See more.

Do more.

Go further.

Look beyond.

Liberty Mutual Group 2004 Annual Report

Our expertise.

SKILLED, KNOWLEDGEABLE, WELL-TRAINED AND EXPERIENCED EMPLOYEES, ALL MOTIVATED BY SHARED GOALS FOCUSED CONSTANTLY ON CUSTOMERS— TODAY'S WORLD DEMANDS NOTHING LESS.

Your Benefit.

POLICYHOLDER MESSAGE | PAGE 2 | LIBERTY MUTUAL GROUP OVERVIEW | PAGE 6 | FINANCIAL HIGHLIGHTS | PAGE 8 | LINES OF BUSINESS | PAGE 9 | FINANCIAL STATEMENTS | PAGE 26

Policyholder message

See more.

EDMUND F. KELLY | CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

TO OUR POLICYHOLDERS 2004, with its four major Florida hurricanes, reminded us of the business we're in, and why we're in it. In response to the devastating losses experienced by people and businesses, more than 900 Liberty Mutual employees from throughout the U.S. responded by settling our policyholders' claims fairly and quickly. So I start with thanks to those Liberty Mutual people who performed their jobs in such exemplary fashion. They make us proud of who we are, and what we do — helping people put their lives back together after devastating losses, such as those caused by the hurricanes.

For the insurance industry as a whole, including Liberty Mutual, the hurricanes — at $21.6 billion in losses — had a significant financial impact. However, despite the hurricanes, Liberty Mutual reported substantial growth in revenue and earnings, and achieved an important milestone in the process. Worldwide revenues were $19.6 billion, up from $16.6 billion in 2003, cash flow from operations totaled $3.2 billion, and we exceeded $1 billion in earnings for the first time, reporting $1.2 billion in net income, up from $851 million in 2003. Pre-tax operating income was $766 million, a $361 million increase over 2003. And policyholders' equity increased $1.3 billion to $8.7 billion in 2004, while consolidated assets totaled $72.4 billion at year end.

Financially, we're in solid shape. Our record earnings, while a large number in absolute terms, reflect the scale, scope and diversity of our operations. Even with the significant losses in Florida we demonstrated the ability to grow and prosper.

Do more.

Today, as always, nothing is more important to us than our commitment, and our obligation, to pay our policyholder claims quickly and fairly. Over the last few years, we've enjoyed strong earnings despite strengthening our balance sheet to address such industry legacy issues as asbestos and pollution exposures. Our robust cash flow has enabled us to grow our investment portfolio. The combination of strong earnings and cash flow has us better positioned than ever to meet our commitments to our policyholders.

> "The aggregate performance and positioning of our business units positions us very well to succeed in an environment that will be considerably more difficult in the coming years."

Fortunately, 2004 brought more than hurricanes to Florida. In positive contrast, in October we opened the "Where's the Fire?™" exhibit at INNOVENTIONS at Epcot® at The Walt Disney World Resort®. A fun, hands-on experience that educates families on fire hazards that may exist in their homes, the exhibit also features a 30-foot-long, fully functioning fire truck built by 76-year Liberty Mutual customer W.S. Darley & Sons. All who have seen the exhibit have been highly pleased and complimentary, and it has been a pleasure working with Disney in another expression of our mission to help people live safer, more secure lives.

As for our operating businesses, each of our four business units — Personal Market, Commercial Markets, Regional Agency Markets and Liberty International — had continued strong results. Today, from a revenue source perspective, we're better balanced than ever before. Strategically, we completed the integration of Prudential Financial's property and casualty business, giving us nearly $1 billion in additional personal lines premium and a new distribution channel, the Prudential agents; and we acquired a company in Chile, expanding our presence to 20 countries worldwide.

The aggregate performance and positioning of our business units positions us very well to succeed in an environment that will be considerably more difficult in the coming years. In addition to growing profitably over the past few years, our businesses have built the necessary infrastructure to ensure flexibility to adapt quickly to changing market conditions and business risks.

Specifically, after a long period during which prices returned to an adequate level, the insurance industry shows signs of reverting to its historical habit of irrational price competition. This means that, in some situations, companies will price risk at inadequate levels, and at levels that will inevitably cause a drain on their capital. In this environment, the most

Go further.

critical task we face is to protect our hard-won financial strength. For this, we will rely on our underwriting and service organizations to manage our risks on an economic basis. Most important, we will use our knowledge of our policyholders to help ensure that they continue to receive high-quality, appropriate coverage, at a fair price.

"Today, as always, nothing is more important to us than our commitment, and our obligation, to pay our policyholder claims quickly and fairly."

Not all threats to the industry, of course, are self generated. For example, as we publish this report, the future of the Terrorism Risk Insurance Act (TRIA) remains uncertain. As most of you know, Congress enacted TRIA as a temporary program with an expiration date of December 31, 2005. Yet terrorism has no expiration date. It is a real and continuing threat to our country and our company. Nothing is more critical for the property and casualty insurance industry than the extension of TRIA. It is far too easy to conceive of a terrorist event that would be far beyond the capabilities of the insurance sector to endure.

In 2004, a bill to extend TRIA failed despite broad bi-partisan support. The House Financial Services Committee passed a two-year extension in September only to see it sidetracked by concerns about the nature and amount of federal support. The challenge in 2005 is to build on last year's momentum and address the concerns of House and Senate leaders who encourage the industry to come forward with new ideas to better balance TRIA's public and private financing. In short, congressional leaders want the industry to assume more of the risk of terrorism, and we're committed to finding an appropriate balance and to vigorously promote it within the industry and on Capitol Hill. We remain optimistic that, with your help, we will get TRIA extended.

Another area of concern is asbestos litigation, described by the Supreme Court as an "elephantine mass" and a national problem that "cries out for a legislative solution."

We have a high degree of confidence that our asbestos reserves are adequate, but we believe it is very desirable for the economy as a whole that Congress pass meaningful asbestos litigation legislation. We are concerned that the current "trust fund" proposal is fundamentally flawed — far too expensive and lacking the necessary finality. Our strong preference is for a bill that would move most asbestos cases to federal court and establish clear medical criteria for compensation. Such a bill would be fair to truly injured claimants, defendant companies and insurers who pay the claims.

Look beyond.

Some positive news came out of Washington in early 2005 when Congress passed long-sought class action reform. The Class Action Fairness Act corrects a much-abused part of our civil justice system where plaintiffs from different states would venue shop and sue deep-pocket defendants in state courts with little or no relationship to the alleged wrong. The new law requires these multi-state class actions to be brought in federal court where the rights of all litigants — plaintiffs and defendants — can be better protected.

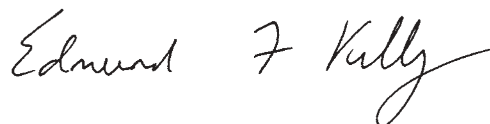
The discussions of TRIA, asbestos legislation and class action reform highlight a broader concern. While Liberty Mutual has long been a champion of state-based regulation of the insurance industry, it's apparent that the issues of most dire consequences are federal rather than state in nature. With that in mind, we continue to monitor the growing discussion of federal insurance oversight with an open mind, being cognizant of the historical benefits of the state regulatory structure but also of its apparent inadequacies in the face of the larger national problems.

Regardless of how we're regulated, we will succeed only if we provide high-quality coverage and service to our policyholders. This requires a continued commitment by all Liberty Mutual Group employees to high-quality service. In this policyholder report, we highlight and celebrate some of our expertise in meeting the needs of the marketplace.

While we offer these examples, we realize that high-quality service is a moving target. What is good today cannot be taken for granted. We must continually ratchet up our service levels. To ensure this happens, we will continue to invest in hiring and training the best employees, build our technology to quickly take advantage of today's e-commerce world, and respond to the product and service needs and preferences of our customers.

So, I look back at 2004 with great pride, and I look forward with tremendous optimism, tempered by the realization that we have much to do. However, I can think of no other group of people with whom I would rather work or from whom I could expect more, than the employees of Liberty Mutual Group. I thank them for their expertise and their commitment to our policyholders, our partners in business, and to our company.

I also thank our Board of Directors for their guidance and support, our distribution partners for their business, our bondholders for their confidence, and most of all you, our policyholders, for continuing to place your trust in us.



EDMUND F. KELLY | CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

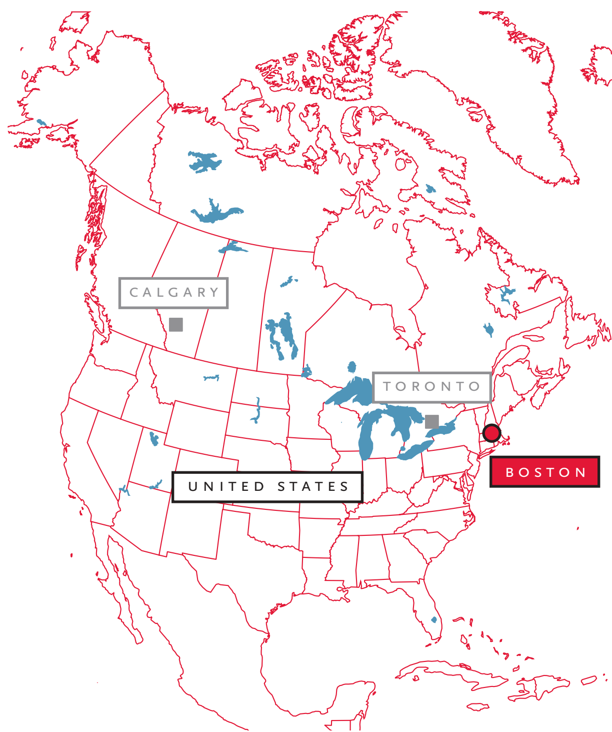
An overview

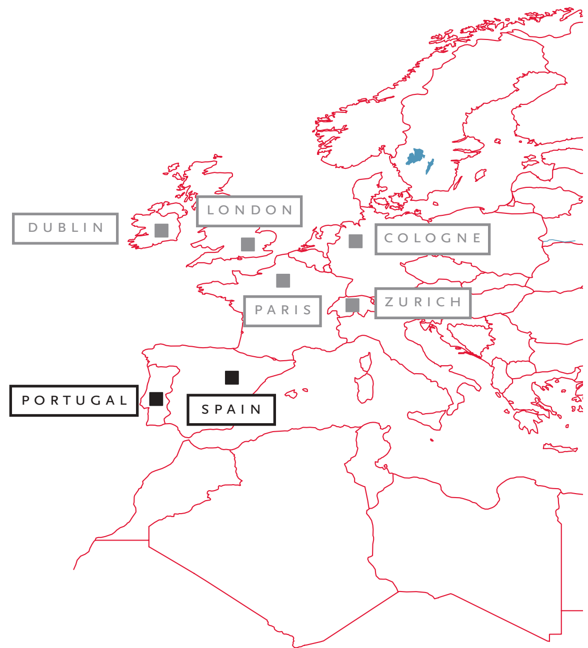
Liberty mutual group is a diversified international group of insurance companies. As of December 31, 2004, Liberty Mutual had $72.4 billion in consolidated assets and $19.6 billion in consolidated revenues. The company ranks 116 on the Fortune 500 list of largest U.S. corporations, and it is the sixth-largest property and casualty insurer in the U.S., based on 2003 direct written premium.

The company offers a wide range of insurance products and services, including private passenger automobile (the company's largest line of business), homeowners, workers compensation, commercial multiple peril/fire, commercial automobile, general liability, global specialty products, group disability and surety.

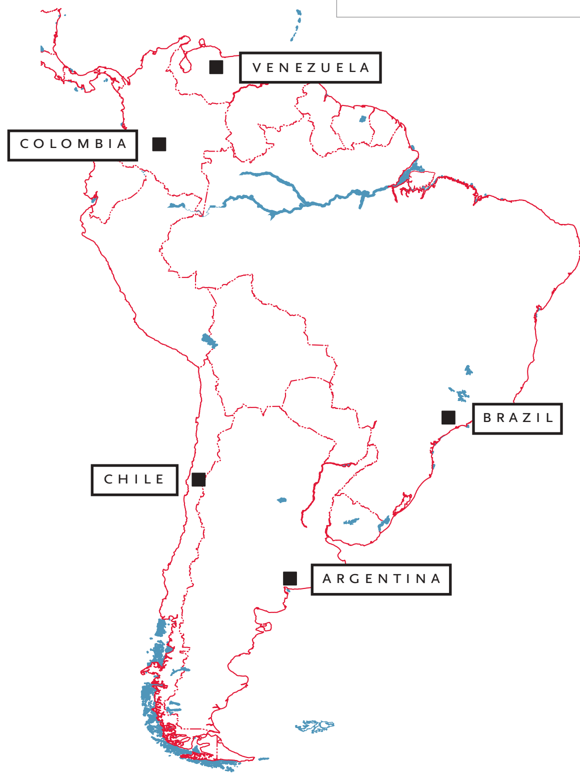
Headquartered in Boston, Massachusetts, Liberty Mutual Group employs more than 38,000 people in approximately 900 offices throughout the world.

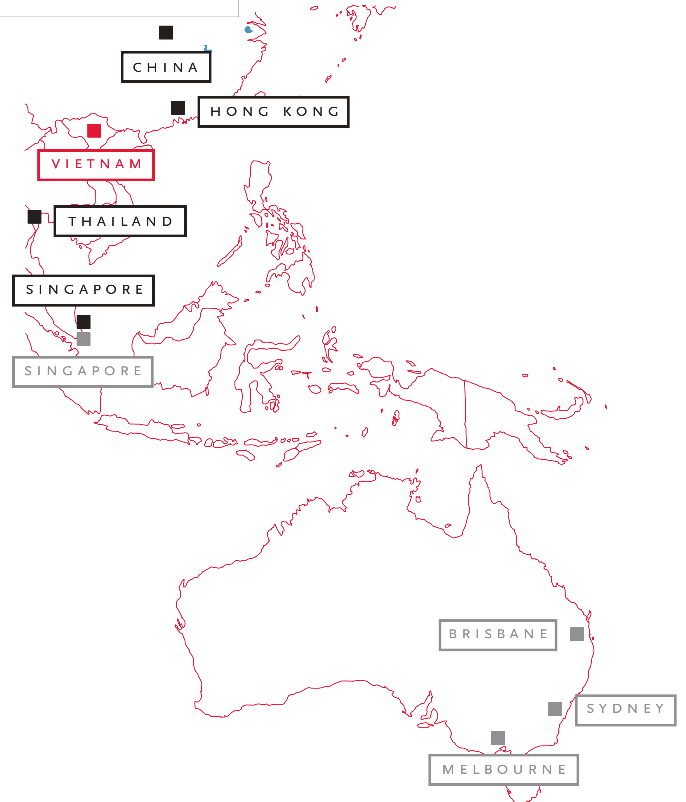
Liberty Mutual Group revenues for 2004 were $19.6 billion, an 18.2 percent increase over 2003. Net investment income increased by $198 million to $2.0 billion, on cash flow of $3.2 billion. Pre-tax operating income for 2004 was $766 million, an increase of $361 million over 2003. The group's GAAP property and casualty combined ratio improved by 1.6 points to 102.9 percent, and GAAP policyholders' equity increased by approximately $1.3 billion to $8.7 billion.





- LOCAL COMPANIES
- LIU OFFICES
- OTHER LIBERTY INTERNATIONAL OFFICES
- HEADQUARTERS





Financial highlights

(dollars in millions)

december 31	2004	2003	2002
Liberty Mutual Group			
Revenues	$19,641	$16,618	$14,290
Pre-tax operating income*	766	405	492
Pre-tax income	1,219	777	611
Cash flow from operations	3,237	2,684	1,566
Total assets	72,359	64,387	55,774
GAAP combined ratio	102.9%	104.5%	105.6%
Personal Market			
Revenues	$ 5,931	$ 4,690	$ 4,178
Pre-tax operating income	613	397	342
Cash flow from operations, pre-tax	990	934	855
Total assets	13,887	14,660	10,344
GAAP combined ratio	95.5%	97.9%	99.9%
Commercial Markets			
Revenues	$ 5,618	$ 5,342	$ 4,646
Pre-tax operating income	401	412	447
Cash flow from operations, pre-tax	1,143	832	221
Total assets	26,078	24,733	23,491
GAAP combined ratio	104.6%	105.9%	107.4%
Regional Agency Markets			
Revenues	$ 3,975	$ 3,387	$ 2,908
Pre-tax operating income	324	302	160
Cash flow from operations, pre-tax	1,006	802	379
Total assets	8,536	7,888	7,218
GAAP combined ratio	100.0%	100.6%	106.1%
Liberty International			
Revenues	$ 3,620	$ 2,926	$ 2,515
Pre-tax operating income	273	130	178
Cash flow from operations, pre-tax	768	750	686
Total assets	13,023	9,672	6,359
GAAP combined ratio	97.8%	101.8%	102.8%
Other**			
Revenues	$ 497	$ 273	$ 43
Pre-tax operating income	(845)	(836)	(635)
Cash flow from operations	(670)	(634)	(575)

* Consistent with the basis used by management for measuring operating performance internally, investment income is allocated to the major businesses on a total return basis, which includes allocating expected long term returns on invested assets and differs from the methodology utilized in the company's recent debt offering and its financial reporting on the company's website.

** Other includes discontinued operations (including asbestos and environmental), interest expense, internal reinsurance programs, certain expenses not allocated to the business units, net realized gains and losses from domestic operations and other revenues from corporate subsidiaries.

Liberty Mutual Group results include all significant business units of Liberty Mutual. Each business unit is reported in accordance with generally accepted accounting principles.

Lines of business

LIBERTY MUTUAL GROUP

Personal market

PAGES | 10 — 13

Commercial markets

PAGES | 14 — 17

Regional agency markets

PAGES | 18 — 21

Liberty international

PAGES | 22 — 25

PERSONAL MARKET

$5.9 BILLION IN REVENUES

AT A GLANCE

PERSONAL MARKET SELLS FULL LINES OF COVERAGE FOR AUTOMOBILES, HOMEOWNERS, VALUABLE POSSESSIONS AND PERSONAL LIABILITY THROUGH ITS OWN SALES FORCE, TWO DIRECT RESPONSE CENTERS, PRUDENTIAL AGENTS AND THE INTERNET. IT ALSO OFFERS A WIDE RANGE OF TRADITIONAL AND VARIABLE LIFE INSURANCE AND ANNUITY PRODUCTS.

DISTRIBUTION

DIRECT SALES FORCE
DIRECT RESPONSE CENTERS
PRUDENTIAL AGENTS
INTERNET

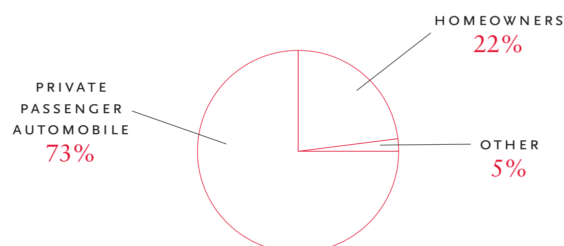
BY THE NUMBERS

8TH-LARGEST WRITER OF PERSONAL LINES P&C INSURANCE IN THE U.S. BASED ON 2003 NET WRITTEN PREMIUM | 4.1 MILLION AUTO AND HOME POLICIES | 11,077 EMPLOYEES | 7,800 AFFINITY RELATIONSHIPS | 1,200 FIELD SALES REPRESENTATIVES | 327 TELESALES COUNSELORS | 2,000 PRUDENTIAL LIFE INSURANCE AGENTS

FINANCIAL RESULTS | DOLLARS IN MILLIONS

	2004	2003	2002
Revenues	$5,931	$4,690	$4,178
Pre-Tax Operating Income	$613	$397	$342
Cash Flow from Operations	$990	$934	$855
GAAP Combined Ratio	95.5%	97.9%	99.9%
Policies in Force	4,489,959	4,468,536	3,138,640

PRODUCT MIX | BASED ON NET WRITTEN PREMIUM



Despite four major hurricanes battering Florida within a six-week period, 2004 was a good year for Liberty Mutual Group's Personal Market, which reported revenues of $5.9 billion, pre-tax operating income of $613 million and a 95.5 percent combined ratio. Contributing to this strong performance were record auto and homeowner sales, a 90.4 percent customer retention rate, and premium rate increases.

Over the last several years, Personal Market has successfully grown and expanded its distribution network, which now includes: 1,200 sales representatives; 327 insurance sales counselors in two telephonic direct response centers; an exclusive distribution agreement with more than 2,000 Prudential agents; and an increasingly interactive internet presence. In 2004 this integrated distribution network continued to prove itself as new business policy sales increased 16 percent over 2003, with Personal Market's direct response centers in Phoenix, Ariz., and Orlando, Fla., making a significant contribution to that growth. On the life insurance side, Personal Market sold 5 percent more policies than a year ago, and it continues to be a leader in selling life insurance through banks.

Critical to the success of each distribution channel has been Personal Market's affinity relationships with the employees and members of more than 7,800 companies and associations throughout the U.S. In 2004, the Affinity Market Group reached $2 billion of premium in force, which translates into a three-year average annual growth rate of 27.9 percent.

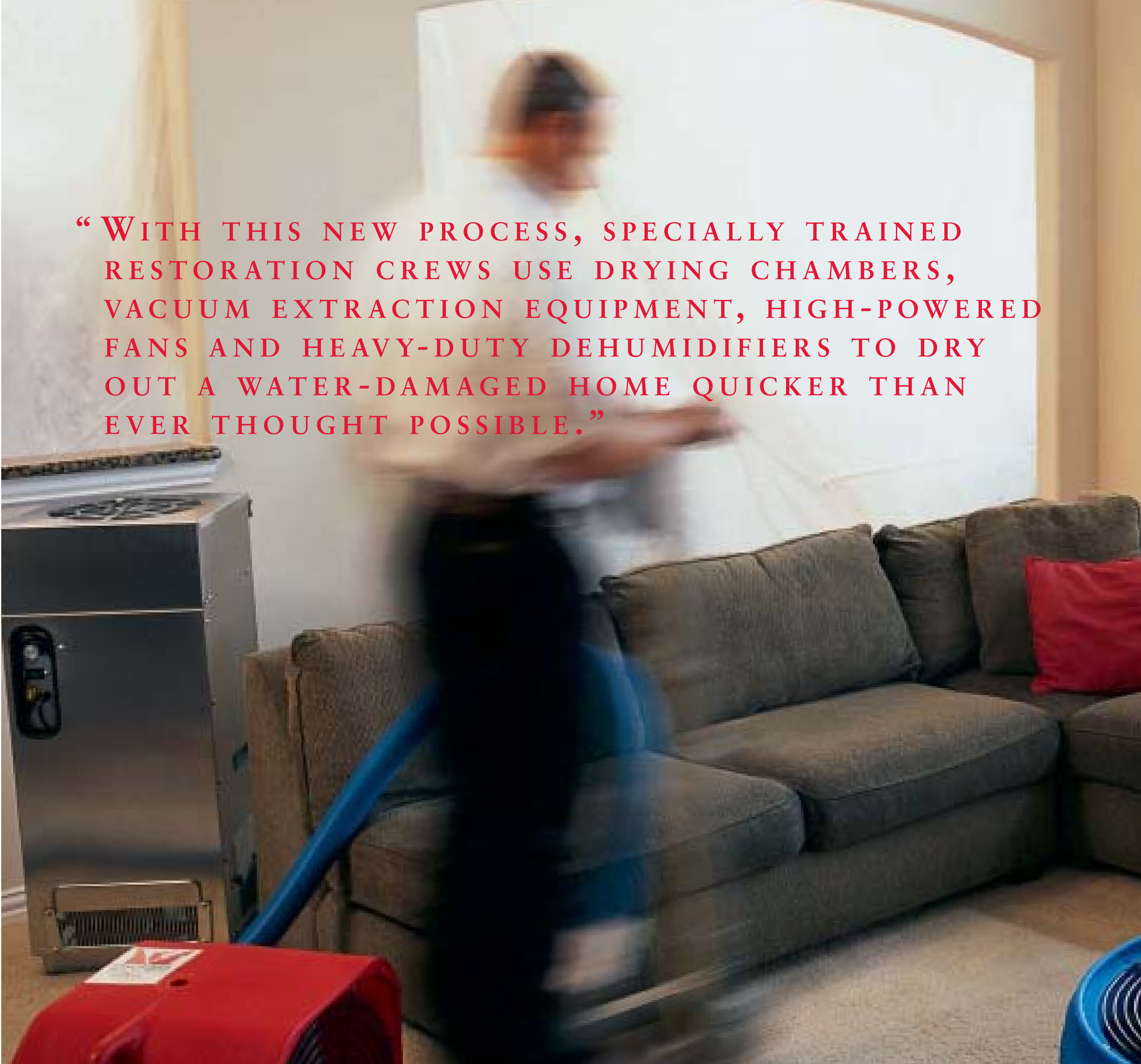
Gaining new customers is one thing, keeping them is another. That's why Personal Market's strategy is to provide fairly priced and comprehensive products that meet its customers' needs and exceed their service expectations. While customer service ratings improved again in 2004, customer satisfaction remains a focal point for Personal Market as it encourages its front-line staff to not simply satisfy customers' expectations, but to exceed them. Complementing these person-to-person transactions is Personal Market's online eService. Today more than 150,000 policyholders take advantage of this online capability to view policies and billing details, pay bills and report claims.

Underpinning this service culture is Personal Market's proactive approach to helping its customers live safer, more secure lives. And nothing more dramatically exemplifies this dedication to safety than the Liberty Mutual-sponsored "Where's the Fire?™" exhibit at INNOVENTIONS at Epcot® at The Walt Disney World Resort® in Florida, which opened to the public in October 2004. Further communicating the safety message, are *Liberty Lines,* Personal Market's consumer magazine, its partnership with Students Against Destructive Decisions or SADD, and the Liberty Mutual Rewards program, which provides value-added discounts on auto- and home-related products and services, along with safety and maintenance information.

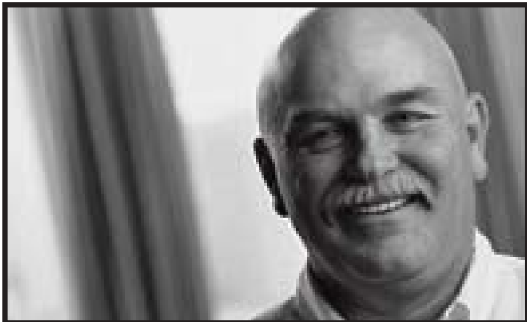
Finally, and perhaps most importantly, there's the commitment of Personal Market employees, through educational seminars on safe driving, identity theft protection and other topics, to the communities in which they conduct business. It's this dedication — to customer service, and consumer safety and security — that will help Personal Market achieve its longer-term goal of continued growth and recognition as the premier provider of personal lines insurance.

"WE ENCOURAGE OUR FRONT-LINE STAFF TO NOT SIMPLY SATISFY CUSTOMERS' EXPECTATIONS, BUT TO EXCEED THEM."

J. PAUL CONDRIN III | EXECUTIVE VICE PRESIDENT



WATER DAMAGE: the words conjure images of squishy carpets, dank smells, stained floors and walls, and the potential for mold. While not a pretty picture, such an image doesn't discourage Liberty Mutual Property Adjuster Bill Welch, who sometimes arrives on the scene before the plumber. As a property loss specialist trained in the drying restoration process called Applied Structural Drying, he knows he can dry out a home quickly with minimal inconvenience to the homeowner leaving most, if not all, furnishings intact. With this new process, specially trained restoration crews use drying chambers, vacuum extraction equipment, high-powered fans and heavy-duty dehumidifiers to dry out a water-damaged home quicker than ever thought possible. "By monitoring temperature, relative humidity and moisture levels inside and outside the house, we can cut drying times and usually avoid costly restoration work, such as ripping out carpets or plasterboard," Welch said.



BILL WELCH | LIBERTY MUTUAL PROPERTY ADJUSTER

Commercial markets

$5.6 Billion in revenues

At a glance

COMMERCIAL MARKETS **USES MULTIPLE CHANNELS OF DISTRIBUTION TO PROVIDE SOPHISTICATED RISK MANAGEMENT AND RISK TRANSFER SERVICES UNDER THE LIBERTY MUTUAL AND WAUSAU BRAND NAMES.**

DISTRIBUTION CHANNELS

DIRECT SALES FORCE
INDEPENDENT AGENTS
NATIONAL AND REGIONAL BROKERS
BENEFITS AND RISK MANAGEMENT CONSULTING FIRMS

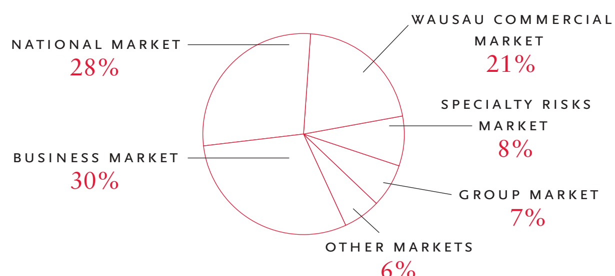
BY THE NUMBERS

5TH-LARGEST WRITER OF COMMERCIAL LINES INSURANCE IN THE U.S. BASED ON 2003 DIRECT WRITTEN PREMIUM | 10,730 EMPLOYEES | 646,000 CLAIMS CALL CENTER CALLS | 520 NATIONAL CUSTOMERS 10,000 MIDDLE-MARKET CUSTOMERS | 480 LOSS PREVENTION CONSULTANTS | $1.2 BILLION IN MEDICAL BILL REVIEW SAVINGS

FINANCIAL RESULTS | DOLLARS IN MILLIONS

	2004	2003	2002
Revenues	$5,618	$5,342	$4,646
Pre-Tax Operating Income	$401	$412	$447
Cash Flow from Operations	$1,143	$832	$221
GAAP Combined Ratio	104.6%	105.9%	107.4%

BUSINESS LINES | BASED ON NET WRITTEN PREMIUM



Liberty Mutual Group's Commercial Markets had another strong year in 2004, with continued growth in earnings, cash flow and revenue, backed by disciplined underwriting, appropriate rate increases and strong customer retention. This group of businesses brought 2004 to a close with pre-tax operating income of $401 million, revenues of $5.6 billion, cash flow of $1.1 billion, and a 104.6 percent GAAP combined ratio. Well-established as a leading workers compensation insurance provider, Commercial Markets continues to diversify its book of business with increased emphasis on its commercial property, auto and liability lines.

Commercial Markets applies a multi-channel distribution strategy through five businesses: National, Business, Wausau, Specialty Risks and Group Markets. Each of these businesses, while diverse in markets served and products offered, strives to lower its customers' overall cost of risk.

The National Market's 55 account executives, working in cooperation with brokers and advisers, serve customers with multi-state operations and annual premium in excess of $2.5 million. In 2004, the National Market's net written premium increased 6 percent to $1.3 billion due to new business growth, rate increases and improved customer retention across all major products: workers compensation, commercial automobile, general liability and umbrella. Premium retention increased to 89.0 percent from 86.6 percent in 2003.

The Business Market uses its 375 exclusive sales representatives to sell to middle-market businesses; those with all-lines annual premium between $75,000 and $2.5 million. Its 2004 net written premium increased 13 percent to $1.4 billion, reflecting strong new premium growth, rate increases and lower reinsurance premium.

Also serving the middle market is Wausau Commercial Market, which distributes its products and services through approximately 215 independent producers, and its own captive sales agents. The first insurer to let producers submit middle-market accounts directly from their own agency management systems, Wausau increased its net written premium by 14 percent to $965 million in 2004.

The Specialty Risks Market, which includes Liberty Mutual Property, Liberty Mutual Surety and Captive Services, uses Commercial Markets distribution channels, as well as its own producer channels, to provide property insurance, surety and fidelity bonds, and captive programs. Its net written premium increased 14 percent in 2004 to $355 million.

The Group Market, which sells group life insurance and disability products through brokers and consultants, increased its net written premium to $335 million.

In 2005, a softening market and increased competition, combined with rising loss and reinsurance costs, make it more critical than ever that Commercial Markets focus on maintaining underwriting discipline, improving loss management, and optimizing its selling and channel management.

"EACH OF OUR BUSINESSES STRIVES TO LOWER ITS CUSTOMERS' OVERALL COST OF RISK."

GARY R. GREGG | EXECUTIVE VICE PRESIDENT

THE CONSTRUCTION OF A MAJOR SPORTS STADIUM COMES WITH SPECIAL SAFETY REQUIREMENTS. That's why the now three-time Super Bowl Champion New England Patriots turned to Liberty Mutual Technical Consultant Greg Pender for his workplace safety expertise when the time came to tear down its old stadium in Foxboro, Mass., and build a new one. With 20-plus years' experience, Pender knew full well he'd be working with a tight, unforgiving schedule. "The football season doesn't wait, so we couldn't demolish the old stadium until the new stadium construction achieved certain milestones," he said. Of particular concern to Pender with any stadium construction project is the structure's unique shape. "A bowl-type shape creates more potential for life-threatening falls as you work outward and upward to heights as great as 180 feet," said Pender, who worked closely with the 50 subcontractors to safeguard against high-severity injuries.

“A bowl-type shape creates more potential for life-threatening falls as you work outward and upward to heights as great as 180 feet.”

GREG PENDER | LOSS PREVENTION TECHNICAL CONSULTANT

Regional agency Markets

$4.0 Billion in revenues

At a glance

REGIONAL AGENCY MARKETS (RAM) IS A NATIONAL ORGANIZATION OF REGIONAL PROPERTY AND CASUALTY INSURANCE COMPANIES THAT CONCENTRATE ON SMALL TO MID-SIZED COMMERCIAL AND PERSONAL LINES MARKETS AND DISTRIBUTE THEIR PRODUCTS AND SERVICES PRIMARILY THROUGH INDEPENDENT AGENTS AND BROKERS.

RAM CONSISTS OF THE FOLLOWING COMPANIES:

AMERICA FIRST INSURANCE | GULF REGION
COLORADO CASUALTY | MOUNTAIN REGION
GOLDEN EAGLE INSURANCE | PACIFIC REGION
HAWKEYE-SECURITY INSURANCE | NORTH CENTRAL REGION
INDIANA INSURANCE | MIDWEST REGION
LIBERTY NORTHWEST | PACIFIC NORTHWEST REGION
MONTGOMERY INSURANCE | SOUTHEAST REGION
PEERLESS INSURANCE | NORTHEAST REGION

RAM ALSO INCLUDES SUMMIT HOLDING SOUTHEAST, INC., A SPECIALTY INSURER OFFERING WORKERS COMPENSATION PRODUCTS AND SERVICES PRIMARILY IN FLORIDA, AND BUSINESS SOLUTIONS GROUP, WHICH ASSISTS THE COMPANIES OF THE RAM ORGANIZATION THROUGH ITS COMMERCIAL SERVICE CENTER OPERATIONS.

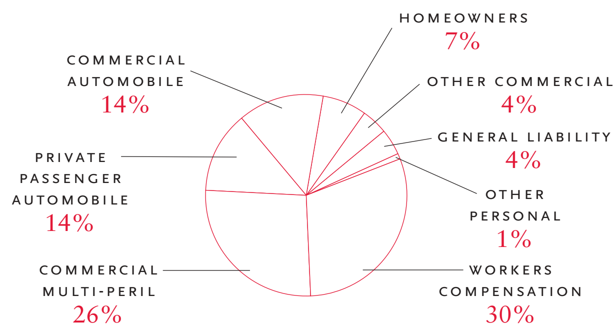
BY THE NUMBERS

TOP THREE CARRIER WITH 70 PERCENT OF ITS AGENCIES | 5,500 INDEPENDENT AGENT AND BROKER RELATIONSHIPS | 5,000 EMPLOYEES | ONE MILLION "VISITS" TO AGENCY PORTALS | 1.4 MILLION POLICIES IN FORCE | $6,500 AVERAGE COMMERCIAL POLICY PREMIUM

FINANCIAL RESULTS | DOLLARS IN MILLIONS

	2004	2003	2002
Revenues	$3,975	$3,387	$2,908
Pre-Tax Operating Income	$324	$302	$160
Cash Flow from Operations	$1,006	$802	$379
GAAP Combined Ratio	100.0%	100.6%	106.1%

PRODUCT MIX | BASED ON NET WRITTEN PREMIUM



Liberty Mutual Group's youngest strategic business unit, Regional Agency Markets (RAM), has significantly grown its revenue base, through acquisitions and organic growth, during its first six years of existence. Today RAM is a well-established contributor among the company's four strategic business units, contributing approximately 20 percent of revenue in 2004.

For the year, RAM reported $4.0 billion in revenue, $324 million in pre-tax operating income, cash flow of $1.0 billion and a 100.0 percent combined ratio.

RAM's eight regionally branded and two specialty companies, which operate across the United States, provide personal and small-to-mid-size commercial insurance products primarily through more than 5,500 independent agents and brokers. All but one of these companies grew profitably in 2004 by combining their local knowledge, decision-making, marketing and claims handling with the financial stability and cost efficiencies of Liberty Mutual Group.

Underpinning RAM's success is its ability to run an efficient, effective organization, and an agency management philosophy and approach that gets the best business from the best agents. Through consistent application of RAM's agency appointment, planning and performance monitoring programs, RAM companies develop strong and profitable agency relationships.

Today, RAM companies enjoy strong brand recognition and high agency satisfaction. Helping to solidify this position are the companies' sophisticated web agency portals, which allow agents to obtain real-time quotes, submit applications, report and monitor claims, make billing inquiries and more — over the internet. In 2004, RAM agents submitted 97 percent of their small commercial business through the web application, Commercial IQ. RAM also enhanced its consumer web sites by giving policyholders secure access to their account and billing information. Overall, the RAM companies' portals received more than one million visits in 2004.

Whether handling commercial or personal lines, fair, efficient claims handling is critical, and it's one of the RAM companies' significant strengths. A centralized claim management model, adherence to best practices, strong technical claim handling skills and an emphasis on customer satisfaction allow RAM company field claim managers to best serve the needs of their local marketplace.

Through a continued focus on the fundamentals — agency management, proper pricing and underwriting, and claims handling — RAM will continue to enhance its strong competitive position in writing small-to-mid-size commercial lines, and improve and grow its position in personal lines.

"TODAY, RAM COMPANIES ENJOY STRONG BRAND RECOGNITION AND HIGH AGENCY SATISFACTION."

ROGER L. JEAN | EXECUTIVE VICE PRESIDENT

DIANNE RICHEY LOVES ORLANDO FLA.-BASED ROSEN HOTELS, BUT IT'S NOT FOR THE ROOM SERVICE. Rather, as a senior claims adjuster with Summit, a Regional Agency Markets company that specializes in workers compensation, Richey appreciates Rosen's aggressive approach to getting injured hotel workers back to work. "No matter what the injury, Rosen will find a job for that employee, even if it's folding napkins," she said. "By doing so everybody wins — the employee, the company and the insurer." Richey should know, having spent the last ten years overseeing claims handling for several of Summit's larger, more-established accounts in Florida. "Dianne and I connect on a daily basis, and we hold conference calls once a month during which we review all outstanding claims," said Rosen Hotels Benefits Manager DeeDee Bracewell. "She really knows our business, and she works proactively with us, whether it's processing claims or researching return-to-work opportunities."

"NO MATTER WHAT THE INJURY, ROSEN WILL FIND A JOB FOR THAT EMPLOYEE, EVEN IF IT'S FOLDING NAPKINS. BY DOING SO EVERYBODY WINS — THE EMPLOYEE, THE COMPANY AND THE INSURER."

DIANNE RICHEY | SENIOR CLAIMS ADJUSTER

Liberty international

$3.6 Billion in revenues

At a glance

LIBERTY INTERNATIONAL OPERATES TWO FRANCHISES: A PERSONAL LINES AND SMALL COMMERCIAL BUSINESS IN SELECTED COUNTRIES IN LATIN AMERICA, EUROPE AND ASIA, AND LIBERTY INTERNATIONAL UNDERWRITERS, A GLOBAL SPECIALTY LINES BUSINESS.

COUNTRY OPERATIONS (57 PERCENT OF INTERNATIONAL NET WRITTEN PREMIUM)

ASIA
CHINA | HONG KONG | SINGAPORE | THAILAND | VIETNAM

EUROPE
PORTUGAL | SPAIN

LATIN AMERICA
ARGENTINA | BRAZIL | CHILE | COLOMBIA | VENEZUELA

LIBERTY INTERNATIONAL UNDERWRITERS (LIU) (43 PERCENT OF INTERNATIONAL NET WRITTEN PREMIUM)
LIBERTY SYNDICATE MANAGEMENT | LIBERTY MUTUAL INSURANCE EUROPE | LIU AUSTRALIA | LIU CANADA | LIU SINGAPORE | LIU U.S.

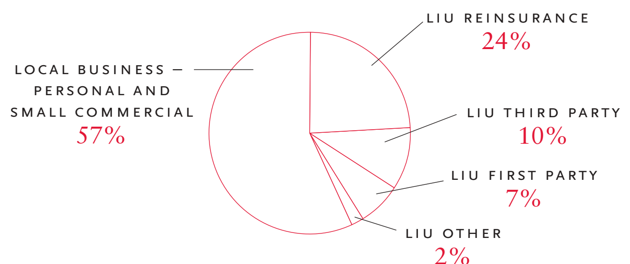
BY THE NUMBERS

6,700 EMPLOYEES | 2ND-LARGEST U.S.-BASED INTERNATIONAL P&C COMPANY | 4TH-LARGEST MANAGING AGENT IN LLOYD'S | NUMBER ONE RANKING IN COLOMBIA AND VENEZUELA | LARGEST FOREIGN-OWNED P&C COMPANY IN THAILAND | FIRST APPROVED FOREIGN INSURER IN WESTERN CHINA | AVERAGE FIVE-YEAR GROWTH RATE OF 37 PERCENT FOR LIU

FINANCIAL RESULTS | DOLLARS IN MILLIONS

	2004	2003	2002
Revenues	$3,620	$2,926	$2,515
Pre-Tax Operating Income	$273	$130	$178
Cash Flow from Operations	$768	$750	$686
GAAP Combined Ratio	97.8%	101.8%	102.8%

PRODUCT MIX | BASED ON NET WRITTEN PREMIUM



Liberty International had its best year ever despite substantial hurricane-related losses, with $3.6 billion in revenues or 24 percent growth, pre-tax operating income of $273 million, excellent cash flow and a combined ratio of 97.8 percent, a 4-point improvement over last year. This performance came from both Liberty International franchises: its personal lines and small commercial business in selected countries, and its global specialty lines business. Together, these two businesses consist of operations in 20 countries.

Liberty International's personal lines and small commercial business consists of 11 significant in-country operations in nations with a large or growing middle class.

In Latin America, Liberty International has the largest insurance company in Venezuela, growing 32 percent in 2004, and the largest property casualty company in Colombia, growing 26 percent. In Argentina and Brazil, Liberty grew 20 percent and 47 percent, respectively. Liberty is the 8th-largest auto underwriter in Brazil. In Chile, with the recent acquisition of AGF Allianz, Chile, S.A., Liberty ranks sixth among property casualty insurers.

In Europe, Liberty International's business in Spain quickly became a national player in a mature market with more channels of distribution — direct sales, agents, brokers, and institutions such as banks and auto clubs — than any of its competitors. This business grew 70 percent overall due to both organic growth and the integration of Genesis, Liberty's acquisition from MetLife, with a 125 percent improvement in the bottom line. In Portugal, Liberty rebuilt the insurance operation acquired from Winterthur in 2003, growing 11 percent in 2004 with a significant growth in profit.

In Asia, Liberty International's licensed operation in Chongqing, China, opened in early 2004, selling insurance to local and foreign businesses. In Thailand, after a year of 38 percent growth, Liberty is now the largest foreign property casualty insurer in the country, and number five in auto overall. Meanwhile, Hong Kong and Singapore together improved the bottom line by 26 percent over last year. Liberty also has a representative office in Hanoi, Vietnam.

Liberty International's global specialty lines business, Liberty International Underwriters (LIU) — after five consecutive years of 37 percent compounded annual growth — grew its gross written premiums by 7 percent, accompanied by a 27 percent increase in its bottom line. Of note on the growth side, LIU's Asia-Pacific region grew 14 percent, and Liberty Mutual Europe continued expanding its operations with the opening of a new office in Zurich, while growing 11 percent overall. Liberty Syndicates, LIU's Lloyd's operation, the fourth-largest managing agent in Lloyd's, merged its two syndicates to create Lloyd's Syndicate 4472, resulting in increased service levels to brokers and clients, and reduced costs.

Going into 2005, Liberty International's established operations, meaningful scale in targeted geographic markets, and overall financial strength, position it well to continue to grow and further solidify its leadership position around the globe.

"BOTH OUR IN-COUNTRY OPERATIONS AND GLOBAL SPECIALTY LINES HAD THEIR BEST YEAR EVER."

THOMAS C. RAMEY | EXECUTIVE VICE PRESIDENT

BIG, BIGGER, BIGGEST. Tony Betteridge has seen them all, including this 1,284 metric ton, 95-meter-long rectifier manufactured in Japan and shipped to a petrochemical plant in China. Betteridge, a former British Merchant Marine captain, is one of two directors of Marine Risk Management for Liberty International Underwriters' Marine Division, which specializes, among other things, in the insurance of project cargos. This includes the transport of oversize and high-value items from origin to destination. Betteridge has responsibility for making sure the heavy-duty cargo reaches its destination safely and on time. "It's difficult not to become a little blasé about the size and fanfare surrounding the objects themselves, given the number of transits with which we've been involved. However, our focus never wanes on ensuring a safe and timely move," he said.

"It's difficult not to become a little blasé about the size and fanfare surrounding the objects themselves, given the number of transits with which we've been involved. However, our focus never wanes on ensuring a safe and timely move."

Tony Betteridge | Director, Marine Risk Management

FINANCIAL STATEMENTS

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(DOLLARS IN MILLIONS) YEARS ENDED DECEMBER 31,	2004	2003	2002
Revenues			
Premiums earned	$16,563	$13,956	$11,902
Net investment income	2,102	1,762	1,590
Net realized investment gains	312	373	274
Fee and other revenues	664	527	524
Total revenues	19,641	16,618	14,290
Claims, Benefits and Expenses			
Benefits, claims and claim adjustment expenses	13,069	11,133	9,882
Insurance operating costs and expenses	2,787	2,620	1,911
Amortization of deferred policy acquisition costs	2,291	1,855	1,661
Other expenses	275	233	225
Total claims, benefits and expenses	18,422	15,841	13,679
Income from continuing operations before income tax expense	1,219	777	611
Federal and foreign income tax expense	—	—	81
Income from continuing operations before extraordinary (loss) gain and discontinued operations	1,219	777	530
Extraordinary (loss) gain, net of tax	(3)	77	—
Discontinued operations, net of tax	29	(3)	(15)
Income before cumulative effect of change in accounting principle	1,245	851	515
Cumulative effect of change in accounting principle	—	—	(7)
Net income	$ 1,245	$ 851	$ 508

SEE ACCOMPANYING NOTES TO THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS.

(DOLLARS IN MILLIONS) DECEMBER 31,	2004	2003
Assets:		
Investments:		
Fixed maturities, available for sale, at fair value (amortized cost of $34,279 and $30,873)	$35,601	$32,287
Equity securities, available for sale, at fair value (cost of $1,126 and $813)	1,802	1,346
Trading securities, at fair value (cost of $447 and $203)	457	208
Other investments	990	768
Short-term investments	687	940
Total investments	39,537	35,549
Cash and cash equivalents	2,590	1,999
Premium and other receivables (net of allowance of $137 and $131)	5,642	5,238
Reinsurance recoverables (net of allowance of $349 and $306)	14,209	12,192
Deferred income taxes (net of valuation allowance of $340 and $800)	938	860
Deferred policy acquisition costs	1,354	1,104
Goodwill and intangible assets	824	762
Prepaid reinsurance premiums	1,330	1,280
Other assets	3,572	3,183
Separate account assets	2,363	2,220
Total assets	$72,359	$64,387
Liabilities:		
Unpaid claims and claim adjustment expense and future policy benefits:		
Property and casualty	$33,884	$29,952
Life	4,802	3,641
Other policyholder funds and benefits payable	2,290	2,090
Unearned premiums	8,240	7,431
Funds held under reinsurance treaties	1,767	1,902
Short-term debt	253	106
Long-term debt	2,074	1,668
Other liabilities	7,989	7,996
Separate account liabilities	2,363	2,220
Total liabilities	63,662	57,006
Policyholders' equity:		
Unassigned equity	7,439	6,194
Accumulated other comprehensive income	1,258	1,187
Total policyholders' equity	8,697	7,381
Total liabilities and policyholders' equity	$72,359	$64,387

SEE ACCOMPANYING NOTES TO THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF CASH FLOWS

LIBERTY MUTUAL HOLDING COMPANY INC.

(DOLLARS IN MILLIONS) YEARS ENDED DECEMBER 31,	2004	2003	2002
Cash flows from operating activities:			
Net income from continuing operations	$ 1,219	$ 777	$ 530
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	191	130	154
Realized investment gains	(312)	(373)	(274)
Undistributed private equity investment (gains) losses	(141)	—	155
Premium, other receivables, and reinsurance recoverables	(2,589)	(779)	(1,518)
Deferred policy acquisition costs and distribution costs	(246)	(182)	(94)
Liabilities for insurance reserves	5,512	2,998	2,762
Taxes payable, net of deferred	(229)	(68)	54
Other, net	(198)	176	(509)
Total adjustments	1,988	1,902	730
Net cash provided by operating activities	3,207	2,679	1,260
Cash flows from investing activities:			
Purchases of investments	(21,467)	(26,384)	(15,392)
Sales and maturities of investments	18,858	23,432	13,912
Property and equipment purchased, net	(208)	(258)	(169)
Other investing activities	(253)	(225)	(30)
Net cash from acquisitions and dispositions	(79)	(346)	(6)
Net cash used in investing activities	(3,149)	(3,781)	(1,685)
Cash flows from financing activities:			
Net activity in policyholder accounts	109	127	103
Debt financing, net	534	381	(185)
Net security lending activity and other financing activities	(146)	(23)	(48)
Other financing activities	—	—	(62)
Net cash provided by (used in) financing activities	497	485	(192)
Net cash provided by discontinued operations	36	1	1
Net increase (decrease) in cash and cash equivalents	591	(616)	(616)
Cash and cash equivalents, beginning of year	1,999	2,615	3,231
Cash and cash equivalents, end of year	$ 2,590	$ 1,999	$ 2,615
Supplemental disclosure of cash flow information:			
Income taxes paid	$ 185	$ 27	$ 71

SEE ACCOMPANYING NOTES TO THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS.

LIBERTY MUTUAL HOLDING COMPANY INC.

(DOLLARS IN MILLIONS)	UNASSIGNED EQUITY	ACCUMULATED OTHER COMPREHENSIVE INCOME	POLICYHOLDERS' EQUITY
Balance, January 1, 2002	$ 4,835	$ 1,050	$ 5,885
Comprehensive income			
Net income	508	—	508
Other comprehensive income (loss), net of taxes:			
Unrealized gains on securities	—	238	238
Less: reclassification adjustment for gains and losses included in net income	—	(177)	(177)
Minimum pension liability	—	(12)	(12)
Foreign currency translation adjustments	—	5	5
Other comprehensive income, net of taxes	—	54	54
Total comprehensive income			562
Balance, December 31, 2002	$ 5,343	$ 1,104	$ 6,447
Comprehensive income			
Net income	851	—	851
Other comprehensive income (loss), net of taxes:			
Unrealized gains on securities	—	144	144
Less: reclassification adjustment for gains and losses included in net income	—	(242)	(242)
Minimum pension liability	—	(13)	(13)
Foreign currency translation adjustments	—	194	194
Other comprehensive income, net of taxes	—	83	83
Total comprehensive income			934
Balance, December 31, 2003	$ 6,194	$ 1,187	$ 7,381
Comprehensive income			
Net income	1,245	—	1,245
Other comprehensive income (loss), net of taxes:			
Unrealized gains on securities	—	189	189
Less: reclassification adjustment for gains and losses included in net income	—	(203)	(203)
Minimum pension liability	—	(1)	(1)
Foreign currency translation adjustments	—	86	86
Other comprehensive income, net of taxes	—	71	71
Total comprehensive income			1,316
Balance, December 31, 2004	$ 7,439	$ 1,258	$ 8,697

SEE ACCOMPANYING NOTES TO THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS.

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts of Liberty Mutual Holding Company Inc. and its subsidiaries (collectively "LMHC" or the "Company"). Certain reclassifications have been made to the 2003 and 2002 consolidated financial statements to conform with the 2004 presentation. All material inter-company transactions and balances have been eliminated.

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States ("GAAP"). The preparation of financial statements in conformity with GAAP requires management 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 (1) unpaid losses and loss expense reserves, including asbestos and environmental reserves, (2) allowance for uncollectible reinsurance and policyholder receivables, (3) other than temporary impairments to the fair value of the investment portfolio, (4) deferred acquisition costs, (5) the valuation of goodwill, and (6) valuation allowance on deferred taxes. While management believes that the amounts included in the consolidated financial statements reflect their best estimates and assumptions, these amounts could ultimately be materially different from the amounts currently provided for in the consolidated financial statements.

Nature of Operations

The Company conducts substantially all of its business through four strategic business units: Personal Market, Commercial Markets, Regional Agency Markets ("RAM") and International.

The Company's Personal Market business unit writes virtually all types of property and casualty insurance covering personal risks, primarily personal automobile and homeowners.

The Commercial Markets business unit is organized into separate marketing and underwriting groups, each of which focuses on a particular customer base, product grouping, or distribution channel to provide tailored products and services that specifically address customers' needs. The Commercial Markets business unit includes National Market, Business Market, Wausau Commercial Market, Specialty Risks (includes Commercial Property and Surety) and Group Market. The Commercial Markets coverages include workers compensation, commercial automobile, general liability, including product liability, multiple peril, group disability and life insurance, property, surety and a variety of other coverages. Commercial Markets is also a servicing carrier for workers compensation and commercial automobile involuntary market pools.

RAM consists of regional property and casualty insurance companies distributing their products and services primarily through independent agents and brokers throughout the United States. RAM provides workers compensation, property, commercial automobile and general liability coverages to small businesses, as well as personal lines coverages (primarily personal automobile and homeowners). RAM also includes two specialty operations: Summit Holding Southeast Inc., that provides workers compensation products and services (primarily in Florida) and GoAmerica Auto Insurance, that offers non-standard automobile insurance (primarily in the Midwest).

The Company's International business unit consists of the global specialty business, known as Liberty International Underwriters ("LIU"), and local personal and commercial businesses, primarily property and casualty. LIU is composed of global specialty commercial insurance and reinsurance with operations principally based in the U.S., Canada, Australia, Singapore, London and European markets. London and European operations consist of Liberty Mutual Insurance Europe Ltd. with branches in Dublin, Paris and Cologne and Lloyd's of London, Syndicate 4472, (formerly known as Syndicates 190 and 282) with branches in Paris and Cologne. International distributes its LIU global specialty commercial insurance and reinsurance products exclusively through brokers channel. LIU provides a variety of specialty products including casualty, marine, engineering, energy, directors and officers, errors and omissions, aviation, property and professional liability insurance together with multi-line insurance and reinsurance including property catastrophe reinsurance, written through Lloyd's of London. International also operates local insurance operations consisting of local companies selling traditional property, casualty and life insurance products to individuals and businesses in several nations with a large and growing middle class, primarily in South America, Asia and Southern Europe.

Adoption of New Accounting Standards

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 142, "*Goodwill and Other Intangible Assets*" ("FAS 142"). FAS 142 requires companies to perform annual reviews for impairment of goodwill and indefinite lived intangible assets. Impairment exists when the carrying value of the goodwill or intangible assets exceeds the fair value, which is determined based on quoted market prices,

discounted cash flows or appraised values. Under the transition provisions of FAS 142, the Company recognized an impairment loss of $7 during 2002 as a cumulative effect of change in accounting principle in the consolidated statements of income.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*" ("FAS 146"). FAS 146 nullifies Emerging Issues Task Force Issue ("EITF") No. 94-3, "*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*" ("EITF 94-3"). The principal difference between FAS 146 and EITF 94-3 relates to the requirement for recognition of costs associated with an exit or disposal activity. Under FAS 146, a liability for costs associated with an exit or disposal activity is recognized when the liability is incurred. Under EITF 94-3, a liability for exit costs was recognized at the date of an entity's commitment to an exit plan. FAS 146 also establishes fair value as the basis for initial measurement of the liability. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002. The Company adopted FAS 146 on January 1, 2003. The Statement did not have a material impact on the Company's results of operations, financial condition or liquidity.

In November 2003, the EITF reached a consensus on the disclosures required for other-than-temporary impairments and continued their discussions on an other-than-temporary impairment model outlined in EITF Issue 03-1, "*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*" ("EITF 03-1"). EITF 03-1 requires investors to disclose quantitative information about the (1) aggregate amount of unrealized losses, (2) the aggregate related fair values of investments with unrealized losses, segregated into less than and greater than 12 months categories and (3) qualitative information that supports their conclusion that the impairments noted in the quantitative disclosures are not other-than-temporary. The Company implemented the disclosure requirements of EITF 03-1 in Note 4.

In October 2004, the FASB issued Staff Position EITF 03-1-1 "*Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*" ("FSP EITF 03-1-1"). FSP EITF 03-1-1 delayed indefinitely the effective date for the measurement and recognition guidance of EITF 03-1. Companies are still required to determine whether an investment is impaired based on existing impairment guidance and provide disclosures as required under EITF 03-1.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was signed into law. The Act provides a prescription drug benefit under Medicare Part D and a 28% non-taxable subsidy to sponsors of defined benefit postretirement health plans that are actuarially equivalent to Medicare Part D. In May 2004, the FASB issued Staff Position 106-2, "*Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act")*" ("FSP 106-2"). FSP 106-2 supercedes FSP 106-1 and provides guidance on accounting for the effects of the Act. The Company adopted FSP 106-2 in the third quarter of 2004 and, as permitted, elected retroactive application to December 31, 2003 (the measurement date following enactment of the Act). The Company and its actuarial advisors determined that the postretirement medical plans for certain existing retirees and their dependents provide a benefit that is at least actuarially equivalent to Medicare Part D under the Act, and, accordingly, the Company is entitled to the subsidy. Accounting for the effect of the Federal subsidy reduced the Company's accumulated postretirement benefit obligation by $32 at January 1, 2004. As a result of adopting FSP 106-2, the net periodic postretirement benefit costs include a reduction in benefit costs of $2 in 2004.

In November 2002, the FASB issued Interpretation No. 45, "*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others*" ("FIN 45"). Along with new disclosure requirements, FIN 45 requires guarantors to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. This differs from the current practice to record a liability only when a loss is probable and reasonably estimable. The recognition and measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The Company adopted FIN 45 on January 1, 2003. The implementation of FIN 45 did not have a material impact on the Company's results of operations, financial condition or liquidity.

In July 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AcSEC") issued Statement of Position 03-1, "*Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*" ("SOP 03-1"). SOP 03-1 provides a conceptual framework that facilitates the determination of the proper accounting for various life and annuity products. SOP 03-1 requires (1) the reporting and measurement of separate account assets and liabilities as general account

assets and liabilities when specified criteria are not met, (2) the capitalization of sales inducements that meet specified criteria and amortizing such amounts over the life of the contracts using the same methodology as used for amortizing deferred acquisition costs, but immediately expensing sales inducements accrued or credited if such criteria are not met, and (3) the classification and valuation of certain nontraditional long-duration contract liabilities. The Company adopted SOP 03-1 on January 1, 2004. The Statement did not have a material impact on the Company's results of operations, financial condition or liquidity.

Future Adoption of New Accounting Standards

In December 2004, the FASB issued Staff Position 109-2, "*Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*" ("FSP 109-2") to address requirements of The American Jobs Creation Act of 2004 ("the AJC Act") that was signed into law on October 22, 2004. The AJC Act will have a significant impact on taxpayers, including corporations that have foreign U.S. operations. Among the changes to the U.S. tax rules, is the favored repatriation of off-shore earnings, executive compensation and other employee benefits provisions. The AJC Act provides U.S. taxpayers with operations abroad, the ability to claim a one-time 85% deduction for repatriation of earnings previously reinvested in foreign subsidiaries. In order to qualify for the deduction, taxpayers must reinvest the dividends under a properly approved domestic reinvestment plan. FSP 109-2 clarifies that reporting entities that currently reinvest all or part of the dividends from their foreign subsidiaries and do not recognize a deferred tax liability for undistributed earnings as provided under APB 23, Accounting for Income Taxes – Special Areas, have until half way through 2005 to evaluate the impact of the AJC Act.

FSP 109-2 permits additional time beyond the financial reporting period of enactment to evaluate the effect of the AJC Act on its plans for repatriation of unremitted earnings for purposes of applying FAS 109, "*Accounting for Income Taxes*" ("FAS 109"). The Statement requires the recognition of the income tax effect when the decision to reinvest or repatriate the foreign earnings is made. The Company adopted FSP 109-2 on December 21, 2004, the date of issuance, however is still evaluating the repatriation provision, amongst others, of the AJC Act and has included the required disclosures in Note 10. The Company expects to complete its evaluation in 2005.

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 December 31, 2003. For VIEs created or acquired by the Company prior to December 31, 2003, the provisions of FIN 46 will be applied in 2005.

The Company has not made any investments in new VIEs created or acquired after December 31, 2003. The Company's primary exposure to FIN 46 and VIEs relates to investments in venture capital and private equity limited partnerships that are accounted for under the equity method. The Company has determined that it is the primary beneficiary for 3 VIEs with total assets of $26 as of December 31, 2004 for which the Company's participation ranges from 66.49% to 99.99%. The Company's maximum exposure to losses from these VIEs is approximately $30 and there is no recourse provision to the general credit of the Company beyond the full amount of the Company's loss exposure. The Company has investments in 16 VIEs for which it is not the primary beneficiary. The cumulative assets of these VIEs is $1,158 of which the Company's maximum exposure is $369.

Investments

Available for sale: Fixed maturity securities classified as available for sale, are debt securities, that have fixed or variable principal payment schedules, held for indefinite periods of time, and are used as a part of the Company's asset/liability strategy or sold in response to risk/reward characteristics, liquidity needs or similar economic factors. These securities are carried at market value with the corresponding unrealized investment gains or losses, net of deferred income taxes, reported in accumulated other comprehensive income.

Equity securities classified as available for sale include common equities and non-redeemable preferred stocks and are reported at quoted market values. Changes in the market values of these securities, net of deferred income taxes, are reflected as unrealized investment gains or losses in accumulated other comprehensive income.

Trading securities: Trading securities are securities bought principally for the purpose of sale in the near term and are reported at market value. Changes in market value are recognized in income as realized gains or losses in the current period.

Realized gains and losses on sales of investments are recognized in income using the specific identification method. Unrealized losses that are other-than-temporary are recognized as realized losses. The Company reviews fixed income and public equity securities for impairment on a quarterly basis and private equity and co-investment securities on a semi-annual basis. All securities are subject to review with the exception of those issued by the government of the United States, its agencies, and government sponsored enterprises such as the Government National Mortgage Association ("GNMA"). Securities are reviewed for both quantitative and qualitative considerations including, but not limited to, (1) the extent of the decline in fair value below book value, (2) the duration of the decline, (3) significant adverse changes in the financial condition or near term prospects for the investment or issuer, (4) significant changes in the business climate or credit ratings of the issuer, (5) the intent and ability of the company to hold its investment for a period sufficient to allow for any anticipated recovery, (6) general market conditions and volatility, (7) industry factors, and (8) the past impairment history of the security holding or the issuer. All mortgage backed securities and asset backed securities are reviewed for other-than-temporary impairment treatment in accordance with the guidance of EITF Issue No. 99-20, "*Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*". 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.

For mortgage-backed fixed maturity securities, the Company recognizes income using a constant effective yield based on anticipated prepayments over the economic life of the security. The mortgage-backed portfolio is accounted for under the retrospective method and prepayment assumptions are based on market expectations. When actual prepayments differ significantly from anticipated prepayments, the effective yield is recalculated to reflect actual payments to date and anticipated future payments and any resulting adjustment is included in net investment income.

Cash equivalents are short-term, highly liquid investments that are both readily convertible into known amounts of cash and so near to maturity that they present insignificant risk of changes in value due to changing interest rates. The Company's cash and cash equivalents include debt securities purchased with maturities of three months or less at acquisition and are carried at amortized cost that approximates fair market value.

Short-term investments are debt securities with maturities at acquisition between three months and one year, are considered available for sale and are carried at amortized cost, that approximates fair market value.

Other investments, principally investments in private equities through limited partnerships, are accounted for using the equity method unless the investment is so minor that the Company has no influence over the partnership's operating and financial policies. Investments in excess of three percent of a limited partnership are considered more than minor. If the private equity investment is considered minor, the investment is accounted for using the cost method.

Recognition of unrealized gains and losses of private equity investments are recorded consistent with the methodology used by the underlying private equity investment (income statement or policyholders' equity).

Derivatives

All derivatives are recognized on the balance sheet at fair value. On the date a contract is entered into, the Company designates the derivative as either (1) a hedge of a fair value of a recognized asset ("fair value hedge") or (2) an economic hedge ("non-designated derivative"). Changes in the fair value of a derivative that is highly effective and is designated and qualifies as a fair value hedge, along with the loss or gain on the hedged asset attributable to the hedged risk, are recorded in current period operations as a component of net investment income. Changes in the fair value of non-designated derivatives are reported in current period operations, as a component of net realized gains and losses and the derivative is included in other assets or liabilities. The Company owns fixed securities which have an option to convert to equity. The derivative features embedded are ancillary to the overall investment. This type of activity is unrelated to hedging.

In 2002, the Company was party to derivative contracts in the form of equity swap contracts. Those contracts were terminated in 2002. The purpose of the contracts was to exchange rates of return of a specified set of common stocks for rates of return consistent with the broad equity markets as represented by the S&P 500 Index.

The Company uses various derivative instruments to hedge exposure against interest rates and equity market returns guaranteed by certain life products. In addition, there may be call, put or conversion options embedded in certain bonds it has purchased. The fair value of these derivative instruments is based on broker quotations. These derivatives are not material to the Company's financial statements.

Securities Lending

The Company participates in a securities lending program to generate additional income, whereby certain domestic fixed income securities are loaned for a short period of time from the Company's portfolio to qualifying third parties, via a lending agent. Terms of the agreement are for borrowers of these securities to provide collateral of at least 102% of the market value of the loaned securities. Acceptable collateral may be in the form of cash or U.S. Government securities. The market value of the loaned securities is monitored and additional collateral is obtained if the market value of the collateral falls below 100% of the market value of the loaned securities. Under the terms of the securities lending program, the lending agent indemnifies the Company against borrower defaults. The loaned securities remain a recorded asset of the Company, however, the Company records a liability for the amount of collateral held, representing its obligation to return the collateral related to the loaned securities.

Goodwill and Intangible Assets

Goodwill represents the excess of amounts paid for acquiring businesses over the fair value of the net assets acquired. The Company adopted FAS 142 effective January 1, 2002 and tests for impairment on an annual basis. The Company records exit activity costs of an acquired company in accordance with EITF Issue 95-3, "*Recognition of Liabilities in Connection with a Purchase Business Combination*" ("EITF 95-3"). EITF 95-3 allows costs associated with exit activities of the acquired company, involuntary employee terminations and relocation costs of the acquired company to be recognized as a liability assumed as of the consummation date of the acquisition and included in the allocation of the acquisition costs. Other changes in the carrying amount of goodwill are primarily caused as a result of foreign currency translation adjustments and adjustments to valuation allowances for acquired tax losses.

Deferred Policy Acquisition Costs

Costs that vary with and are primarily related to the acquisition of new and renewal insurance and investment contracts are deferred and amortized over the respective policy terms. Deferred policy acquisition costs are reviewed annually for recoverability. Investment income is considered in the recoverability assessment. For short-duration contracts, acquisition costs include commissions, underwriting expenses and premium taxes. For long-duration insurance contracts, these costs include first year commissions in excess of annual renewal commissions and variable sales, underwriting and administrative expenses.

For short-duration contracts, acquisition costs are amortized in proportion to earned premiums. For traditional long-duration contracts, acquisition costs are amortized over the premium paying period of the related policies using assumptions consistent with those used in computing policy benefit reserves. For universal life insurance, annuity and investment products, acquisition costs are amortized in relation to expected gross profits.

For long-duration contracts, to the extent unrealized gains or losses on fixed income securities carried at fair value would result in an adjustment of estimated gross profits had those gains or losses actually been realized, the related unamortized deferred policy acquisition costs are recorded net of tax as a reduction of the unrealized capital gains or losses and included in accumulated other comprehensive income.

Real Estate and Other Fixed Assets

The costs of buildings and furniture and equipment are depreciated, principally on a straight-line basis, over their estimated useful lives (a maximum of 40 years for buildings and 10 years for furniture and equipment). Expenditures for maintenance and repairs are charged to income as incurred while expenditures for improvements are capitalized and depreciated.

Separate Account Assets and Liabilities

Separate and variable accounts represent funds for which investment income and investment gains and losses accrue directly to the policyholders who predominantly bear the investment risk. Each account has specific investment objectives, and the assets are carried at fair value. The assets of each account are legally segregated and are not subject to claims that arise out of any other business of the Company. The assets of these accounts are equal to the account liabilities. Investment income, realized investment gains (losses), and policyholder account deposits and withdrawals related to separate accounts are excluded from the consolidated statements of income. The fees earned for administrative and contract holder maintenance services performed for these separate accounts are included in fee and other revenue.

Insurance Liabilities and Reserves

For short-duration contracts, the Company establishes reserves for unpaid insurance claims and claim adjustment expenses covering events that occurred in 2004 and prior years. These reserves reflect estimates of the total cost of claims reported but not yet paid and the cost of claims not yet reported, as well as the estimated expenses necessary to settle the claims. Reserve estimates are based on past loss experience modified for current claim trends, as well as prevailing social, economic and legal conditions. Final claim payments, however, may ultimately differ from the established reserves, since these payments might not occur for several years. Reserve estimates are continually reviewed

and updated, and any resulting adjustments are reflected in current operating results. The Company does not discount reserves other than tabular discounting on the long-term indemnity portion of workers compensation claims, the long-term disability portion of group accident and health claims as permitted by insurance regulations in certain states and specific asbestos structured settlements. Reserves are reduced for estimated amounts of salvage and subrogation and deductibles recoverable from policyholders.

For long-duration contracts, measurement of liabilities is based on generally accepted actuarial techniques but requires assumptions about mortality, lapse rates and assumptions about future returns on related investments. Annuity and structured settlement contracts without significant mortality or morbidity risk are accounted for as investment contracts, whereby the premium received plus interest credited less policyholder withdrawals represents the investment contract liability. Credited interest rates for domestic structured settlement contracts in force were between 1.0% and 9.0% in 2004 and 2003 and between 5.0% and 11.5% in 2002. Credited interest rates for foreign structured settlement contracts in force were between 2.5% and 6.0% in 2004, 2003 and 2002. Credited rates for domestic universal life contracts in force were between 4.0% and 8.0% in 2004 and between 4.0% and 8.5% in 2003 and 2002. Credited rates for foreign universal life contracts in force were between 1.0% and 6.0% in 2004, 2003, and 2002. Liabilities for future policy benefits for traditional life policies have been computed using the net level premium method based upon estimated future investment yields (between 4.1% and 10.3% for all years of issue), mortality assumptions (based on the Company's experience relative to standard industry mortality tables) and withdrawal assumptions (based on the Company's experience).

Policyholder Dividends

Policyholder dividends are accrued using an estimate of the ultimate amount to be paid in relation to premiums earned based on the underlying contractual obligations.

For domestic property-casualty insurance certain insurance contracts, primarily workers compensation policies are issued with dividend plans to be paid subject to approval by the insurer's board of directors. Such policies approximate 2% of domestic property-casualty insurance premiums written at December 31, 2004, 2003 and 2002.

For life insurance, dividends to participating policyholders are calculated as the sum of the difference between the assumed mortality, interest and loading, and the actual experience of the Company relating to participating policyholders. As a result of statutory regulations, the major portion of earnings from participating policies inures to the benefit of the participating policyholders and is excluded from the consolidated net income and policyholders' equity. Participating policies approximate 10% and 16% of ordinary life insurance in force at December 31, 2004 and 2003, respectively, and 20% and 17% of premiums for the years ended December 31, 2004 and 2003.

Long-Term Incentive and Performance Based Incentive Plans

The Company maintains short and long-term incentive compensation plans. Long-term plans that vest over the requisite service period and are based upon notional restricted and appreciated units are accounted for using guidance within Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*" ("APB 25"), FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, an Interpretation of APB Opinions No. 15 and 25* ("FIN 28"), and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25* ("FIN 44"). Additionally, the Company provides various performance based incentive compensation to the majority of employees meeting the participation requirements of the respective plans. Compensation cost related to these plans is determined in accordance with plan formulas and recorded ratably over the years the employee service is provided.

Revenue Recognition

For short-duration insurance contracts, premiums are reported as earned income generally on a pro-rata basis over the terms of the related policies. For retrospectively rated policies and contracts, premium estimates are continually reviewed and updated and any resulting adjustments are reflected in current operating results. For traditional long-duration insurance contracts (including term and whole life contracts and annuities), premiums are earned when due. For annuities and structured settlements without significant mortality or morbidity risk (investment contracts) and universal life contracts (long-duration contracts with terms that are not fixed or guaranteed), revenues represent investment income earned on the related assets. Universal life and annuity contract revenues also include mortality, surrender and administrative fees charged to policyholders.

Reinsurance

All assets and liabilities related to reinsurance ceded contracts are reported on a gross basis in the consolidated balance sheets. The consolidated statements of income reflect premiums, benefits and settlement expenses net of reinsurance ceded.

Transactions that do not transfer risk are included in other assets or other liabilities. Ceded transactions that transfer risk but are retroactive are included in reinsurance recoverables. The excess of estimated liabilities for claims and claim costs over the consideration paid net of experience adjustments is established as a deferred credit at inception. The deferred amounts are subsequently amortized using the effective interest method over the expected settlement period. The periodic amortization is reflected in the accompanying consolidated statements of income through operating costs and expenses.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liabilities associated with the reinsured business. The Company evaluates reinsurance collectibility and a provision for uncollectible reinsurance is recorded.

Translation of Foreign Currencies

The Company translates the financial statements of its foreign operations into U.S. dollars from the functional currency designated for each foreign unit, generally the currency of the primary economic environment in which it does its business. Assets and liabilities are translated into U.S. dollars at period-end exchange rates, while income and expenses are translated using average rates for the period. The resulting translation adjustments are recorded, net of tax, as a separate component of policyholders' equity.

For subsidiaries operating in highly inflationary economies, monetary assets and liabilities are translated at the rate of exchange as of the balance sheet date and non-monetary items are translated at historical rates. Gains and losses from balance sheet translation adjustments and foreign currency transactions are included in net income.

The aggregate exchange gains included in income from continuing operations for the years ended December 31, 2004, 2003, and 2002 were $24, $28, and $79, respectively. These amounts have been included in insurance operating costs and expenses in the accompanying consolidated statements of income.

Income Taxes

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 investments, insurance reserves, unearned premiums, deferred policy acquisition costs, certain employee benefits expenses and net operating losses.

Service Revenues and Expenses

Service revenues consist primarily of fees generated from processing business for involuntary assigned risk pools and are earned on a pro-rata basis over the term of the related policies and are included in fee and other revenues in the consolidated statements of income. Qualifying acquisition expenses are deferred and amortized over the period in which the related revenues are earned.

Accumulated Other Comprehensive Income

Other comprehensive income consists of foreign currency translation adjustments, minimum pension liability and unrealized gains and losses on certain investments in debt and equity securities.

The components of accumulated other comprehensive income, net of related deferred acquisition costs and taxes, are as follows:

	2004	2003	2002
Unrealized gains on securities	$1,167	$1,181	$1,279
Foreign currency translation adjustments	117	31	(163)
Minimum pension liability	(26)	(25)	(12)
Accumulated other comprehensive income	$1,258	$1,187	$1,104

Catastrophe Exposure

The Company writes insurance policies that cover catastrophic events. The Company's policies cover unpredictable natural and other disasters, such as hurricanes, windstorms, earthquakes, floods, fires, terrorist attacks and explosions. Although the Company carries reinsurance to mitigate its exposure to certain catastrophic events, claims from catastrophic events could reduce the Company's earnings and cause substantial volatility in its financial results for any year and adversely affect its financial condition or results of operations.

The Terrorism Risk Insurance Act (the "Terrorism Act"), effective November 26, 2002, requires all commercial property and casualty insurers writing business in the U.S. to make terrorism coverage available to commercial policyholders and provides a Federal backstop for certain terrorist acts which result in losses above individual insurance company deductible amounts. The Terrorism Act directly applies to the Company's U.S. property and casualty insurance business. Participating insurers will receive reimbursement from the Federal government for 90% of paid losses in excess of the deductible. The Company estimates its deductible for commercial policies subject to the Terrorism Act (the amount the Company will have to pay before the Federal backstop becomes available) to be $1,264 in 2005. This amounts

to 15% of the Company's direct earned premium from commercial lines of business subject to the Terrorism Act and approximately 15% of policyholders' equity of the Company at December 31, 2004, prior to consideration of terrorism reinsurance that the Company has purchased for 2005. The Terrorism Act is in effect until December 31, 2005. The Terrorism Act does not protect the Company from losses insured by the Company, which are not certified pursuant to the Terrorism Act, such as acts of domestic terrorism, like the Oklahoma City disaster. Damage outside the U.S. is not covered except in limited circumstances, such as damage to a U.S. airplane. Therefore, future losses from terrorist attacks could prove to be material to the Company's business, financial condition and results of operations.

(2) DIVESTITURES AND DISCONTINUED OPERATIONS

Divestitures

Effective June 30, 2003, the Company sold its Liberty Health business in Canada, a business line of the International business unit, and received proceeds approximating $98 and realized a gain of $82. This transaction did not meet the requirements for presentation as discontinued operations.

On April 1, 2004, the Company completed the sale of its Canadian personal lines business, consisting of private passenger automobile, homeowners and personal property insurance, to Meloche Monnex, Inc., a member of TD Bank Financial Group ("Meloche Monnex"). The transaction resulted in the transfer of approximately 350,000 automobile and homeowners insurance policies and approximately $300 (C$390) in direct written premiums to Meloche Monnex. Neither party has disclosed the financial terms of the transaction, which the Company believes is not material to its business, financial condition or results of operations.

Canadian Personal Lines Property and Casualty Operations

	2004	2003	2002
Revenues	$82	$296	$244
Income (loss) before income taxes and minority interest	$12	$ (1)	$ (18)
Federal and foreign income tax benefit	(6)	—	(3)
Net income (loss)	$18	$ (1)	$ (15)

Total assets and liabilities of discontinued operations included in the balance sheet, composed primarily of the Canadian personal lines property and casualty operations, at December 31, 2003 are as follows:

	2003
Assets:	
Investments, cash and cash equivalents	$399
Premium and other receivables	116
Reinsurance recoverables	21
Deferred policy acquisition costs	5
Deferred income taxes	9
Other assets	8
Total assets	$558
Liabilities:	
Unpaid claims and claim adjustment expense	$357
Unearned premiums	157
Other liabilities	4
Total liabilities	$518

Discontinued Operations

During 2003, the Company's Board of Directors approved a plan to dispose of the operations of a non-insurance subsidiary that had net losses of $(2), and $0 for the years ended December 31, 2003, and 2002, respectively.

In December 2004, the Company's management approved a plan to sell the pension externalization business of Seguros Genesis S.A operations. The Company expects to complete the disposition by the end of the first quarter of 2005.

	2004
Revenues	$31
Operating expenses	14
Income before income tax expense	17
Income tax expense	6
Net income	$11

Total assets and liabilities of the discontinued operations included in the balance sheet, composed primarily of the Genesis externalization operations, at December 31, 2004 are as follows:

	2004
Assets:	
Investments, cash and cash equivalents	$235
Other assets	3
Total assets	$238
Liabilities:	
Future policyholder benefits	$149
Deferred tax liability	6
Other liabilities	70
Total liabilities	$225

(3) ACQUISITIONS AND GOODWILL

Effective May 2003, the Company acquired 100% of the outstanding shares of Winterthur's Portuguese business units and branch offices, including its subsidiary companies Companhia Europeia de Segueros and Winterthur Pensoes.

The transaction resulted in goodwill of $23. The results of operation for the acquired business are included subsequent to May 2003.

On October 31, 2003, LMGI acquired all the outstanding stock of Prudential Property and Casualty Insurance Company, Prudential General Insurance Company and Prudential Commercial Insurance Company (collectively referred to as "PruPac") from Prudential Financial Inc. ("Prudential"). The acquisition included PruPac's U.S. personal lines property and casualty business and operations in 47 states, excluding the New Jersey business and also excluding the specialty automobile and affinity business. The cost of PruPac was $520 and consideration was a combination of cash and two series of promissory notes to Prudential. The Series A promissory note had an aggregate principal balance of $130, due on October 31, 2008 and accrues interest annually at an interest rate of 7%. On April 16, 2004, LMGI repaid this note. The Series B promissory note has an aggregate principal balance of $260, matures on October 31, 2013 and accrues interest annually at an interest rate of 8%.

The following is a final condensed balance sheet of PruPac at November 1, 2003:

Assets:	
Investments, cash and cash equivalents	$1,734
Premium and other receivables	127
Reinsurance recoverables	345
Structured settlement assets	560
Other assets	124
Total assets	$2,890
Liabilities:	
Unpaid claims and claim adjustment expenses	$1,127
Unearned premiums	413
Structured settlement liabilities	560
Other liabilities	196
Total liabilities	$2,296

LMGI recorded the acquisition in accordance with Financial Accounting Standards No. 141, *Business Combinations* ("FAS 141") and assigned fair values to the identifiable assets and liabilities of PruPac on October 31, 2003. The excess of the assigned fair value of net assets over the purchase price, or negative goodwill, of $77 was recorded by LMGI as an extraordinary gain in the accompanying consolidated statements of income in 2003. Management completed its allocation of the purchase price in October 2004, which resulted in a decrease of $3 to the previously recognized negative goodwill. Additionally, as part of the transaction and integration of PruPac's operations, $36 of restructuring charges were recorded relating to the acquisition costs of PruPac. The restructuring liability primarily includes severance and retention bonuses for employees that were involuntarily terminated or relocated.

In connection with the acquisition, the Company acquired the discontinued channels business of Prudential agency business. Prudential, through its wholly owned subsidiary, Vantage Casualty Insurance Company ("Vantage"), reinsured and guaranteed 100% of the first $50 and 75% of the next $60 of the net losses of the operation. To support the surplus of the Company in writing the discontinued channels business, Prudential provided the Company with a $30 cash payment in exchange for a note that matures on December 31, 2008 and accrues interest at a rate of 5% annually. The note is repaid annually in amounts corresponding to the reduction in the Company's gross written premium in the discontinued channels business. Vantage's obligations are guaranteed by Prudential. Additionally, the discontinued channel runoff business includes performance incentives for the Company. The remaining note payable was $14 and $30 at December 31, 2004 and 2003, respectively.

In addition to the above-mentioned agreement, certain risks, including, without limitation, asbestos and other environmental risks, assumed reinsurance arrangements, unlimited medical benefits and certain mold claims, and various litigation arising out of or relating to conduct prior to closing have been ceded and transferred by virtue of reinsurance, indemnification and guaranty arrangements with Prudential and certain of its subsidiaries.

Effective January 9, 2004, the Company acquired MetLife's Spanish operations, including its non-life subsidiary, Genesis Seguros Generales, S.A., and its life subsidiary, Seguros Genesis, S.A (collectively referred to as "Genesis"). The transaction resulted in goodwill of $74.

The following is a condensed balance sheet of Genesis at January 9, 2004:

Assets:	
Investments, cash and cash equivalents	$ 946
Premium and other receivables	38
Reinsurance recoverables	9
Deferred policy acquisition costs	9
Deferred income taxes	10
Goodwill and intangible assets	109
Other assets	52
Total assets	$1,173
Liabilities:	
Unpaid claims and claim adjustment expenses	$ 798
Unearned premiums	96
Other liabilities	116
Total liabilities	$1,010

Included in the consolidated statements of income is $21 generated from this acquisition.

Effective August 19, 2004, the Company acquired the insurance operations of AGF Allianz Chile S.A., resulting in goodwill of $13. The Company is in the process of

finalizing the evaluation of the fair value of the acquired business. Therefore, the allocation of the purchase price is subject to refinement.

(4) INVESTMENTS

Components of Net Investment Income

YEARS ENDED DECEMBER 31,	2004	2003	2002
Interest income	$1,944	$1,759	$1,701
Dividends	89	56	72
Limited partnerships	141	—	(155)
Other investment income	2	12	25
Gross investment income	2,176	1,827	1,643
Investment expenses	(74)	(65)	(53)
Net investment income	$2,102	$1,762	$1,590

Components of Net Realized Investment Gains

YEARS ENDED DECEMBER 31,	2004	2003	2002
Fixed maturities			
Gross realized gains	$365	$ 381	$ 403
Gross realized losses	(61)	(180)	(233)
Equities			
Gross realized gains	108	119	447
Gross realized losses	(84)	(60)	(317)
Other			
Gross realized gains	5	126	10
Gross realized losses	(21)	(13)	(36)
Net realized investment gains	$312	$ 373	$ 274

During the years ended December 31, 2004, 2003, and 2002, other-than-temporary impairments recognized were $35, $74, and $165, respectively.

During the years ended December 31, 2004, 2003, and 2002, proceeds from sales of fixed maturities available for sale were $9,219, $8,930, and $10,491, respectively. The gross realized gains and (losses) on such sales totaled $344 and $(38) in 2004, $378 and $(87) in 2003, and $385 and $(200) in 2002, respectively. The net realized gains (losses) related to trading securities held as of the end of the year amounted to $10, $5, and $(6) for the years ended December 31, 2004, 2003 and 2002.

Components of Change in Net Unrealized Investment Gains

	2004	2003	2002
Fixed maturities	$ (92)	$ (267)	$ 929
Equities	143	213	(756)
Other	8	—	—
Adjustments to deferred policy acquisition costs	(80)	(97)	(24)
Net change in unrealized investment (losses) gains	(21)	(151)	149
Deferred income taxes	7	53	(88)
Net change in unrealized investment (losses) gains, net of tax	$ (14)	$ (98)	$ 61

Available for Sale Investments

The gross unrealized gains and losses and fair values of available for sale investments at December 31, 2004 and 2003 are as follows:

DECEMBER 31, 2004	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
U.S. Treasury securities	$ 2,644	$ 72	$ (13)	$ 2,703
Mortgage and asset-backed securities of government and corporate agencies	12,710	309	(51)	12,968
State and municipal	1,096	49	(4)	1,141
Corporate and other	17,829	1,039	(79)	18,789
Total fixed maturities	34,279	1,469	(147)	35,601
Total equity securities	1,126	698	(22)	1,802
Total securities available for sale	$35,405	$2,167	$(169)	$37,403

DECEMBER 31, 2003	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
U.S. Treasury securities	$ 2,639	$ 90	$ (12)	$ 2,717
Mortgage and asset-backed securities of government and corporate agencies	11,204	365	(70)	11,499
State and municipal	1,204	56	(10)	1,250
Corporate and other	15,826	1,068	(73)	16,821
Total fixed maturities	30,873	1,579	(165)	32,287
Total equity securities	813	571	(38)	1,346
Total securities available for sale	$31,686	$2,150	$(203)	$33,633

At December 31, 2004 and 2003, fixed maturities carried at $4,410 and $4,790, respectively, were on deposit with regulatory authorities as required by law.

At December 31, 2004 and 2003, the fair values of fixed maturities loaned were approximately $572 and $462, respectively. Cash and short-term investments received as collateral in connection with the loaned securities were approximately $192 and $335 as of December 31, 2004 and 2003, respectively. Non-cash and short-term investments collateral received in connection with the loaned securities was approximately $390 and $135 as of December 31, 2004 and 2003, respectively.

The amortized cost and fair value of fixed maturities at December 31, 2004 by contractual maturity are set forth as follows:

	AMORTIZED COST	FAIR VALUE
Due to mature:		
One year or less	$ 885	$ 890
Over one year through five years	5,376	5,543
Over five years through ten years	7,786	8,148
Over ten years	7,522	8,052
Mortgage and asset-backed securities	12,710	12,968
	$34,279	$35,601

Expected maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following table shows a schedule of the Company's unrealized losses and fair value by security type by duration that individual securities have been in a continuous unrealized loss position at December 31, 2004 that are not deemed to be other-than-temporarily impaired.

	LESS THAN 12 MONTHS		GREATER THAN 12 MONTHS	
	UNREALIZED LOSSES	FAIR VALUE OF INVESTMENTS WITH UNREALIZED LOSSES	UNREALIZED LOSSES	FAIR VALUE OF INVESTMENTS WITH UNREALIZED LOSSES
U.S. Treasury securities	$ (9)	$1,062	$ (4)	$ 105
Mortgage and asset-backed securities of government and corporate agencies	(24)	2,627	(27)	664
State and municipal	(2)	196	(2)	42
Corporate and other	(42)	3,184	(37)	882
Equities	(17)	136	(5)	25
Total	$ (94)	$7,205	$ (75)	$1,718

The following table shows a schedule of the Company's unrealized losses and fair value by security type by duration that individual securities have been in a continuous unrealized loss position at December 31, 2003 that are not deemed to be other-than-temporarily impaired.

	LESS THAN 12 MONTHS		GREATER THAN 12 MONTHS	
	UNREALIZED LOSSES	FAIR VALUE OF INVESTMENTS WITH UNREALIZED LOSSES	UNREALIZED LOSSES	FAIR VALUE OF INVESTMENTS WITH UNREALIZED LOSSES
U.S. Treasury securities	$ (12)	$ 544	$ —	$ —
Mortgage and asset-backed securities of government and corporate agencies	(65)	3,206	(5)	86
State and municipal	(10)	351	—	3
Corporate and other	(72)	2,315	(1)	31
Equities	(20)	101	(18)	63
Total	$(179)	$6,517	$ (24)	$ 183

The above table for 2004 includes $64 of unrealized losses related to securities issued and guaranteed by the United States government, its agencies, government sponsored enterprises and state and municipal governments. There were $141, or approximately 84%, of the unrealized losses as of December 31, 2004 on securities where the market value of the security is 10% or less below the book value for the security. The decrease in unrealized losses is indicative of the relative strength in the markets during that period. The unrealized losses as of December 31, 2004 involve approximately 4,520 lots across more than approximately 1,530 different securities within the holdings of the Company.

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.

The Company has cost method investments consisting primarily of equities with a market value of $124 at December 31, 2004. All of the Company's cost method investments are evaluated systematically for identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment.

(5) DEFERRED POLICY ACQUISITION COSTS

The following reflects the policy acquisition costs deferred for amortization against future income and related amortization charged to income:

YEARS ENDED DECEMBER 31,	2004	2003	2002
Balance at beginning of year	$ 1,104	$ 913	$ 819
Acquisition costs deferred	2,543	2,053	1,762
Amortization charged to continuing income	(2,291)	(1,855)	(1,661)
Amortization included in discontinued operations	(2)	(7)	(7)
Balance at end of year	$ 1,354	$ 1,104	$ 913

(6) ASBESTOS AND ENVIRONMENTAL RESERVES

The Company has exposure to asbestos and environmental claims that emanate principally from general liability policies written prior to the mid-1980's. In establishing the Company's asbestos and environmental reserves, the Company estimates case basis reserves for anticipated losses and bulk reserves for loss adjustment expenses and IBNR losses. The Company maintained casualty excess of loss reinsurance during the relevant periods. The reserves

are reported net of cessions to reinsurers and include any reserves reported by ceding reinsurers on assumed reinsurance contracts.

Upon their de-affiliation from the Nationwide Group and affiliation with the Company, Employers Insurance Company of Wausau ("EICOW"), Wausau Business Insurance Company ("WBIC"), Wausau General Insurance Company ("WGIC"), and Wausau Underwriters Insurance Company ("WUIC") entered into ceded reinsurance contracts whereby Nationwide Indemnity Company assumed full responsibility for obligations on certain policies with effective dates prior to January 1, 1986, including all asbestos and environmental exposures.

The process of establishing reserves for asbestos and environmental claims is subject to greater uncertainty than the establishment of reserves for liabilities relating to other types of insurance claims. A number of factors contribute to this greater uncertainty surrounding the establishment of asbestos and environmental reserves, including, without limitation: (i) the lack of available and reliable historical claims data as an indicator of future loss development, (ii) the long waiting periods between exposure and manifestation of any bodily injury or property damage, (iii) the difficulty in identifying the source of asbestos or environmental contamination, (iv) the difficulty in properly allocating liability for asbestos or environmental damage, (v) the uncertainty as to the number and identity of insureds with potential exposure, (vi) the cost to resolve claims, and (vii) the collectibility of reinsurance.

The uncertainties associated with establishing reserves for asbestos and environmental losses and loss adjustment expenses are compounded by the differing, and at times inconsistent, court rulings on environmental and asbestos coverage issues involving: (i) the differing interpretations of various insurance policy provisions and whether asbestos and environmental losses are or were ever intended to be covered, (ii) when the loss occurred and what policies provide coverage, (iii) whether there is an insured obligation to defend, (iv) whether a compensable loss or injury has occurred, (v) how policy limits are determined, (vi) how policy exclusions are applied and interpreted, (vii) the impact of entities seeking bankruptcy protection as a result of asbestos-related liabilities, (viii) whether clean-up costs are covered as insured property damage, and (ix) applicable coverage defenses or determinations, if any, including the determination as to whether or not an asbestos claim is a products/completed operation claim subject to an aggregate limit and the available coverage, if any, for that claim. The uncertainties cannot be reasonably estimated, but could have a material impact on the Company's future operating results and financial condition.

In recent years, the Company, as well as the industry generally, has witnessed a significant increase in the number of asbestos claims being filed, due to a number of variables, including more intensive advertising by lawyers seeking asbestos claimants, and the increasing focus by plaintiffs on new and previously peripheral defendants, attempts to broaden the interpretation of compensable loss, and courts expanding the scope of the coverage.

During 2004, the Company completed a comprehensive study of its environmental reserves. The study was performed with the assistance of an independent actuarial firm, and focused on the implications of claim and litigation trends and other significant developments. The study encompassed the Company's liabilities with respect to both National Priority List (NPL) claims and direct site claims involving the presence of hazardous waste at sites owned or operated by the insured. As a result of the comprehensive study, the Company increased net loss and allocated loss adjustment expense reserves by $316.

In 2003, the Company completed a study of asbestos reserves with the assistance of an independent actuarial firm, focusing on the implications of claim and litigation trends and other significant developments, with special attention to major asbestos defendants and non-products claims alleging that the Company's coverage obligations are not subject to aggregate limits. This included further categorization of policyholders, conducting an examination of recent claim activity from policyholders reporting claims for the first time, and a review of past settlements. As a result of the study, the Company reflected a charge in 2003 relating to increased asbestos net loss reserves of $173 and increased its asbestos liability reinsurance recoverable allowance by $158 for a total expense of $331.

As a result of the significant uncertainty inherent in determining a company's asbestos and environmental liabilities and establishing related reserves, the amount of reserves required to adequately fund the Company's asbestos and environmental claims cannot be accurately estimated using conventional reserving methodologies based on historical data and trends. As a result, the use of conventional reserving methodologies frequently has to be supplemented by subjective considerations including managerial judgment.

Unpaid claims and claim adjustment expenses for asbestos and environmental related claims net of reinsurance and allowance for reinsurance on unpaid losses were $1,641 and $1,547 at December 31, 2004 and 2003, respectively.

The following tables summarize the activity for the Company's asbestos and environmental claims and claim adjustment expenses, a component of the Company's unpaid claims and claim adjustment expenses, for the years ended December 31, 2004, 2003 and 2002:

	2004	2003	2002
GROSS ASBESTOS:			
January 1 reserves:	$2,039	$1,686	$1,482
Acquisitions	—	175	—
Incurred activity	683	548	501
Paid activity	323	370	297
Ending reserves	$2,399	$2,039	$1,686
NET ASBESTOS:			
January 1 reserves:	$1,120	$ 974	$ 854
Acquisitions	—	118	—
Incurred activity	20	178	295
Paid activity	179	150	175
Ending reserves	$ 961	$1,120	$ 974
Allowance for reinsurance on unpaid losses	127	140	—
Total unpaid losses including allowance for unpaid reinsurance	$1,088	$1,260	$ 974

The large increase in gross asbestos incurred for 2004 is primarily attributable to claims against 1985 and prior policies issued by EICOW and its affiliates, which are 100% ceded to Nationwide Indemnity Company and guaranteed by Nationwide Mutual Insurance Company. The Company's acquisition of PruPac included $175 and $118 of gross and net asbestos reserves, respectively. Any increase in Prudential related asbestos reserves is reinsured by Vantage and guaranteed by Prudential.

	2004	2003	2002
GROSS ENVIRONMENTAL:			
January 1 reserves:	$ 410	$ 577	$702
Acquisitions	—	15	—
Incurred activity	484	(106)	53
Paid activity	78	76	178
Ending reserves	$ 816	$ 410	$577
NET ENVIRONMENTAL:			
January 1 reserves:	$ 287	$ 317	$444
Acquisitions	—	12	—
Incurred activity	316	—	(11)
Paid activity	50	42	116
Ending reserves	$ 553	$ 287	$317

(7) UNPAID CLAIMS AND CLAIM ADJUSTMENT EXPENSES

The Company establishes reserves for payment of claims and claims adjustment expenses that arise from the policies issued. As required by applicable accounting rules, no reserves are established until a loss, including a loss from a catastrophe, occurs. The Company's reserves are segmented into three major categories: reserves for reported claims (estimates made by claims adjusters); incurred but not reported claims reserves ("IBNR") representing reserves for unreported claims and supplemental reserves for reported claims; and reserves for the costs to settle claims. The Company establishes its reserves net of salvage and subrogation by line of business or coverage and year in which losses occur.

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 litigation, medical costs, the costs of repair materials and labor rates can all affect ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement can be. 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.

Catastrophes are an inherent risk of the property-casualty insurance business and have contributed to material period-to-period fluctuations in the Company's results of operations and financial position. The level of catastrophe losses experienced in any period cannot be predicted and can be material to the results of operations and financial

position of the Company. Catastrophe losses incurred during the years ended December 31, 2004, 2003 and 2002 were $856, $193, and $187, respectively, and related to the four hurricanes in 2004 and other natural disasters and weather related events (California wildfires in 2003).

Please see Note 6 for a discussion of incurred attributable to prior years for asbestos and environmental reserves.

Activity in property and casualty unpaid claims and claim adjustment expenses of the Company is summarized as follows:

	2004	2003	2002
Balance as of January 1	$29,952	$26,751	$25,772
Less: unpaid reinsurance recoverables [1]	9,671	8,651	7,495
Net balance as of January 1	20,281	18,100	18,277
Balance attributable to dispositions, acquisitions, and affiliations	(236)	905	19
Incurred attributable to:			
Current year	11,672	9,684	8,325
Prior years:			
Asbestos and environmental	324	178	284
Discount accretion	98	66	48
All other	262	497	442
Total incurred	12,356	10,425	9,099
Paid attributable to:			
Current year	5,109	4,355	4,401
Prior years	5,108	5,059	4,874
Total paid	10,217	9,414	9,275
Amortization of deferred retroactive reinsurance gain	47	48	50
Net adjustment due to foreign exchange	105	217	(70)
Add: unpaid reinsurance recoverables [1]	11,548	9,671	8,651
Balance as of December 31	$33,884	$29,952	$26,751

[1] In addition to the unpaid reinsurance recoverable balances noted above, and as a result of retroactive reinsurance agreements discussed in Note 8, the Company has recorded retroactive reinsurance recoverable balances of $2,225, $2,200 and $2,298 at December 31, 2004, 2003 and 2002, respectively.

In 2004, incurred attributable to prior years, excluding asbestos and environmental, is primarily related to the workers compensation line of business. Excluding asbestos and environmental, the majority of the balance of incurred attributable to prior years in 2003 was due primarily to workers compensation losses. In 2002, incurred claims and claim adjustment expenses attributable to prior years was primarily due to rising loss trends in commercial lines including workers compensation and asbestos.

The Company has not discounted unpaid property and casualty insurance claims and claim adjustment expenses other than tabular discounting on the long-term indemnity portion of workers compensation claims, the Company's disability claims as permitted by insurance regulations in certain states and specific asbestos structured settlements.

The tabular discounting on these workers compensation claims is based on Unit Statistical Plan tables as approved by the respective states and ranges from 3.50% to 4.00% for the years ended December 31, 2004 and 2003. Unpaid claims and claim adjustment expenses at December 31, 2004 and 2003 include liabilities of $4,668 and $4,332 at discounted values of $3,234 and $2,965, respectively. The discounting of the disability claims is based on the 1987 Commissioners Group Disability Table (CGDT) at annual discount rates varying from 4.50% to 7.00% in 2004 (5.00% to 6.00% in 2003). Unpaid claims and claim adjustment expenses at December 31, 2004 and 2003 include liabilities of $984 and $951 carried at discounted values of $720 and $687, respectively.

For certain commercial lines of insurance, the Company offers experience-rated insurance contracts whereby the ultimate premium is dependent upon the claims incurred. At December 31, 2004 and 2003, the Company held $3,934 and $3,738, respectively, of unpaid claims and claim adjustment expenses related to experience-rated contracts. Premiums receivable included accrued retrospective and unbilled audit premiums of $867 and $902 at December 31, 2004 and 2003, respectively. For the years ended December 31, 2004, 2003, and 2002, the Company recognized additional premium income of $93, $173, and $(7), respectively, relating to prior years.

Unpaid claims and claim adjustment expenses are recorded net of anticipated salvage and subrogation of $579 and $532 as of December 31, 2004 and 2003, respectively.

At December 31, 2004 and 2003, the reserve for unpaid claim reserves was reduced by $3,800 and $3,159, respectively, for large dollar deductibles. Large dollar deductibles billed and recoverable were $236 and $238 at December 31, 2004 and 2003, respectively.

(8) REINSURANCE

In the ordinary course of business, the Company assumes reinsurance and also cedes reinsurance to other insurers to reduce overall risk, including exposure to large losses and catastrophic events. The Company is also a member of various involuntary pools and associations and serves as a servicing carrier for residual market organizations.

A summary of reinsurance financial data reflected within the consolidated statements of income is presented below:

	2004		2003		2002	
	WRITTEN	EARNED	WRITTEN	EARNED	WRITTEN	EARNED
Direct	$19,812	$19,059	$16,949	$16,187	$14,874	$13,918
Assumed	1,314	1,333	1,370	1,539	1,637	1,482
Ceded	3,805	3,829	3,837	3,770	3,940	3,498
Net premiums	$17,321	$16,563	$14,482	$13,956	$12,571	$11,902

The following table summarizes the Company's ceded reserves by reinsurers' Standard & Poor's ("S&P") rating (or the rating of any guarantor) as of December 31, 2004.

S&P RATING	REINSURANCE RECOVERABLES
AAA	$ 1,317
AA+, AA, AA-	3,905
A+, A, A-	3,772
BBB+, BBB, BBB-	292
BB+ or below	145
Involuntary Pools	2,981
Voluntary Pools	358
Other	1,788
Gross Recoverables	14,558
less: Allowance	349
Net Recoverables	$14,209

The Company remains contingently liable in the event reinsurers are unable to meet their obligations for paid and unpaid reinsurance recoverables and unearned premiums ceded under reinsurance agreements. The Company holds $3,589 of collateral as security under related reinsurance agreements in the form of funds, securities and/or letters of credit.

The Company has an aggregate reinsurance recoverable from Nationwide Indemnity Company in the amount of $1,838 and $1,034 as of December 31, 2004 and 2003, respectively. The reinsurance recoverable is guaranteed by Nationwide Mutual Insurance Company. Additionally, the Company has significant reinsurance recoverable concentrations with Swiss Reinsurance Group, Berkshire Hathaway Group and Chubb Group totaling $1,359, $653, and $311, respectively, as of December 31, 2004, net of offsetting collateral under the contracts.

Recoverables from state mandated involuntary market pools and associations primarily represent servicing carrier business. As a servicing carrier, the Company retains no direct underwriting risk but instead cedes 100% of the involuntary premium and losses back to the pool. Payment of losses is shared among the pool participants in proportion to their pool participation. Credit risk with respect to any given pool or association is a composite of the cumulative credit of all participants.

The Company is party to retroactive reinsurance arrangements where a significant portion of the consideration is 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 as of December 31, 2004 and 2003) that are amortized into income using the effective interest method over the estimated settlement periods. At December 31, 2004 and 2003, the deferred gains related to these retroactive reinsurance arrangements were $973 and $995, respectively, and are included in other liabilities within the consolidated balance sheets. Interest credited to the funds held balances for the years ended December 31, 2004, 2003 and 2002 was $103, $88 and $77, respectively. Deferred gain amortization was $47, $48 and $50 for the years ended December 31, 2004, 2003 and 2002, respectively. Reinsurance recoverables related to these transactions including experience related profit accruals were $2,219 and $2,197 as of December 31, 2004 and 2003, respectively.

(9) DEBT OUTSTANDING

Debt outstanding at December 31, 2004 and 2003 includes the following:

Short-term debt:

	2004	2003
Commercial paper	$ 147	$ 84
Revolving credit facilities	29	22
Current maturities of long-term debt	77	—
Total short-term debt	$ 253	$ 106

Long-term debt:

	2004	2003
8.20%, Surplus Notes, due 2007	$ 121	$ 250
6.75%, Notes, due 2008	15	15
5.00% Notes, due 2008	14	30
7.00% Notes, due 2008	—	130
8.00% Notes, due 2013	260	260
5.75% Notes, due 2014	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%, Notes due 2034	250	—
7.697%, Surplus Notes, due 2097	500	500
6.76% - 8.10%, Medium Term Notes, with various maturities	27	88
	2,090	1,676
Unamortized discount	(16)	(8)
Total long-term debt excluding current maturities	$2,074	$1,668

Short-term Debt

The Company issues commercial paper to meet short-term operating needs. The total facility was $600 at December 31, 2004 and 2003 and is supported by a $450 line of credit facility. Commercial paper issued and outstanding at December 31, 2004 and 2003 was $147 and $84, respectively. Interest rates ranged from 1.08% to 2.50% in 2004 and 1.03% to 1.55% in 2003.

Long-term Debt

Payments of interest and principal of the surplus notes are expressly subordinate to all policyholder claims and other obligations of LMIC. Accordingly, interest and principal payments are contingent upon prior approval of the Commissioner of Insurance of the Commonwealth of Massachusetts.

At December 31, 2004, the principal maturity schedule of long-term borrowings is as follows:

2006	$ —
2007	121
2008	31
2009	—
Thereafter	1,938
Less: discount	(16)
Total long-term debt	$2,074

On April 12, 2004, LMIC retired approximately $129 of its $250 of 8.20% Surplus Notes due 2007 and realized a loss of approximately $19. As discussed in Note 3, the Company entered into two promissory note agreements with Prudential in conjunction with the acquisition of all the outstanding stock of PruPac. On April 16, 2004, LMGI repaid approximately $130 of these notes.

In 2004, 2003 and 2002, the Company entered into an arrangement to sell and leaseback certain furniture and equipment. The weighted average interest rate on the lease is LIBOR plus 145 basis points. The transactions are accounted for as capital leases. The capital lease obligations as of December 31, 2004 and 2003 were $109 and $101, respectively, and are included in other liabilities in the accompanying consolidated balance sheets.

As of December 31, 2004, the Company's future minimum lease payments under the sale-leaseback agreement through maturity are approximately $30 for 2005, $30 for 2006, $12 for 2007, $11 for 2008, and $7 for 2009.

Interest

The Company paid $146, $106, and $113 of interest in 2004, 2003, and 2002, respectively, and incurred $157, $113, and $118 of interest expense in 2004, 2003, and 2002, respectively, for all indebtedness.

(10) FEDERAL AND FOREIGN INCOME TAXES

The Company files a consolidated U.S. federal income tax return for substantially all of its operations. Pursuant to intercompany Federal income tax allocation agreements among each of these companies and their respective subsidiaries, the consolidated tax liabilities are allocated to each company based on its separate return tax liability. Tax benefits are allocated to each company for its portion of net operating losses and tax credit carry forwards in the year they are used by the consolidated group. Intercompany tax balances are settled quarterly. A provision is made, where applicable, for taxes on foreign operations.

The components of Federal and foreign income tax expense (benefit) related to continuing operations are:

YEARS ENDED DECEMBER 31,	2004	2003	2002
Current tax expense (benefit):			
United States Federal	$ 111	$ 198	$ 241
United States Federal benefit of net operating losses	(140)	(118)	(195)
Foreign	31	47	39
Total current tax expense (benefit)	2	127	85
Deferred tax expense (benefit):			
United States Federal	(30)	(137)	(27)
Foreign	28	10	23
Total deferred tax (benefit) expense	(2)	(127)	(4)
Total Federal and foreign income tax expense	$ —	$ —	$ 81

A reconciliation of the income tax expense (benefit) attributable to continuing operations computed at U.S. federal statutory tax rates to the income tax expense (benefit) as included in the consolidated statements of income follows:

YEARS ENDED DECEMBER 31,	2004	2003	2002
Expected Federal income tax expense (benefit)	$ 427	$ 272	$ 213
Tax effect of:			
Nontaxable investment income	(25)	(23)	(29)
Change in valuation allowance	(389)	(226)	(35)
Goodwill	(20)	(10)	(14)
IRS Settlement	(18)	—	—
Revisions to estimates	37	12	(64)
Other	(12)	(25)	10
Actual Federal and foreign income tax expense	$ —	$ —	$ 81

The significant components of the deferred income tax assets and liabilities at December 31, are summarized as follows:

	2004	2003
Deferred tax assets:		
Unpaid claims discount	$ 492	$ 663
Unearned premium reserves	452	409
Net operating losses	221	382
Employee benefits	267	308
Retroactive reinsurance deferred gain	340	349
Credits	267	212
Other	246	479
	2,285	2,802
Less: valuation allowance	(340)	(800)
Total deferred tax assets	1,945	2,002
Deferred tax liabilities:		
Deferred acquisition costs	352	309
Net unrealized gains and other-than-temporary declines in investments	607	507
Other	48	326
Total deferred tax liabilities	1,007	1,142
Net deferred tax assets	$ 938	$ 860

The total decrease in valuation allowance differs from the $389 change reflected in income primarily due to purchase price adjustments. Based on the assumption that future levels of income will be achieved, management believes it is more likely than not that the net deferred tax assets will be realized.

The Company's subsidiaries had net operating loss carry forwards of $650, alternative minimum tax credit carry forwards of $219 and foreign tax credit carry forwards of $49 as of December 31, 2004. The net operating losses available in the U.S. and various non-U.S. tax jurisdictions will begin to expire, if not utilized, as follows:

2005	$ —
2006	3
2007	7
2008	11
2009	2
Thereafter	627
Total	$ 650

The foreign tax credits will begin to expire, if not utilized, in 2010 and the alternative minimum tax credits do not expire.

The Company has not provided for deferred taxes on unremitted earnings of subsidiaries outside the United States where such earnings are permanently reinvested. At December 31, 2004, unremitted earnings of foreign subsidiaries were $458. If these earnings were distributed in the form of dividends or otherwise, the Company would be subject to U.S. income taxes less an adjustment for applicable foreign tax credits.

As discussed in Note 1, the American Jobs Creation Act of 2004 ("the AJC Act") introduced a special 85% dividends received deduction on the repatriation of certain foreign earnings to a United States taxpayer, provided certain criteria are met. The maximum amount of foreign earnings eligible for the deduction is limited to the greater of $500 or the amount shown in the Company's most recent audited financial statements filed prior to June 30, 2003 as earnings permanently reinvested outside of the United States. The Company is currently evaluating the opportunity presented by this provision and expects to complete such analysis in the first half of 2005. A reasonable estimate of the range of income tax effects of a repatriation of foreign earnings under The AJC Act cannot be made at this time.

During 2004 the Company reached a settlement with the Internal Revenue Service ("IRS") relating to its federal income tax liability for the 1994 through 1996 tax years. Results for the year ended December 31, 2004 increased $18 million due to settlements of these prior year tax issues.

The IRS has completed its review of the Company's federal income tax returns through the 1998 tax year and is currently reviewing income tax returns for the 1999 through 2001 tax years. Any adjustments that may result from the IRS examinations of these income tax returns are not expected to have a material impact on the financial position, liquidity or results of operations of the Company.

(11) BENEFIT PLANS

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

The Company sponsors supplemental retirement plans to provide pension benefits above the levels provided by the pension plans without regard to the statutory earnings limitations of qualified defined benefit pension plans. The supplemental plans are unfunded.

The Company also provides certain healthcare and life insurance benefits ("Postretirement") covering substantially all U.S. and Canadian employees. Life insurance benefits are based on a participant's final compensation subject to the plan maximum.

Assets of the defined benefit pension and postretirement plans consist primarily of investments in life insurance company separate accounts that invest primarily in fixed income and Standard and Poor's 500 Index of equity securities. At December 31, 2004 and 2003, assets of the Plans totaling $2,170 and $1,930, respectively, were held in separate accounts of the Company.

The Company sponsors defined contribution savings plans (a 401(k) plan) for substantially all U.S. and Canadian employees who meet certain eligibility requirements. During 2004, 2003 and 2002, employees could contribute a percentage of their annual compensation on a before and after-tax basis, subject to Federal limitations. The benefits are based on the employee's contribution amount and Company profitability. In 2004, 2003 and 2002, the Company made matching contributions of $68, $60, and $61, respectively, including the supplemental defined contribution plans.

Some foreign subsidiaries sponsor non-contributory pension plans to employees which provide benefits based on final pay. The assets of the plans are held separately from the assets of the foreign subsidiaries. The pension reporting for these plans has been restated on a FAS 87 basis for 2004 and 2003. Therefore, the assets, obligations, and benefit costs are included within the following U.S. and Canada pension plan tables. The net periodic benefit costs charged to foreign subsidiaries in 2002 was $5.

Compensation expense related to the Company's long-term and short-term incentive compensations plans was $389, $388, and $135 for the years ended December 31, 2004, 2003 and 2002, respectively.

The following table sets forth the assets, obligations and assumptions associated with the various U.S., Canadian, and certain foreign subsidiary pension and post-retirement benefits. The amounts are recognized in the accompanying consolidated balance sheets as of December 31, 2004 and 2003, and consolidated statements of income for the years ended December 31, 2004, 2003, and 2002.

	Pension		Supplemental Pension		Postretirement	
	2004	2003	2004	2003	2004	2003
Change in benefit obligations:						
Benefit obligation at beginning of year	$2,537	$2,060	$ 207	$ 160	$ 498	$ 439
Service costs	125	99	7	5	18	15
Interest cost	161	144	12	11	30	30
Amendments	(17)	(3)	1	—	—	—
Actuarial loss	125	339	26	44	90	45
Currency exchange rate change	3	8	—	—	—	—
Divestitures	(5)	(17)	—	—	(4)	(4)
Benefits paid	(102)	(96)	(35)	(13)	(25)	(29)
Other	2	3	1	—	1	2
Benefit obligations at end of year	$2,829	$2,537	$ 219	$ 207	$ 608	$ 498
Accumulated benefit obligations	$2,334	$2,091	$ 162	$ 158	$ 608	$ 498
Change in plan assets:						
Fair value of plan assets at beginning of year	$2,097	$1,843	—	—	$ 20	$ 20
Actual return on plan assets	217	366	—	—	2	2
Currency exchange rate change	2	9	—	—	—	—
Divestiture	—	(25)	—	—	—	—
Employer contribution	128	6	—	—	23	27
Benefits paid	(102)	(96)	—	—	(25)	(29)
Other	(3)	(6)	—	—	—	—
Fair value of plan assets at end of year	$2,339	$2,097	$ —	$ —	$ 20	$ 20
Reconciliation of funded status:						
Funded status of the plan	$ (490)	$ (440)	$ (219)	$ (207)	$ (588)	$ (478)
Unrecognized net loss	641	525	94	87	103	11
Unrecognized prior service cost	23	45	15	16	(41)	(44)
Unrecognized net transition (asset)/obligation	(31)	(37)	—	2	114	127
Net amount recognized	$ 143	$ 93	$ (110)	$ (102)	$ (412)	$ (384)
Amounts recognized in the consolidated balance sheets consist of:						
Prepaid benefit cost	$ 143	$ 93	$ —	$ —	$ —	$ —
Accrued benefit liability	(6)	(5)	(162)	(158)	(412)	(384)
Intangible asset	6	5	14	18	—	—
Accumulated other comprehensive income	—	—	38	38	—	—
Net amounts recognized at year end	$ 143	$ 93	$ (110)	$ (102)	$ (412)	$ (384)
Additional Information:						
Increase in minimum liability included in other comprehensive income	—	—	$ (1)	$ 19	—	—

The expected long-term rate of return assumption is primarily driven by two factors: (1) the asset allocation targets and (2) the expected long-run returns associated with each asset class. The starting point for generating long-run expected asset class returns for large-cap equities, small-cap equities, private equities and high yield bonds is an analysis of historic asset class returns and risk premiums relative to the 5-year U.S. Treasury. Investment grade bonds and cash are expected to earn returns that are generally consistent with prevailing market yields.

This approach is not entirely formulaic as professional judgment is used to make modest adjustments to these numbers in cases where the Company believes that certain data are at abnormal levels relative to long-run averages. For example, the spread between Treasury yields and inflation appeared low relative to long-run averages at the end of 2003. The 5-year U.S. Treasury was approximately 3.2% and inflation (as measured by the CPI-U) was 1.9%, resulting in a difference of 1.3%. Over the past ten and twenty years, this difference has averaged approximately 2.8% and 3.4%, respectively. Based on this information, the Company assumed a modest increase in future 5-year Treasury yields in generating its expected long-run return estimates.

The net benefit costs for the years ended December 31, 2004, 2003, and 2002 included the following components:

DECEMBER 31, 2004	PENSION	SUPPLEMENTAL PENSION	POSTRETIREMENT
Components of net periodic benefit costs			
Service costs	$ 125	$ 7	$ 18
Interest cost	161	12	30
Expected return on plan assets	(208)	—	(1)
Amortization of unrecognized:			
Net (gain)/loss	—	6	(1)
Prior service cost	5	2	(3)
Net transition (assets)/obligation	(5)	—	9
Net periodic benefit costs	$ 78	$ 27	$ 52
Curtailment (gain)/loss	—	15	(1)
Total expense	$ 78	$ 42	$ 51

DECEMBER 31, 2003	PENSION	SUPPLEMENTAL PENSION	POSTRETIREMENT
Components of net periodic benefit costs			
Service costs	$ 99	$ 5	$ 15
Interest cost	144	11	30
Expected return on plan assets	(203)	—	(1)
Amortization of unrecognized:			
Net (gain)/loss	—	3	—
Prior service cost	5	2	(3)
Net transition (assets)/obligation	(5)	—	9
Net periodic benefit costs	$ 40	$ 21	$ 50

DECEMBER 31, 2002	PENSION	SUPPLEMENTAL PENSION	POSTRETIREMENT
Components of net periodic benefit costs			
Service costs	$ 88	$ 4	$ 13
Interest cost	131	10	29
Expected return on plan assets	(215)	2	(2)
Amortization of unrecognized:			
Net (gain)/loss	(14)	1	(2)
Prior service cost	5	1	(1)
Net transition (assets)/obligation	(7)	1	10
Net periodic benefit costs	$ (12)	$ 19	$ 47

The measurement date used to determine pension and other postretirement measurements is December 31, 2004.

Weighted-average actuarial assumptions for benefit obligations are set forth in the following table.

DECEMBER 31,	2004	2003
Pension		
Discount rate	6.25%	6.50%
Rate of compensation increase	5.20%	5.20%
Supplemental Pension		
Discount rate	6.25%	6.50%
Rate of compensation increase	4.90%	4.90%
Postretirement		
Discount rate	6.25%	6.50%

Weighted-average actuarial assumptions for net periodic benefit costs are set forth in the following table.

DECEMBER 31,	2004	2003	2002
Pension			
Discount rate	6.50%	7.00%	7.00%
Expected return on plan assets	8.50%	8.50%	9.00%
Supplemental Pension			
Discount rate	6.50%	7.00%	7.00%
Postretirement			
Discount rate	6.50%	7.00%	7.00%
Expected return on plan assets	7.15%	7.15%	7.15%

The weighted-average healthcare cost trend rates are expected to be 11.4% in 2005 graded down to 5.2% in 2012. Healthcare cost trend rate assumptions have a material impact on the postretirement benefit obligation. A one-percentage change in assumed healthcare cost trend rates would have the following effects:

	1% POINT INCREASE	1% POINT DECREASE
Effect on Postretirement Benefit Obligation	$72	$(65)
Effect on total service and interest costs	$ 9	$ (7)

Plan Assets

The pension plan's weighted-average asset allocation by asset category is as follows:

ASSET CATEGORY	2004	2003
Equity Investments	58%	58%
Debt Investments	33%	37%
Other	9%	5%
Total	100%	100%

The fundamental investment policies of the Plans have been formulated so they balance the primary objectives of (1) achieving long-term growth sufficient to fund, as fully practicable, future obligations and (2) supporting the short-term requirement of meeting current benefit payments, all after giving due consideration to the underlying characteristics of the Company's employment base. Overall, the Plans' policies have traditionally emphasized the maximization of long-term returns in a manner that is consistent with an asset base that: consists of high quality investments as a means of enhancing capital preservation; is broadly diversified; generates a relatively high level of investment income in accordance with the level of risk incurred; and is generally, highly marketable.

Asset allocation and selection guidelines for the Plans have been developed around the aforementioned fundamental policies. Equities have been considered the most appropriate asset class for the Plan given their record of superior, long-term, real rates of return and the Plan's ability to accommodate the shorter-term volatility typically associated with equity investments. The guidelines for equity investing have historically focused on high quality stocks and the diversification of risk. The Plans' target allocation for equity investments is 65%, with a range of from 45% to 80%.

The other major component of the Plans' assets consists of fixed income securities. The primary investment objective for this class of assets is to balance the pursuit of total return and the generation of a relatively high level of investment income. Once again, from a policy perspective, emphasis is placed on high quality investments and the diversification of risk. The Plans' target allocation for debt investments is 29%, with a range of from 17% to 42%.

The remaining assets of the Plans are maintained in cash or invested in limited partnerships, which are principally engaged in venture capital investing and other so-called "non-traditional" forms of investment. The Plans' target allocation for other investments is 6%, with a range of from 3% to 12%.

The Postretirement Plan weighted-average asset allocations by asset category are as follows:

ASSET CATEGORY	2004	2003
Equity Investments	25%	23%
Debt Investments	14%	14%
Other	61%	63%
Total	100%	100%

The Postretirement Plan maintains assets in an insurance contract used to pay current life insurance premiums for certain retirees. These amounts are classified as other assets. The investment strategy for this portion of the assets places a greater emphasis on funding current benefits and a lesser emphasis on long-term growth.

Cash Flows

Contributions

The Company contributed $128 to the qualified plans, and directly funded $35 to retirees in the supplemental pension plans in 2004. In addition, the Company directly funded $23 to the postretirement benefit plans in 2004.

The Company expects to contribute $100 to the qualified plan, and directly fund $21 to retirees in the supplemental pension plan in 2005. In addition, the Company expects to directly fund $27 to the postretirement benefit plan in 2005.

Expected Future Benefit Payments
The following benefit payments, which reflect expected future service, as appropriate are expected to be paid:

	PENSION	SUPPLEMENTAL PENSION	POST-RETIREMENT EXCLUDING POST 65 DRUG	POST-RETIREMENT POST 65 DRUG	POST-RETIREMENT MEDICARE SUBSIDY
2005	$101	$21	$ 19	$ 8	$ —
2006	103	8	20	9	(3)
2007	106	10	20	9	(3)
2008	111	10	21	10	(3)
2009	118	10	22	11	(4)
2010-2014	760	56	136	64	(21)

(12) FAIR VALUE OF FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 107, "*Disclosures about Fair Value of Financial Instruments*" ("FAS 107") requires disclosure of fair value information about financial instruments, as defined therein, for which it is practicable to estimate such fair value. FAS 107 excludes certain financial instruments, including those related to certain insurance contracts. In the measurement of the fair value of certain financial instruments, quoted market prices were not available and other valuation techniques were utilized. These derived fair value estimates are significantly affected by the assumptions used. The following methods and assumptions were used to estimate the fair value of the financial instruments presented:

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

Fixed maturities: Fair values for fixed maturities were generally based on quoted market prices. For certain fixed maturities securities for which quoted market prices were not available, fair values were estimated using values obtained from independent pricing services, or in the case of private placements, were determined by discounting expected future cash flows using a current market rate applicable to the yield, credit quality, and maturity of the securities.

Equity and trading securities: Fair values for equity and trading securities were based upon quoted market prices.

Other investments: Fair values represent the Company's equity in the partnerships' net assets as determined by the respective general partners.

Individual and group annuities: Fair values for deferred annuity contracts are equal to current net surrender value. Fair values of liabilities under investment-type insurance contracts, including individual and group annuities, are estimated using discounted cash flow calculations at pricing rates at December 31, 2004 and 2003.

Debt outstanding: Fair values of commercial paper and short-term borrowings approximate carrying value. Fair values of long-term debt were based on either quoted market prices or estimated using discounted cash flow analyses based on the Company's incremental borrowing rate at December 31, 2004 and 2003.

The fair values and carrying values of the Company's financial instruments at December 31, 2004 and 2003 are as follows:

	2004		2003	
	CARRYING VALUE	FAIR VALUE	CARRYING VALUE	FAIR VALUE
Fixed maturity securities	$35,601	$35,601	$32,287	$32,287
Equity securities	1,802	1,802	1,346	1,346
Trading securities	457	457	208	208
Other investments	990	990	768	768
Short-term investments	687	687	940	940
Cash and cash equivalents	2,590	2,590	1,999	1,999
Individual and group annuities	911	1,040	891	1,037
Debt	2,327	2,485	1,774	1,811

(13) COMMITMENTS AND CONTINGENT LIABILITIES

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

The Company has been in various insurance coverage disputes with Armstrong World Industries ("Armstrong") for over twenty years relating to asbestos liabilities and insurance covering the period 1973 to 1981. The Company has prevailed in a favorable arbitration ruling before an appellate panel regarding Armstrong's insurance coverage. Armstrong filed a Chapter 11 Bankruptcy petition in the United States Bankruptcy Court for the District of Delaware in December 2000 and is still operating under the protection of Chapter 11. A declaratory judgment action, filed by Armstrong in 2002, is pending in the United States District Court for the Eastern District of Pennsylvania seeking coverage for asbestos claims under insurance policies issued to Armstrong during the period of 1973 to 1981, including, but not limited to, damages and a declaration regarding the availability, applicability and scope of alleged non-product coverage not subject to the aggregate limits of the policies. Armstrong contends that a significant portion of its asbestos liability arises from operations that would entitle Armstrong to insurance coverage under the disputed policies without regard to the aggregate limit of liability. The Pennsylvania action is currently in the initial pleading stages and inactive by agreement of the parties. Armstrong has also recently filed, in the same Pennsylvania District Court, a Motion to Vacate the appellate arbitration award that was favorable to the Company. The Company intends to vigorously defend its position. Management believes that the ultimate liability, if any, to Armstrong will not be resolved for at least one year and very likely may not be known for several years. In the opinion of management, the outcome of these pending matters is difficult to predict and in the event of an adverse outcome, could have a material adverse effect on the Company's results of operations, financial condition and liquidity.

The Company leases certain office facilities and equipment under operating leases expiring in various years through 2017. Rental expense amounted to $179, $151 and $156 for the years ended December 31, 2004, 2003 and 2002, respectively. Future minimum rental payments under non-cancelable leases with terms in excess of one year are estimated as follows:

2005	$ 159
2006	138
2007	112
2008	90
2009	77
Thereafter	228
Total	$ 804

In 2003, the Company entered into an arrangement to sell and leaseback certain equipment. The transaction is accounted for as an operating lease. Rental expense amounted to $12 for the year ended December 31, 2004 and $9 for the years ended 2003 and 2002. Future minimum rental payments under these leases are estimated as follows:

2005	$11
2006	11
2007	11
2008	11
2009	11
Thereafter	10
Total	$ 65

It is expected that as leases expire they will be replaced.

At December 31, 2004, the Company had unfunded capital commitments to limited partnership investments of $646.

At December 31, 2004, the Company had commitments to purchase various mortgage-backed securities settling in 2005, at a cost of $291 with a fair value of $293 and are included as fixed maturities in the consolidated balance sheets.

At December 31, 2004 and 2003, the Company had $560 and $697, respectively, in assigned structured settlement annuities in connection with the Prudential transaction. The asset and annuity liability of the same amount are correspondingly classified as other assets and other liabilities in the consolidated balance sheets.

Liabilities for guaranty fund and other insurance-related assessments are accrued when an assessment is probable, when it can be reasonably estimated, and when the event obligating the entity to pay an imposed or probable assessment has occurred (based on past premiums for life lines and future premiums for property and casualty lines). Liabilities for guaranty funds and other insurance-related assessments are not discounted and are included as part of

other liabilities in the consolidated balance sheets. As of December 31, 2004 and 2003, the liability balance was $137 and $172, respectively. As of December 31, 2004 and 2003, included in other assets were $14 and $16, respectively, of related assets for premium tax offsets or policy surcharges. The related asset is limited to the amount that is determined based on future premium collections or policy surcharges from policies in force. Current assessments are expected to be paid out over the next five years; while premium tax offsets are expected to be realized within one year.

The Company has reinsurance funds held balances of approximately $1,630, which are subject to ratings triggers whereby if any of the Company's insurance financial strength ratings (with the three major rating agencies) fall below the A- (or equivalent) categories, the funds may be required to be placed in trust and invested in assets acceptable to the Company. Additionally, the Company has a letter of credit in the amount of 152 British pounds (approximately $293) that can be terminated in the event that the Company's insurance financial strength rating with S&P falls below the BBB+ or Moody's below Baa1. The Company has no additional material ratings triggers.

(14) POLICYHOLDERS' EQUITY

Statutory Surplus

The Statutory surplus of the Company's domestic insurance companies was $8,739 and $7,216 at December 31, 2004 and 2003, respectively. The Company's domestic insurance subsidiaries prepare the statutory basis financial statements in accordance with the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual ("NAIC APP"), subject to any deviations prescribed or permitted by the insurance commissioners of the various insurance companies' states of domicile. The Company does not have any material permitted practices that deviate from NAIC APP.

Dividends

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 and LMFIC, 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 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, LMFIC and certain other affiliates which effectively limit LMIC and LMFIC 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. The maximum dividend payout in 2005 that may be made prior to regulatory approval is $859.

(15) EVENT (UNAUDITED) SUBSEQUENT TO THE DATE OF THE INDEPENDENT AUDITOR'S REPORT

In March 2005, the Company issued Senior ("the Notes") in the aggregate principal amount of $500 that carry an interest rate of 6.50% and mature in 2035. Interest on the Notes will be paid March 15 and September 15 of each year.

REPORT OF MANAGEMENT

THE BOARD OF DIRECTORS

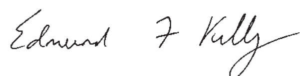
LIBERTY MUTUAL HOLDING COMPANY INC.

The accompanying consolidated financial statements and related information contained in this annual report are the responsibility of management and have been prepared in conformity with generally accepted accounting principles. These consolidated financial statements include amounts that are based on management's estimates and judgments, particularly our reserves for losses and loss adjustment expenses. We believe that these consolidated financial statements present fairly the Company's financial position and results of operations and that other information contained in the annual report is consistent with the consolidated financial statements

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

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

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



EDMUND F. KELLY | CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

DENNIS J. LANGWELL | SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER

REPORT OF INDEPENDENT AUDITORS

THE BOARD OF DIRECTORS

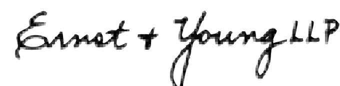
LIBERTY MUTUAL HOLDING COMPANY INC.

We have audited the accompanying consolidated balance sheets of Liberty Mutual Holding Company Inc. and subsidiaries (the Company) as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in policyholders' equity, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Liberty Mutual Holding Company Inc. and subsidiaries at December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the consolidated financial statements, in 2002, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" and the remaining provisions of Statement of Financial Accounting Standards No. 141, "Business Combinations".



FEBRUARY 11, 2005

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Dexter R. Legg
Vice President and Secretary

Laurance H.S. Yahia
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Chief Operating Officer

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General Manager, Field Operations

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Chief Underwriting Officer

Specialty Risks Market
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Wausau Commercial Market
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Vietnam

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Liberty Seguros
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Portugal

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Ignacio Barriga
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Liberty Seguros
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Liberty International
Underwriters
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Sean Dalton
Managing Director
Liberty Syndicate Management

Sean Rocks
Managing Director
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Mike Molony
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Executive Vice President

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President and Chief Executive Officer
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Newark, Delaware

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Newark, Delaware

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PENCO Corporation
Seaford, Delaware

Terrence M. Shannon
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I. D. Griffith, Inc.
Wilmington, Delaware

P. Coleman Townsend, Jr.
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Chief Executive Officer
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Wilmington, Delaware

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President
AmStaff Human Resources, Inc.
Pensacola, Florida

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Miami, Florida

Eugene McNichols
President
McNichols Company
Tampa, Florida

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President and Owner
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Ft. Pierce, Florida

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President
Polk Nursery Company, Inc.
Auburndale, Florida

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Stiefel Laboratories, Inc.
Coral Gables, Florida

Kenneth N. Trask
President and
Chief Executive Officer
Conshor, Inc.
Bonita Springs, Florida

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Chief Executive Officer
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Duluth, Georgia

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Valdosta, Georgia

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Atlanta Bonded Warehouse
Corporation
Kennesaw, Georgia

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Alpharetta, Georgia

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Smyrna, Georgia

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Chromcraft Revington
Delphi, Indiana

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Chief Executive Officer
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Milford, Indiana

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Chairman of the Board
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Prospect, Kentucky

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Louisville, Kentucky

Fred J. Merrick, Sr.
Chief Executive Officer and President
Multi-Industries Incorporated
Louisville, Kentucky

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President
B. Frank Joy, LLC
Hyattsville, Maryland

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Ramsay, Scarlett & Co., Inc.
Baltimore, Maryland

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Forestville, Maryland

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Chief Executive Officer
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Framingham, Massachusetts

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M. F. Foley, Inc.
New Bedford, Massachusetts

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President
Wayne J. Griffin Electric, Inc.
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