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COMPANY NAME: AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

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AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Surplus and Schedules

December 31, 2006 and 2005

(With Independent Auditors' Report Thereon)

KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

Independent Auditors' Report

The Board of Directors
American Manufacturers Mutual Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of American Manufacturers Mutual Insurance Company (the Company) as of December 31, 2006 and 2005. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the statutory 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 statutory financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall statutory financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note 2 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation-Division of Insurance (Division of Insurance), which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of American Manufacturers Mutual Insurance Company as of December 31, 2006 and 2005.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of American Manufacturers Mutual Insurance Company as of December 31, 2006 and 2005, on the basis of accounting described in Note 2.

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the Supplemental Schedule of Investments, Supplemental Schedule of Investment Risk Interrogatories, and Reinsurance Risk Interrogatories Schedule is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

The accompanying statutory financial statements and supplementary information have been prepared assuming that the Company will continue as a going concern. The Company is exposed to credit risk related to reinsurance recoverables as discussed in Notes 5 and 9 and operating risk related to administrative sharing agreements, including a shared management group, as discussed in Note 7 with Lumbermens Mutual Casualty Company (LMC), an affiliated company. As discussed in Note 8 to the statutory financial statements, the Division of Insurance imposes risk-based capital (RBC) requirements on insurance enterprises, including the Company. As of December 31, 2006, the Company's total adjusted capital, as reported in the 2006 Annual Statement filed with the Division of Insurance, was above any action levels based on the RBC calculation required by the Division of Insurance; however, LMC's RBC was at the "authorized control level." LMC's RBC was at the "mandatory control level" as of December 31, 2005. At the "authorized control level" and the "mandatory control level", the Division of Insurance has substantial authority to exercise control over LMC, its subsidiaries and affiliates, including the Company. The Division of Insurance is mandated to place a company at the "mandatory control level" under its control, except where, as is the case with LMC, such company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director of the Division of Insurance has discretion to allow the continued run-off. In the first half of 2003, as a result of a combination of various business factors including certain ratings downgrades and LMC's deteriorating statutory surplus, LMC, its subsidiaries, and affiliates, including the Company, substantially ceased underwriting activities. Since July 2003, the Company and most of its subsidiaries and affiliates have been subject to a Corrective Order by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance. On March 19, 2004, LMC, along with the Company, submitted to the Division of Insurance its commercial run-off plan which was approved on June 9, 2004.

The Division of Insurance could seek to place LMC, its subsidiaries, and affiliates, in formal proceeding (receivership, rehabilitation, or other) at any time based on LMC's financial condition or operating performance. This risk of a proceeding would be further increased if LMC fails to execute successfully on its commercial run-off plan, if LMC fails to have sufficient liquid assets to meet its current obligations, or if LMC's reported statutory liabilities at any time would exceed its reported statutory assets as discussed in Note 8 to the statutory financial statements.

There are a number of factors that could adversely affect the Company's surplus and liquidity position and its adequacy through future years. There can be no assurance that LMC will be successful to the extent necessary to avoid a negative surplus in future years.

The matters discussed in the preceding paragraphs raise substantial doubt about the ability of the Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, the most important of which is regulatory action, including the continued acceptance of LMC's commercial run-off plan and the continued collection of reinsurance recoverables from LMC. Management's plans in regards to these matters are described throughout the notes to the statutory financial statements. The accompanying statutory financial statements and the supplementary information do not include any adjustments that might result from the outcome of this uncertainty.

KPMG LLP

May 29, 2007

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

Admitted Assets		**2006**	**2005**
Cash, cash equivalents, and short-term investments	$	1,511,650	4,005,007
Common stocks		—	2,486
Bonds		8,897,195	6,809,557
Total cash and invested assets		10,408,845	10,817,050
Investment income due and accrued		149,460	79,662
Total admitted assets	$	10,558,305	10,896,712
Liabilities and Surplus			
Liabilities:			
Payable to affiliates	$	74,329	622,843
Other expenses payable		900	1,000
Total liabilities		75,229	623,843
Surplus:			
Guaranty fund		1,500,000	1,500,000
Unassigned surplus		8,983,076	8,772,869
Total surplus		10,483,076	10,272,869
Total liabilities and surplus	$	10,558,305	10,896,712

See accompanying notes to statutory statements of admitted assets, liabilities, and surplus.

(1) Business Operations

American Manufacturers Mutual Insurance Company (the Company) is a mutual property and casualty insurance company domiciled in the state of Illinois. Under common management with Lumbermens Mutual Casualty Company (LMC), the Company cedes 100% of its premiums, losses, and loss adjustment expenses (LAE) to LMC. LMC is the lead company of a group of insurers, now in run-off status, which have operated under the trade name of the Kemper Insurance Companies (Kemper).

The Company's risk-based capital (RBC) ratio exceeds any regulatory action levels; however, LMC's RBC ratio fell below the "authorized control level" as of December 31, 2002, and has remained below that level to date (see note 8). Because of the Company's heavy reliance on reinsurance recoveries and operations support from LMC, the regulatory and financial status of LMC has had and will continue to have a significant impact on the Company's operations.

(2) Basis of Presentation and Summary of Significant Accounting Policies

The accompanying statutory statements of admitted assets, liabilities, and surplus (the statutory balance sheets) have been prepared in accordance with the National Association of Insurance Commissioners (the NAIC) *Accounting Practices and Procedures Manual* (the Manual), and in conformity with prescribed accounting practices (including accounting allowances under Corrective Orders) or permitted accounting practices by the Illinois Department of Financial and Professional Regulation – Division of Insurance (the Division of Insurance), which vary in some respects from U.S. generally accepted accounting principles (GAAP). The most significant of these differences are as follows:

- the costs related to acquiring business are charged to income when incurred rather than deferred and amortized over the life of the related insurance policy;
- investments in bonds are generally carried at amortized cost, while under GAAP, such fixed maturity investments are designated at purchase as held-to-maturity, available-for-sale, or trading. Held-to-maturity investments are reported at amortized cost. Available-for-sale and trading investments are reported at fair value with unrealized gains and losses reported in operations for those designated as trading and as a separate component of stockholder's equity, net of applicable deferred income taxes, for those designated as available-for-sale;
- assets are included in the statutory balance sheets at admitted asset value, and nonadmitted assets are excluded through a direct charge against surplus, while under GAAP, such assets would be recognized at the lower of cost or net realizable value;
- the realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10 – *Income Taxes*. Any gross deferred tax assets determined not to be realizable are nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in net income under GAAP, whereas under statutory accounting principles, these changes are charged or credited to surplus;

- ceded reinsurance balances are netted against direct and assumed balances on the statutory balance sheets rather than shown gross under GAAP;
- liabilities for losses and LAE are discounted using discount rates prescribed by the Division of Insurance; and
- the correction of errors related to previously issued financial statements is charged directly to surplus rather than restating prior period results.

The effects of such differences between these statutory accounting practices and GAAP have not been determined but are presumed to be material.

Correction of Errors

In accordance with SSAP No. 3, *Accounting for Changes and Corrections of Errors*, the Company has reflected as a direct charge to surplus corrections of errors of $262 thousand as of December 31, 2005, which related to certain expenses of the Company that had been expensed and paid by LMC in 2004.

Invested Assets and Related Income

Bonds, cash equivalents, and short-term investments are valued at amortized cost. The amortized cost of bonds is adjusted for amortization of premiums and accretion of discounts using a level effective yield method to maturity, or in the case of loan-backed securities, over the estimated life of the security. Amortization of the discount or premium from loan-backed securities is recognized retrospectively based on the estimated timing and amount of prepayments of the underlying assets and is adjusted to reflect differences which arise between the prepayments originally anticipated and the actual prepayments received and currently anticipated. Prepayment assumptions used for loan-backed securities were obtained from an external securities information service and are consistent with the current interest rate and economic environment.

The Company defines cash and cash equivalents as cash in banks or short-term, highly liquid investments that are both readily convertible to cash and have original maturities of three months or less. The Company considers all other highly liquid investments with an original maturity of one year or less to be short-term investments.

Unaffiliated common stocks are carried at fair value.

The Company does not accrue interest income on fixed maturities deemed to be impaired on an other-than-temporary basis when it determines that the likelihood of collection of interest is doubtful.

Premium Balances

Premiums are earned on a daily pro-rata basis over the term of the policies. Unearned premiums are stated after deduction for premiums ceded to reinsurers. Premiums received in advance are recorded as a liability and are not considered income until due. Agents' balances and uncollected premiums receivable are recorded at the effective date of the underlying contract or in the case of audit premiums in accordance with the terms of the underlying contracts. The Company evaluates the collectibility of all receivables for possible impairment. When the Company determines it is probable a receivable balance will not be collected, such amount is written off. The Company anticipates investment income as a factor in determining the premium deficiency liability. As of both December 31, 2006 and 2005, the Company did not require an ending premium deficiency liability.

Liability for Losses and Loss Adjustment Expenses

The Company records liabilities for unpaid claims, losses, and related LAE based upon management's best estimate of aggregate case-basis estimates for losses reported, estimates received from ceding reinsurers, and estimates of incurred but not reported (IBNR) losses related to direct and assumed business, less amounts ceded to reinsurers. Liabilities for unreported losses are established using various statistical and actuarial techniques reflecting historical patterns of development of paid and reported losses adjusted for current trends.

Because the ultimate settlement of claims is subject to future events, no single loss or LAE liability can be considered accurate with certainty. The Company's analysis of the reasonableness of loss or LAE liability estimates includes an analysis of the amount of variability in the estimate. The Company develops its estimate considering a range of liability estimates bounded by a high and a low estimate. The high and low ends of the range do not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's best estimate therefore does not include the set of all possible outcomes but only those outcomes that are considered reasonable.

Management believes the liabilities for losses and LAE are adequate to cover the ultimate liability; however, due to the underlying risks and high degree of uncertainty associated with the determination of the liability for losses, such estimates may be more or less than the amounts ultimately paid when the claims are settled. In the event reinsurance companies are unable to pay their portion of any claim under reinsured policies, the Company would remain liable for such payments.

Federal Income Taxes

The Company's federal income tax return is not consolidated with any other entities. Federal income taxes are charged to operations based on income that is currently taxable. The Company provides, as a component of surplus, an estimate of deferred income tax assets and liabilities which reflect the expected future tax consequences of unrealized capital gains or losses and the temporary differences generated between statutory accounting and the tax bases of assets and liabilities that are anticipated to reverse within one year or can be recovered through loss carrybacks.

Nonadmitted Assets

Assets included in the statutory balance sheets are at admitted asset value. Certain assets designated as "nonadmitted assets" are excluded from the statutory balance sheets and are charged to unassigned surplus at December 31, 2006 and 2005 as follows:

		2006	2005
		(In thousands)	
Deferred tax assets	$	88,759	100,637
Prepaid expenses		58	—
Total nonadmitted assets	$	88,817	100,637

Use of Estimates

The preparation of the statutory balance sheets requires management to make estimates and assumptions that affect the reported statutory balance sheet amounts as well as the disclosure of contingent assets and liabilities. Accordingly, actual results could differ from those estimates.

As further discussed in the accompanying notes to the statutory balance sheets, significant estimates and assumptions affect various provisions including losses and policyholder dividends. The liabilities for losses and LAE, although supported by actuarial analysis and other data, are ultimately based on management's reasoned expectations of future events. As further described in note 4, estimates of losses and LAE related to environmental and asbestos claims are also subject to a greater degree of uncertainty and variability.

(3) Invested Assets

Bonds

The fair values of the Company's bonds have been determined using prices provided by the Securities Valuation Office of the NAIC (the SVO), or when such values are not available from the SVO, using prices from independent pricing services that use market quotations, prices provided by brokers, or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or prices determined in good faith by the Company's engaged portfolio manager. Such values are referred to in the accompanying tables as "NAIC fair value."

The statement value and NAIC fair value of bonds at December 31, 2006 and 2005 were as follows:

	2006			
	Statement value	**Gross unrealized gains**	**Gross unrealized losses**	**NAIC fair value**
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 6,520	—	(22)	6,498
State, political subdivision, and special revenue obligations	410	26	—	436
Debt securities issued by foreign governments	77	1	—	78
Corporate securities	1,101	—	—	1,101
Asset-backed securities	789	—	(1)	788
Total bonds	$ 8,897	27	(23)	8,901

	2005			
	Statement value	**Gross unrealized gains**	**Gross unrealized losses**	**NAIC fair value**
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 5,270	—	(96)	5,174
State, political subdivision, and special revenue obligations	411	42	—	453
Debt securities issued by foreign governments	78	2	—	80
Asset-backed securities	1,051	—	(1)	1,050
Total bonds	$ 6,810	44	(97)	6,757

Bonds in an unrealized loss position are regularly reviewed for other-than-temporary declines in value. Factors considered in determining whether a decline is other-than-temporary include the length of time a bond has been in an unrealized loss position and the reasons for the decline in value. Assessments include judgments about an obligor’s current and projected financial position, an issuer’s current and projected ability to service and repay its debt obligations, the existence of, and realizable value for, any collateral backing the obligations, and the macro-economic and micro-economic outlooks for specific industries and issuers. Assessing the duration of loan-backed securities can also involve assumptions regarding underlying collateral such as prepayment rates, default and recovery rates, and third party servicing abilities.

In performing its other-than-temporary impairment reviews, the Company, in consultation with its engaged portfolio manager, considers the relevant facts and circumstances relating to each investment and exercises judgment in determining whether a bond is other-than-temporarily impaired. Among the factors considered is whether the decline in fair value results from a change in the quality of the security itself, or from a downward movement in the market as a whole, and the likelihood of recovering the carrying value based on the current and short-term prospects of the issuer. Unrealized losses that are considered to be primarily the result of market conditions, such as increasing interest rates, unusual market volatility or industry-related events, and where the Company also believes there exists a reasonable expectation of recovery and, furthermore, has the intent to hold the investment until maturity or the market recovery, are usually determined to be temporary.

The bonds shown in the following table are all rated “A” or better or are either U.S. government obligations or are U.S. government agency mortgage-backed obligations; have minimal credit risk; and are subject to normal market fluctuations. The Company intends to hold them until they mature or recover in value. However, if the specific facts and circumstances surrounding a bond, or the outlook for its industry sector or the economy change, the Company may sell the bond and realize a loss.

The risks inherent in reviewing the impairment of any investment include the risk that market results may differ from expectations; facts and circumstances may change in the future and differ from estimates and assumptions; or the Company may later decide to sell the security as a result of changed circumstances.

(Continued)

As of December 31, 2006 and 2005, the gross unrealized losses that were in that position for more than twelve months and for less than twelve months were as follows:

	2006			2005		
	Number of issues	Gross unrealized losses	NAIC fair value	Number of issues	Gross unrealized losses	NAIC fair value
			(In thousands)			
Bonds in a loss position more than 12 months:						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	2	$ (11)	2,881	1	$ (92)	4,881
	2	(11)	2,881	1	(92)	4,881
Bonds in a loss position less than 12 months:						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	1	(11)	3,617	1	(4)	294
Corporate securities	3	—	850	—	—	—
Asset-backed securities	1	(1)	292	2	(1)	1,050
	5	(12)	4,759	3	(5)	1,344
Total bonds in a loss position	7	$ (23)	7,640	4	$ (97)	6,225

The following table sets forth the maturity aging schedule of bonds at December 31, 2006. The actual maturities may differ from the contractual maturities because debtors may have the right to call or prepay obligations with or without call or prepayment penalties.

	Statement value	NAIC fair value
	(In thousands)	
One year or less	$ 3,694	3,687
Over one year through five years	4,004	3,990
Over ten years	410	436
Securities not due at a single maturity date	789	788
Total bonds	$ 8,897	8,901

At December 31, 2006 and 2005, bonds carried at $4.4 million and $4.2 million, respectively, were on deposit with government authorities as required by law.

Proceeds from sales of investments in bonds prior to maturity during 2006 and 2005 were $2.4 million and $0, respectively.

(4) Liability for Losses and Loss Adjustment Expenses

The Company establishes a liability for losses and LAE to cover its estimated ultimate liability for property and casualty losses and LAE with respect to reported claims and claims IBNR as of the end of each accounting period. Loss and LAE liabilities are estimates of what the Company expects the ultimate settlement and administration of claims will cost based on facts and circumstances then known, predictions of future events and estimates of future trends in claims severity and frequency, judicial theories of liability, and other factors. The inherent uncertainties of estimating insurance liabilities are generally greater for liability coverages or where judicial and political climates involving certain types of claims are changing, than for property coverages due to the longer periods of time (the tail) that elapse before a definitive determination of ultimate loss may be made.

As of December 31, 2006 and 2005, the Company had a gross liability for losses and LAE of $314.4 million and $434.0 million, respectively, which was carried at $0 net of reinsurance recoverables.

The Company's gross exposure to asbestos and environmental claims arises principally from general liability insurance contracts. Establishing liabilities for asbestos and environmental claims is subject to greater uncertainties than those presented by other types of claims. Among the complications are lack of historical data, long reporting delays, uncertainty as to the number and identity of insurers with potential exposure, and unresolved legal issues regarding policy coverage and the extent and timing of any such contractual liability. The legal issues concerning the interpretation of various insurance policy provisions and whether asbestos and environmental losses are or were ever intended to be covered are complex. Courts have reached different and sometimes inconsistent conclusions as to when the loss occurred and what policies provided coverage; what claims are covered; whether there is an insured obligation to defend; how policy limits are determined; how policy exclusions are applied and interpreted; and whether clean-up costs are covered as insured property damage. Based on the foregoing, liabilities for asbestos and environmental claims cannot be estimated with traditional loss reserving techniques. Liabilities for losses including IBNR have been established when sufficient information has been developed to indicate the involvement of a specific insurance policy. The Company estimates the impact of these exposures by establishing case basis liabilities on all known losses and LAE and by computing IBNR losses based on previous experience.

The gross asbestos liability for losses and LAE at December 31, 2006 and 2005 of $24.0 million and $28.5 million, respectively, includes IBNR liabilities in the amount of $6.5 million and $8.9 million gross of reinsurance recoverables, respectively, which was carried at $0 net of reinsurance recoverables for both years. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

The gross environmental liability for losses and LAE at December 31, 2006 and 2005 of $820 thousand and $1.4 million, respectively, includes IBNR liabilities in the amount of $44 thousand and $177 thousand gross of reinsurance recoverables, respectively, which was carried at $0 net of reinsurance recoverables for both years. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also included adjusting and other expenses in the amounts shown above.

(5) Reinsurance

The Company cedes 100% of its premiums, losses, and LAE to LMC pursuant to a quota share pooling agreement. All reinsurance recoverables from LMC are unsecured, and the Company remains primarily liable as the direct insurer on all risks reinsured if LMC is unable to pay such claims. As noted elsewhere in these notes, the regulatory and financial status of LMC has had and will continue to have a significant impact on the Company's operations.

LMC shares with the Company common management and directors. The Company has been one of the Kemper Insurance Companies for over 50 years. At December 31, 2003, LMC assumed most of the Company's liabilities, agreed to perform for the Company all insurance policy-related obligations including handling and paying claims, and issued an LMC policy to each holder of a policy ever issued by the Company, including any policy no longer in force but excluding any policy that is cut-through reinsured by a subsidiary of Unitrin, Inc. The additional LMC policy is substantively identical to the policy previously issued by the Company, although the LMC policy is nonparticipating and nonvoting with respect to LMC's corporate governance. The additional LMC policy assures affected Company policyholders that their claims will be treated equally with the claims of other LMC policyholders not only in the event of a managed run-off of the Company and LMC, but also in the event of any insolvency proceedings with respect to the two companies. The Company remains liable for its policy liabilities in the event LMC does not comply with all the terms of the affected policies.

The Company's assumptions from and cessions to LMC were as follows:

	Assumed	Ceded
	(In thousands)	
2006:		
Unearned premiums	$ —	525
Outstanding losses and LAE (including IBNR)	—	314,442

	Assumed	Ceded
	(In thousands)	
2005:		
Unearned premiums	$ —	1,274
Outstanding losses and LAE (including IBNR)	—	434,005

LMC historically has reinsured portions of the risks it underwrote in an effort to control its exposure to losses and protect surplus. LMC ceded to reinsurers a portion of these risks and paid premiums based upon the risk and exposure of the policies subject to such reinsurance. Reinsurance is subject to collectibility in all cases and to aggregate loss limits in certain cases. Although the reinsurer is liable to the extent of the reinsurance limits purchased, LMC remains primarily liable as the direct insurer on all risks reinsured. LMC also holds collateral, including escrow funds, letters of credit, and trust funds, under certain reinsurance agreements. LMC monitors the financial condition of reinsurers on an ongoing basis, and reviews its reinsurance arrangements periodically.

The estimated maximum amount of return commission due LMC if all of the Company's reinsurance was canceled as of December 31, 2006 is as follows:

	Assumed reinsurance		Ceded reinsurance		Net	
	Unearned premium liability	**Commission equity**	**Unearned premium liability**	**Commission equity**	**Unearned premium liability**	**Commission equity**
Affiliates	$ —	—	524,916	27,321	(524,916)	(27,321)
All other	—	—	—	—	—	—
Total	$ —	—	524,916	27,321	(524,916)	(27,321)

(6) Federal Income Taxes

The components of the Company's net deferred tax asset as of December 31, 2006 and 2005 were as follows:

	2006	**2005**
	(In thousands)	
Total of gross deferred tax assets	$ 88,772	100,651
Total of deferred tax liabilities	(13)	(14)
Net deferred tax asset	88,759	100,637
Deferred tax asset nonadmitted	(88,759)	(100,637)
Net admitted deferred tax asset	$ —	—
Decrease in nonadmitted asset	$ 11,878	214

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31, 2006 and 2005 were as follows:

		2006	2005
		(In thousands)	
Deferred tax assets:			
Section 197 intangible	$	70,164	69,073
Loss carryforwards		18,588	31,567
Other, net		20	11
Total deferred tax assets		88,772	100,651
Nonadmitted deferred tax assets		(88,759)	(100,637)
Admitted deferred tax assets		13	14
Deferred tax liabilities:			
Investments		(13)	(14)
Net admitted deferred tax asset	$	—	—

The change in net deferred income taxes as of December 31, 2006 and 2005 was comprised of the following:

		2006	2005		Change
			(In thousands)		
Total deferred tax assets	$	88,772	100,651		(11,879)
Total deferred tax liabilities		(13)	(14)		1
Net deferred tax asset	$	88,759	100,637		(11,878)
Tax effect of unrealized gains or losses					—
Decrease in net deferred income tax in surplus				$	(11,878)

At December 31, 2006, the Company had $52.9 million of operating loss carryforward which originated and expires as follows:

Origination year	Expiration year		Amount
			(In thousands)
2003	2023	$	9,011
2004	2024		14,888
2005	2025		15,420
2006	2026		13,553
		$	52,872

There are no income taxes incurred in the current year and prior year that will be available for recoupment in the event of future net losses.

Tax returns for the years through 2002 are closed for Internal Revenue Service (IRS) examination. The Company is not currently under examination by the IRS for any open tax years.

(7) Transactions with Affiliates and Related Parties

The Company utilizes the services of the employees and the office facilities of LMC pursuant to the terms of a quota share pooling agreement. Charges for these services, which include benefit plan expenses for such employees, are allocated to the Company based on actual expenses incurred in accordance with the Company’s use of the services and facilities. Under the existing quota share reinsurance agreement, all such charges are ceded to LMC, resulting in no net impact to surplus.

As mentioned elsewhere in the notes, the Company is largely dependent on LMC’s financial and regulatory status. If LMC does not or cannot meet its reinsurance obligations to the Company, the Company’s liquidity and financial status would be significantly affected.

In connection with a portion of LMC’s and its affiliates’, including the Company’s, corporate insurance program, including D&O coverage, a wholly owned LMC subsidiary, Specialty Surplus Insurance Company, entered into a reinsurance agreement, effective January 1, 2005 for a three-year period ending December 31, 2007, facultatively reinsuring a corresponding three-year management liability policy issued by an unaffiliated third party to LMC and the Company.

In various other notes to the statutory balance sheets, transactions with affiliates and related parties are also discussed. At December 31, 2006 and 2005, the Company had an obligation to LMC of $74 thousand and $623 thousand, respectively, for services and payments made on behalf of the Company. Intercompany balances are settled on a quarterly basis, to the extent that the Company has sufficient unencumbered assets to make the payment.

(8) Risk-Based Capital

The NAIC utilizes a RBC formula intended for regulatory monitoring of property-casualty insurers. Under RBC rules in Illinois, state regulators may mandate remedial action for inadequately capitalized companies. The focus of the capital rules is a risk-based formula that applies prescribed factors to various risk elements in an insurer's business and investments to develop a minimum capital requirement designed to be proportional to the amount of risk assumed by the insurer. For the last three years (and for 2006 excluding the benefit of prescribed accounting practices), LMC's level of surplus has been at the "mandatory control level" under the RBC rules. At this level, the Division of Insurance has substantial authority to exercise control over LMC and its affiliates, including the Company. The Division of Insurance is mandated to place a company at this level under its control, except where, as is the case with LMC, such company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director of the Division of Insurance (the Director) has discretion to allow the continued run-off.

Having entered into voluntary run-off in the first half of 2003, Kemper has been operating under guidance provided within certain agreed to Corrective Orders with the Division of Insurance, pursuant to which Kemper, including the Company, has ceased to write virtually all insurance business and is settling its liabilities under the administrative supervision of the Division of Insurance. As required by the Division of Insurance, Kemper is operating under a confidential RBC plan (the run-off plan) to address its RBC level. The run-off plan is designed to help Kemper meet its goal of resolving, to the maximum extent possible, all valid policyholder claims. Kemper updates the run-off plan based on current information from time to time. Details of the plan are confidential pursuant to the state's RBC statute.

Risks and uncertainties involved in implementing the run-off plan include the need to achieve significant policy buybacks and novations (the volume of which has declined in each of the last two years as overall liabilities also declined); to conclude other surplus-enhancing transactions; to commute certain reinsurance agreements; to conclude other liquidity-enhancing transactions, to hire and retain the staff and resources necessary to implement the plan; to further reduce expenses; and to consummate agreements with regulators and other third parties. Achieving the surplus and liquidity projections in the run-off plan requires the consummation of agreements with insureds for policy buybacks and novations; the timely performance of payment and other contractual obligations owed to Kemper, including the Company, by various third parties, including reinsurers as well as insureds and agents; agreements with regulators in various jurisdictions; and the absence of significant additional disputes not only with reinsurers but also with creditors, including insureds and certain states, which could involve judicial or other actions to seek either to force Kemper to collateralize its unsecured obligations or to not timely release collateral back to Kemper. Therefore, no assurance can be given that the run-off plan will continue to be successfully implemented.

The Division of Insurance continues to closely monitor Kemper's progress in achieving the objectives of the run-off plan. As has been the case for four years, the Division of Insurance retains the discretion at any time to seek to place Kemper, including the Company, in a formal proceeding (conservatorship or receivership, rehabilitation or liquidation). The risk of a proceeding would be exacerbated if Kemper fails to have sufficient liquid assets to meet its current obligations, or if Kemper's reported liabilities at any time exceed its reported assets, or if Kemper fails to meet the surplus and liquidity projections set forth in the run-off plan.

The Company has also entered into consent agreements with certain states under which the Company agreed to cease writing business in those jurisdictions. In addition, as of December 31, 2006, the Company agreed to its licenses being suspended in Florida in 2004 and Tennessee in 2005, with the Company permitted to maintain its licenses but not permitted to write any new business. The Company has appealed its 2006 license suspension in the state of North Carolina as not being in the best interests of the Company's policyholders or claimants.

The Company's RBC ratio, unlike LMC's, exceeds any regulatory action levels. However, because of the Company's heavy reliance on reinsurance recoveries and operations support from LMC, the regulatory and financial status of LMC has had and will continue to have a significant impact on the Company's operations.

(9) Commitments, Contingent Liabilities, Liquidity, and Other Contingencies

Ratings

In early 2005, LMC requested that A.M. Best cease rating Kemper, including the Company. As of December 31, 2004, A.M. Best had assigned the Company a D (poor) rating. In June and July 2003, respectively, Moody's Investor Services and Standard & Poors last downgraded the Company's financial strength ratings to Caa3 (very poor) and CCC (very weak), respectively, when, at LMC's request, they ceased rating Kemper.

The downgrades to below A- effectively ended Kemper's ability to write most new commercial lines of business or retain existing policyholders. In the first half of 2003, as a result of a combination of various business factors including the ratings downgrades and Kemper's deteriorating statutory surplus, the Company substantially ceased underwriting activities other than as required by contract or law. Since then Kemper has been subject to Corrective Orders by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance.

Liquidity

Although the Company's positive operating cash flow (along with the portion of the investment portfolio that is held in cash and highly liquid short-term securities) has historically met the liquidity requirements of the Company's operations, the Company is heavily dependent on its reinsurance with LMC to meet its current obligations and maintain its surplus. LMC is experiencing and will most likely continue to experience negative cash flow from operations. Other than reinsurance recoverables from business ceded to LMC, the Company's cash inflow consists primarily of income from investments and sales and maturities of investments. Thus, it is critical for the Company to be able to collect its reinsurance recoverables from LMC. However, Corrective Orders prohibit the transfer of assets from, or liabilities to, any affiliated parties without the prior written approval of the Director.

Other Items

In the ordinary course of business, the Company is involved in various legal actions for which it establishes liabilities where appropriate. In the opinion of the Company's management, based upon the advice of legal counsel, contingent liabilities arising from litigation, tax, and compliance matters are not expected to have a material adverse effect on the Company's statutory balance sheets due to established liabilities and anticipated insurance and reinsurance recoverables, but there can be no assurance that such matters will not become material due to future developments, including any changes with respect to the financial condition of the Company.

(10) Fair Value of Financial Instruments

Fair value estimates are made at specific points in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Fair value estimates for financial instruments are generally determined using discounted cash flow models and assumptions that are based on judgments regarding current and future economic conditions and the risk characteristics of the investments. Although fair value estimates are calculated using assumptions that management believes are appropriate, changes in assumptions could significantly affect the estimates and such estimates should be used with care.

Fair value estimates are determined for existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and certain liabilities that are not considered financial instruments. Accordingly, the aggregate fair value estimates presented do not represent the underlying value of the Company. In addition, tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

Cash equivalents, short-term investments, bonds, and unaffiliated stocks: Fair values for cash equivalents, short-term investments, bonds, and unaffiliated stocks have been determined using prices provided by the SVO, or when such values are not available from the SVO, using prices from independent pricing services that use market quotations, prices provided by brokers, or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or prices determined in good faith by the Company's engaged portfolio manager.

Cash: The statement value reported for cash approximates fair value.

(Continued)

The statement values and estimated fair values of the Company's financial instruments at December 31, 2006 and 2005 were as follows:

	2006		2005	
	Statement value	**Estimated fair value**	**Statement value**	**Estimated fair value**
	(In thousands)			
Financial instruments recorded as assets:				
Bonds	$ 8,897	8,901	6,810	6,757
Cash, cash equivalents, and short-term investments	1,512	1,512	4,005	4,004
Unaffiliated stocks	—	—	2	2

(11) Subsequent Event

At December 31, 2006 and 2005, the Company held in its name certain Texas guaranty fund premium tax credits that previously had been ceded to LMC under an intercompany reinsurance agreement. LMC and certain other affiliates also held other Texas premium tax credits. In the first quarter of 2007, the Company and those affiliates sold the premium tax credits in two sales transactions. Both transactions received regulatory approvals in both Texas and Illinois. Most of the credits were sold to two subsidiaries of Unitrin, Inc. in February 2007. LMC also sold $28,408 of its credits to the Company.

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Investments

December 31, 2006

The following is a summary of certain financial data as of December 31, 2006 and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual*. Such data is included in the Company's 2006 Annual Statement as filed with the Division of Insurance.

	Gross investment holdings		Admitted assets as reported in the annual statement	
Investment categories	**Amount**	**Percentage**	**Amount**	**Percentage**
Bonds:				
U.S. Treasury securities	$ 6,520,196	62.641%	$ 6,520,196	62.641%
Foreign government (including Canada, excluding mortgage-backed securities)	77,151	0.741	77,151	0.741
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
Revenue and assessment obligations	410,095	3.940	410,095	3.940
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	1,889,753	18.155	1,889,753	18.155
Cash, cash equivalents and short-term investments	1,511,650	14.523	1,511,650	14.523
Total invested assets	$ 10,408,845	100.000%	$ 10,408,845	100.000%

See accompanying independent auditors' report.

(Continued)

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Investment Risks Interrogatories

December 31, 2006

The following interrogatories as of December 31, 2006 and for the year then ended are for the purpose of complying with the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual.*

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on page 2 of the annual statement: $10,558,305

2. Ten largest exposures to a single issuer/borrower/investment.

Issuer	Description of exposure		Amount	Percentage of total admitted assets
1. JPMorgan Prime MMKT FD-INST	Class 1 MMF – Cat. 8	$	514,256	4.9%
2. CARAT 2003-3 B1 Asset-Backed	Bond – Cat. 2.1		495,948	4.7
3. Chicago IL PUB Bldg ETM	Bond – Cat. 1.43		410,095	3.9
4. American General Finance	Bond – Cat. 2.1		348,112	3.3
5. WINM 2006-A A Asset-Backed	Bond – Cat. 2.1		292,670	2.8
6. BB&T Corp	Bond – Cat. 2.1		252,467	2.4
7. Goldman Sachs Group Inc	Bond – Cat. 2.1		250,291	2.4
8. Boeing Capital Corp	Bond – Cat. 2.1		250,264	2.4
9. Hydro Quebec	Bond – Cat. 1.3		77,151	0.7

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

Bonds		Amount	Percentage of total admitted assets	Preferred stocks		Amount	Percentage of total admitted assets
NAIC-1	$	10,408,845	98.6%	P/RP-1	$	—	—%
NAIC-2		—	—	P/RP-2		—	—
NAIC-3		—	—	P/RP-3		—	—
NAIC-4		—	—	P/RP-4		—	—
NAIC-5		—	—	P/RP-5		—	—
NAIC-6		—	—	P/RP-6		—	—

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Investment Risks Interrogatories

December 31, 2006

4. Assets held in foreign investments:

1.	Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?			YES [X] NO [ ]	
2.	Total admitted assets held in foreign investments	$	—		—%
3.	Foreign-currency-denominated investments	$	—		—%
4.	Insurance liabilities denominated in that same foreign currency	$	—		—%

If response to 1. above is yes, responses are not required for interrogatories 5 – 10.

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:

   Not applicable.

6. Two largest foreign investment exposures in a single country, categorized by NAIC sovereign rating:

   Not applicable.

7. Aggregate unhedged foreign currency exposure:

   Not applicable.

8. Aggregate unhedged foreign currency exposure categorized by the country's NAIC sovereign rating:

   Not applicable.

9. Two largest unhedged foreign currency exposures to a single country, categorized by the country's NAIC sovereign rating:

   Not applicable.

10. Ten largest nonsovereign (i.e. nongovernmental) foreign issues:

    Not applicable.

11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure.

    Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, detail is not required for the remainder of interrogatory 11.

(Continued)

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Investment Risks Interrogatories

December 31, 2006

12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.

    Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 12.

13. Amounts and percentages of admitted assets held in the ten largest equity interests.

    Are assets held in equity interests less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 13.

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities.

    Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 14.

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests.

    Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 15.

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans.

    Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 16 and interrogatory 17.

17. Not applicable.

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Investment Risks Interrogatories

December 31, 2006

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate.

    Are assets held in real estate reported in Schedule A less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 18.

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments in mezzanine real estate loans:

    Are assets held in investments in mezzanine real estate loans less than 2.5% of the reporting entity's total admitted assets? Yes [X] No [ ]

    If response is yes, responses are not required for the remainder of interrogatory 19.

20. Amounts and percentages of the reporting entity's total admitted assets subject to securities lending agreements, repurchase and reverse repurchase agreements, and dollar repurchase and dollar reverse repurchase agreements:

    None.

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps, and floors:

    None.

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

    None.

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

    None.

See accompanying independent auditors' report.

 (Continued)

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Reinsurance Risk Interrogatories

December 31, 2006

1. The reporting entity does not have any risks reinsured under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions).

2. The reporting entity did not cede any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during 2006: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

   a. A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;

   b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

   c. Aggregate stop loss reinsurance coverage;

   d. An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions which are only triggered by a decline in the credit status of the other party;

   e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

   f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

3. During 2006, the reporting entity did not cede any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:

   a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statements; or

   b. Twenty–five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.

(Continued)

Schedule III

AMERICAN MANUFACTURERS MUTUAL INSURANCE COMPANY

Supplemental Schedule of Reinsurance Risk Interrogatories

December 31, 2006

4. The reporting entity did not cede any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during 2006 that was either:

   a. Accounted for as reinsurance (either prospective or retroactive) under SSAP and as a deposit under GAAP; or
   b. Accounted for as reinsurance under GAAP and as a deposit under SSAP.

See accompanying independent auditors' report.