 2005, respectively. Amortization of the deferred gain for the three months and six months ended June 30, 2006 was $14 million and $30 million, respectively, as compared to $46 million and $58 million for the three months and six months ended June 30, 2005, respectively. Reinsurance recoverables related to these transactions including experience related profit accruals were $2.195 billion and $2.211 billion as of June 30, 2006 and December 31, 2005, respectively.

Additionally, the Company has an aggregate stop loss program covering substantially all of Commercial Markets voluntary workers compensation business from the fourth quarter 2000 through the fourth quarter 2002 accident year periods. Under these contracts, losses in excess of a specified loss ratio are reinsured up to a maximum loss ratio and were accounted for as prospective reinsurance at inception. However, due to a material contract change at the January 1, 2002 renewal, premium and loss activity subsequent to December 31, 2001 is now accounted for as retroactive reinsurance for coverage provided from the fourth quarter 2000 through the fourth quarter 2001 covered accident year periods. Moreover, approximately $38 million and $31 million of additional losses were ceded to these retroactive and prospective contracts for the six months ended June 30, 2005, with additional premium of $24 million and $22 million, respectively.

On June 21, 2006, LMIC entered into a multi-year property catastrophe reinsurance agreement with Mystic Re Ltd. ("Mystic Re"), a Cayman Islands domiciled reinsurer, to provide $200 million of additional reinsurance coverage for LMIC and its affiliates, in the event of a Northeast hurricane. The reinsurance agreement is fully collateralized by proceeds received by Mystic Re from the issuance of catastrophe bonds, and provides coverage for hurricane related losses from Washington, D.C. to Maine for the 2006-2008 hurricane seasons. The reinsurance limit is proportionally available, based on industry insured losses between $30 billion and $40 billion in the covered area, as reported by Property Claim Services ("PCS"), and is exhausted with the full $200 million available, in the event of PCS reported industry insured losses

of $40 billion. The Company has not recorded any recoveries under this program. Mystic Re has no other reinsurance in force.

**Impairment Losses on Investments**

The total impairment losses on investments for the three and six months ended June 30, 2006 were $17 million and $32 million, an increase of $10 million and $24 million over the same period in 2005. The increase was primarily associated with the Company's recognition of impairment losses on securities previously anticipated to be held to recovery. Unrealized losses that are other-than-temporary are recognized as realized losses. The Company's accounting policy for other-than-temporary impairment recognition requires other-than-temporary impairment charges to be recorded when it is determined that the Company is unlikely to recover its cost basis in an investment in the near-term. Factors considered in evaluating whether a decline in value is other-than-temporary include: (a) the length of time and extent to which the fair value has been below cost; (b) the financial condition and near-term prospects of the issuer; and (c) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for any anticipated recovery. In addition, for securities expected to be sold, an other-than-temporary impairment charge is recognized if the Company does not expect the fair value of a security to recover to cost or amortized cost prior to the expected date of sale.

The Company employs a systematic methodology to evaluate declines in fair value below the book value for equity securities and other investments. The methodology utilizes a quantitative and qualitative process ensuring that available evidence concerning the declines in fair value below carrying value is evaluated in a disciplined manner. Based on that evaluation and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a recovery of fair value, the Company views the decline in market value of these investments as being temporary in accordance with the Company's impairment policy. However, the Company reserves the flexibility to trade any investment as deemed appropriate based on changes in credit or other market factors in managing the invested asset positions of the Company.

Effective January 1, 2006, the Company adopted FASB Statement of Position No. FAS 115-1 and FAS 124-1, Meaning of Other-Than-Temporary Impairments and Its Application to Certain Investments ("FSP FAS 115-1 and FAS 124-1"), which provides guidance on determining whether investment impairment is other-than-temporary regardless of the intent to sell and when a security is impaired due to fluctuations in interest rates.

**Variable Interest Entities**

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" ("FIN 46"). FIN 46 requires certain variable interest entities ("VIEs") to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or the entity does not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 was revised in late 2003 (FIN 46(R)) and was effective January 1, 2004 for the Company for all new VIEs created or acquired after March 31, 2003. For VIEs created or acquired by the Company prior to March 31, 2003, the provisions of FIN 46 have been applied beginning in 2005.

The Company's exposure to investment structures subject to analysis under FIN 46(R), relates primarily to investments in energy and private equity limited partnerships that are accounted for under the equity method. The Company has determined that it is the primary beneficiary for two VIEs in the energy investment sector at June 30, 2006. In addition, the Company has investments in six VIEs for which it is not the primary beneficiary at June 30, 2006. The Company's investments in VIE's are not material to the Company's consolidated financial position, results of operations or cash flows as of June 30, 2006. The Company's maximum exposure to losses from VIEs is $116 million as of June 30, 2006, and there is no recourse provision to the general credit of the Company beyond the full amount of the Company's loss exposure.

**Derivatives**

The Company has a Derivative Use Policy (DUP) which has been approved by the Investment Committee and state insurance regulatory authorities. Pursuant to the DUP, the Company may enter into derivative transactions. As of June 30, 2006, the Company had several embedded derivative instruments in its portfolio, warrants and two interest rate swaps acquired with the assets and liabilities of the Genesis life insurance business. As of June 30, 2006, the value of these instruments was immaterial. The Company recognized approximately $1.8 million in realized investment gains in the first half of 2006 associated with the derivative positions.

**Deferred Policy Acquisition Costs**

Total deferred policy acquisition costs were $1.644 billion and $1.476 billion as of June 30, 2006 and December 31, 2005, respectively. Deferred policy acquisition costs are costs that vary with, and are primarily related to, the acquisition of new and renewal insurance and investment contracts that are deferred and amortized over the respective policy terms. Deferred acquisition costs are reviewed annually for recoverability. Investment income is considered in the recoverability assessment. For short-duration insurance contracts, acquisition costs include commissions, underwriting expenses, and premium taxes and assessments. For long-duration insurance contracts, these costs include first year commissions in excess of annual renewal commissions and variable sales, underwriting and administrative expenses.

**Goodwill and Intangibles**

Goodwill and intangible assets were $829 million and $810 million at June 30, 2006 and December 31, 2005, respectively.

**Deferred Income Taxes**

The net deferred income tax asset was $2.016 billion and $1.627 billion as of June 30, 2006 and December 31, 2005, respectively, net of a valuation allowance of $107 million and $99 million, respectively. Management believes it is more likely than not that the Company’s net deferred income tax asset will be realized based on the Company’s ability and likelihood of generating future taxable income.

The income tax provision is calculated under the liability method. Deferred tax assets and liabilities are recorded based on the difference between the financial statement and tax bases of assets and liabilities at the enacted tax rates. The principal assets and liabilities giving rise to such differences are unrealized capital gains and losses on certain investments, insurance loss reserves, unearned premiums, deferred policy acquisition costs, employee benefits, net operating losses, and alternative minimum tax credits.

The Company provides for Federal and foreign income taxes based on amounts that it believes it ultimately will owe. Inherent in the provision for Federal and foreign income taxes are estimates regarding the deductibility of certain expenses and the realization of certain tax credits. In the event the ultimate deductibility of certain expenses or the realization of certain tax credits differs from estimates, the Company may be required to significantly change the provision for Federal and foreign income taxes recorded in the consolidated financial statements.

**About the Company**

Boston-based Liberty Mutual Holding Company Inc., the parent corporation of the Liberty Mutual Group of entities ("LMG" or the "Company"), is a diversified global insurer and sixth largest property and casualty insurer in the U.S. based on 2005 direct written premium. The Company also ranks 102nd on the Fortune 500 list of largest corporations in the United States based on 2005 revenue. As of December 31, 2005, LMG had $78.824 billion in consolidated assets, $69.966 billion in consolidated liabilities, and $21.161 billion in annual consolidated revenue.

LMG, through its subsidiaries and affiliated companies, offers a wide range of property-casualty insurance products and services to individuals and businesses alike. In 2001 and 2002, the Company formed a mutual holding company structure, whereby the three principal mutual insurance companies, LMIC, LMFIC and EICOW, each became separate stock insurance companies under the ownership of Liberty Mutual Holding Company.

Functionally, the Company conducts its business through four strategic business units: Personal Market, Commercial Markets, Agency Markets (formerly Regional Agency Markets but now includes Wausau and Surety) and International. Each business unit operates independently of the others and has dedicated sales, underwriting, claims, actuarial, financial and certain information technology resources. Management believes this structure allows each business unit to execute its business strategy and/or to make acquisitions without impacting or disrupting the operations of the Company's other business units.

LMG employs over 39,000 people in more than 900 offices throughout the world. For a full description of the Company's business operations, products and distribution channels, please visit Liberty Mutual's Investor Relations web site at www.libertymutual.com/investors.